

The World Economy

The directors of the six IMF area departments assess the current situations in their regions, the challenges these regions face, and their opportunities for growth in the coming years.

AFRICA

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SUB-SAHARAN AFRICA has made considerable economic progress in recent years, as reflected in lower inflation and consistently higher real GDP growth, which has averaged more than 4 percent a year since 1994. These improvements have resulted from better macroeconomic policies (that is, stronger fiscal policies and a cautious monetary policy) and far-reaching structural reforms to improve overall economic efficiency. These reforms have included price liberalization, public enterprise restructuring and privatization, agricultural sector reforms, the rationalization of regulations governing economic activity, civil service reform, and the liberalization of foreign exchange and trade systems.

Sub-Saharan Africa needs much higher and more sustained growth to reduce its pervasive poverty. However, growth performance is still constrained by inadequate infrastructure, poor public services, persistent weaknesses in regulatory and incentive systems, and low savings, all of which discourage investment and adversely affect productivity. Policies must therefore aim to increase the level and efficiency of investment and stimulate substantially higher domestic and foreign saving. Moreover, the process must be led by the private sector. If the private sector does not take off, these countries will have difficulty achieving sustained growth. The policies necessary to achieve these objectives are not new, but they do bear repeating. For these policies to be successful, however, there must be an *environment of peace*, characterized by political stability and democratic, participatory forms of government; it is necessary to dispel Africa's negative image and encourage domestic and foreign investment.

First, *macroeconomic stability* is critical for economic growth. To foster investor confidence, sub-Saharan Africa must continue to adhere to sound fiscal and monetary policies and, where necessary, strengthen them. Fostering confi-

dence will also require complementary efforts to promote good governance and combat corruption, including the development of a modern and efficient legal framework.

Second, sub-Saharan African countries must act decisively to remove the remaining impediments to *economic efficiency, productivity, and competitiveness*. Reforms in the financial sector should boost domestic savings and channel resources to the most efficient uses. The legal and regulatory frameworks should be rationalized to reduce the high costs of doing business. To increase the efficiency of production, national authorities must pay more attention to rehabilitating and extending transport and communications networks and to modernizing the energy and water sectors, while continuing to restructure and privatize major public enterprises.

Third, African countries need to accelerate the *opening up of their economies to competition* and deepen their integration into the world economy. Further liberalization of exchange and trade regimes is essential. Regional cooperation can be an effective stepping-stone for broad-based external liberalization. It provides a useful framework in which countries can create common regulatory frameworks, harmonize fiscal policy, reduce tariffs, and liberalize multilateral trade, as well as cooperate in developing infrastructure and preventing and resolving conflicts.

Fourth, government activity should be concentrated on extending the *provision of key public services*—including basic health care and primary education—and improving their quality and on building up the economic infrastructure, an area where sub-Saharan Africa still trails other developing regions. This will entail strengthening public institutions, including the framework for policy formulation and implementation, and reforming the civil service to instill a sense of professionalism and commitment.

Finally, African countries must focus their adjustment efforts more tightly on *reducing poverty*. Each country must define a comprehensive strategy to reduce poverty that takes into account the links between macroeconomic, structural, and social policies.

Africa's policy agenda at the start of the next century must build on the improvements of the past few years

through further structural reform and a strengthening of the foundation for high and sustained growth. This is essential if African countries are to accelerate their social and economic development and participate as equal partners in the global economy. This is particularly true of the poorest among them that stand to benefit from far-reaching debt relief under the Initiative for the Heavily Indebted Poor Countries (HIPC Initiative), launched by the IMF and the World Bank.

ASIA AND PACIFIC

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ASIA has made substantial progress in recovering from the unprecedented macroeconomic and financial market crisis that swept the region in 1997–98. The most severely affected countries—Indonesia, Korea, Malaysia, the Philippines, and Thailand—have shown remarkable rebounds in activity; Japan seems to be emerging from a decade of stagnation, which is especially encouraging given its importance to the regional economy; and economic prospects in most other countries have also improved.

The swiftness of the recovery owes much to the macroeconomic policy response in many countries—fiscal stimulus helped sustain domestic demand, and monetary policy was eased considerably once financial market confidence was restored. Structural reform initiatives also played a key role. Countries took major steps to recapitalize banks, improve their prudential and supervisory systems, and strengthen the institutional framework for corporate sector restructuring, including developing procedures for bankruptcy and liquidation. In addition, the substantial financial support of the international community—including the IMF—has been critical in restoring stability and confidence.

This said, Asia still needs to do more if it is to restore its position as one of the fastest-growing regions in the world and, at the same time, reduce its vulnerability to future crises. This is the strategic goal that the IMF will urge in its dialogue with the countries of the region.

The first priority in that context must be to *solidify the recoveries* that are already under way. To this end, macroeconomic policies need to remain accommodative. Once it is evident that the recoveries are self-sustaining, policies should shift progressively toward a more neutral stance. This will require a measured pace of fiscal consolidation, designed to

reestablish more balanced fiscal positions and relieve the burden on monetary policy in maintaining price stability. On the structural side, the Asian countries must step up efforts to restore the health of balance sheets and promote restructuring in both the financial and the corporate sector. Social safety nets need to be further strengthened to lessen the impact of restructuring on the most vulnerable segments of society.

Still deeper reforms will be needed to make the above strategic goal a reality in the coming decade. Recent experience has demonstrated the risks of relying on rapid increases in inputs to spur growth, since this often results in unsustainable rates of capital accumulation and unhealthy debt levels. These risks have intensified with the increased globalization of capital and product markets. In this new environment, Asian economies should instead spur growth by promoting improvements in productivity. Meeting this goal will require efficient resource allocation based much more on market forces, and much less on government intervention than in the past. More open and freer financial, goods, and labor markets ensure a level playing field and are also essential for rapid productivity growth. At the same time, substantial investment in education systems will be required for these economies to keep pace with, and reap the maximum benefit from, worldwide technological advances.

Measures to improve risk management and reduce vulnerability must play a central part in the region's longer-term strategy. Prudential and supervisory systems will need to evolve quickly in the face of rapid innovation in capital markets. The authorities must take care to avoid macroeconomic imbalances, including unsound fiscal positions, excessive external debt (particularly with short maturities), and unsustainable exchange rate policies. Policy coordination—including in the context of regional forums such as the Asia-Pacific Economic Cooperation, the Manila Framework Group, and the Association of South East Asian Nations—can and should play an important role in promoting regional dynamism and reducing the risk of future crises.

While the basic strategy outlined above is immediately relevant for the economies most affected by the Asian crisis, it is no less important for the rest of the region, particularly for low-income countries and countries that are moving toward market-oriented systems. Even those economies that have already implemented this approach with remarkable success—Australia and New Zealand, for example—face the continued challenges of large current account deficits and adverse demographic trends, which will require them to hold to their chosen policy course.

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EUROPE

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AS ELSEWHERE, the European countries are facing the need to adjust their institutional and socioeconomic structures to meet the challenges and exploit the opportunities created by global integration and rapid technological change. Their actions, however, will also be influenced by European Economic and Monetary Union (EMU), which will continue to dominate the policy agenda in the region, as it has for the last few decades.

For the *countries that already are members of EMU*, the key issues are likely to be

- reconciling the political priorities of independent states (reflected in different fiscal policies and different approaches to taxation and social entitlements) within a fully integrated European economy;
- refining further the coordination of monetary and budgetary policies so as to be able to respond to cyclical fluctuations and shocks; and
- increasing the flexibility of their economies, particularly labor markets.

Given that labor mobility within Europe is likely to remain limited, there will be a correspondingly greater need for flexible wages and working conditions, so that the process of adjustment works smoothly and does not take place through unemployment. Because of the single currency, the exchange rate can no longer be used to correct a loss of competitiveness, so inflation and wage costs cannot be allowed to get out of line in any of the countries of the euro area. If this misalignment were to occur in one country, it would be evident in rising unemployment. The public might see this as a consequence of adopting the euro, which could provoke a backlash against integration. The relative immobility of labor also implies the need to continue removing barriers to the integration of the markets for goods and services. These reforms are still far from complete.

For the *countries of the region outside EMU*, a key issue will be how they will be integrated with EMU. For those Western European countries that have not joined the common currency area but have harmonized their budgetary and other policies, as have the United Kingdom and several Scandinavian countries, the costs and benefits of EMU membership will continue to frame the political debate. Eventual accession seems likely for most of these countries, especially if EMU is viewed as a success and the switch to the euro proceeds smoothly.

The *transition economies of Central and Eastern Europe* will continue to focus on improving their economic performance and building market economies. This is particularly important for the countries of Southeastern Europe, where—as in the countries of the Commonwealth of Independent States

(CIS)—the process of establishing market economies, structural reforms, and nation building is less advanced. Albania and the countries that have emerged from the former Yugoslavia (Bosnia-Herzegovina, Croatia, and the former Yugoslav Republic of Macedonia), as well as the remaining parts of the former Yugoslavia (Kosovo, Montenegro, and Serbia), which are only just emerging from conflict, face particularly difficult challenges.

The *further enlargement of the European Union* and its relations with the rest of Europe will be another key theme in the coming years. The accession of those countries with which negotiations have already been opened (Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia) will not be easy. Many of these countries are still working toward adopting—and, more important, implementing—procedures and regulations of the European Union (for example, the *acquis communautaire*, or established body of law). Some of these, such as environmental regulations, may have considerable costs. These six countries and others (Bulgaria, Malta, Romania, Slovakia, and the remaining Baltic countries that are also candidates for accession) will be absorbed in these efforts over the next few years. For the European Union itself, enlargement will require renegotiating its internal decision-making arrangements and reaching a consensus on recasting its budgetary arrangements and agricultural policies—an arduous agenda. Turkey's bid for membership in the European Union will also have to be considered again, especially as it makes progress in stabilizing its macroeconomic situation and in such noneconomic areas as human rights.

BALTICS, RUSSIA, AND OTHER COUNTRIES OF THE FORMER SOVIET UNION

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THE PAST DECADE has witnessed striking changes in the economies of the Baltic states, Russia, and the other countries of the former Soviet Union. Since the formal dissolution of the Soviet Union in late 1991, virtually all of these countries have abandoned most elements of the old command economy. Yet the pace and extent of their transition to a market economy and to sustained growth have differed greatly.

The transformation has been most pronounced in the three Baltic countries. Comprehensive economic liberalization, extensive privatization, and macroeconomic stabilization have enabled these countries to achieve a strong recovery in output, although there has been some slowdown

this year because of the Russian crisis. In the other 12 countries in the region, however, the transition is generally less advanced. For example, Belarus, Turkmenistan, and Uzbekistan have yet to embark on comprehensive reform programs. Some reforming countries—Armenia, Azerbaijan, Georgia, and the Kyrgyz Republic—have managed in recent years to attain high growth rates, frequently recovering from extremely low output levels. Economic recovery in the other countries has generally been much more hesitant, because they have only partially carried out important fiscal and structural reforms.

The key challenges of the next decade will differ among the various groups of countries. The Baltics will need to consolidate their reforms and stabilization gains and move forward with accession to the European Union. Russia, Ukraine, and most other countries, however, must still address some key elements of the shift to a market system. In most cases, high inflation has been eliminated and the uncertainties caused by an inflationary environment are no longer an obstacle to sustained growth. Nevertheless, in many countries the authorities have not yet succeeded in complementing tighter monetary policy with an adequate degree of enterprise and banking reforms and the establishment of hard budget constraints. In those countries, therefore, a large segment of the economy still does not have a real incentive to become more efficient and competitive in order to survive in a market environment. Instead, a debilitating culture of barter and nonpayments has evolved, characterized by arrears on wages, interenterprise payments, bank credits, taxes, and many government expenditures.

Many of these problems are linked to the issue of *governance*. Most of these countries still need to establish a state with the moral authority and strength to impose the rule of law, collect the taxes that are due, pay its own bills, establish clear and stable “rules of the game” for market participants, and remove itself from most economic activity so as to minimize the scope for rent seeking and corruption. Finding the right role for the state will not be easy, but it will be essential if these countries are to enjoy the full benefits of becoming effectively integrated into the world economy.

Finally, greater integration into the world economy has led many of the countries of the region to incur growing current account deficits and expand their external debt, which should be expected because they are undergoing a fundamental economic transformation. If these countries are to avoid future debt-servicing problems, however, it will be important for them to establish and maintain a favorable business climate so as to attract additional foreign direct investment, thereby creating the basis for growth and the capacity to repay debts in the future.

MIDDLE EAST AND NORTH AFRICA

Paul Chabrier

Director, Middle Eastern Department

AT THE BEGINNING of the millennium now ending, the Middle East and North Africa was one of the most developed regions in the world. Its cultural influence radiated through much of Africa, Asia, and Europe; a large share of the trade between these three continents passed through, and was organized by, the region's traders; and its coins were trusted means of international payment and commerce.

As the new millennium begins, the countries of the region, like many others, must meet the challenge of reducing the large income and technology gaps between them and the advanced industrialized countries. This challenge is particularly daunting, given their rapidly growing populations, especially of those between 15 and 30 years old, whose expectations are highest. At the same time, a young population offers great opportunities, and the region can also draw upon its vast cultural heritage and exceptional endowments of natural resources. However, to accelerate development and, in particular, to promote a modern and competitive industrial sector, most countries need to shed the remaining vestiges of the public-sector-dominated and inward-looking development strategies followed in the past. While there is a broad consensus on the importance of developing a private-sector-driven and market-based economy integrated with world markets, achieving such an objective requires politically difficult reforms.

• *Developing the institutions and infrastructure needed to underpin market economies.* Most countries in the region are reducing trade and investment controls, dismantling labor market rigidities, and ceding the role of the state in the productive sector to private entrepreneurs, including through privatization. This process will need to be accelerated, even in the most reform-minded countries. In many countries, weaknesses in governance and a lack of transparency undermine investor confidence and constrain development. Also, judicial systems are often weak, particularly in enforcing bankruptcy provisions and bank credit recovery.

• *Liberalizing trade systems.* Apart from the countries of the Gulf Cooperation Council, the region remains relatively protected, although in recent years a number of initiatives to open markets to Europe, dismantle intraregional trade barriers, or participate more actively in global trade liberalization have been launched. Given the complementarity, for example, between the resource- and capital-rich countries of the Persian Gulf and the labor-rich countries of North Africa and the Levant, closer regional economic integration is likely to yield large benefits and

could also serve as a stepping-stone to more global trade liberalization.

- *Strengthening banking systems and developing capital markets.* While banking systems in the region are generally solid, there is scope for strengthening regulation and supervision. Also, because public sector institutions still dominate many of the region's financial systems, privatization in this area is a priority. The development of capital markets, especially bond markets, needs to be accelerated to support private-sector-led growth.

- *Increasing social expenditures.* While the region's considerable natural resources have been well developed, much less progress has been made in developing its human resources. This reflects both inadequate education systems that are poorly attuned to market needs and insufficient spending on health care. Developing the region's human capital will be critical if the hopes and aspirations of its people for the coming millennium are to be met.

Although this agenda is a large one and the countries of the region range from those with established track records of reform to others that are at an earlier stage of transition, their governments are moving in a common direction. All indications point to a broadening and deepening of reforms as countries enter the new millennium. Indeed, the process could gather pace surprisingly quickly, in particular if the region were to succeed in overcoming long-standing political differences and creating greater regional stability. If the countries of the region can successfully meet these challenges, the new millennium holds considerable promise.

WESTERN HEMISPHERE

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THE END of the twentieth century has been a time of far-reaching changes in the Americas. Macroeconomic fundamentals have been strengthened, in both North and South America, as the fiscal deficit was brought down in Canada and the United States, and high inflation, for long a dominant feature of the Latin American economic scene, was eliminated. Trade with the rest of the world and within the hemisphere has grown enormously as trade regimes have been liberalized, at times in the context of regional integration agreements. Countries have begun to pay closer attention to the issue of governance, and nearly all countries of the Western Hemisphere will enter the third millennium with democratically elected governments at the helm.

But the Americas still face significant challenges. These differ somewhat across the three American subregions.

- Thanks to their determined macroeconomic policy efforts during the 1990s, both *Canada and the United*

States find themselves in the enviable position of debating what to do with large prospective fiscal surpluses. In Canada, the debate will center on how to use these surpluses to finance income tax reforms and greater spending for education and health care to meet the needs of an aging population, while continuing to reduce the country's rela-

“The end of the twentieth century has been a time of far-reaching changes in the Americas.”

tively high ratio of government debt to GDP. In the United States, the debate will focus on the extent to which the prospective budget surpluses should be maintained to meet the long-term financing needs of social security and Medicare for the aged or be used to fund tax cuts or increases in spending.

- In *Latin America*, there is a need for further macroeconomic consolidation, particularly in the fiscal area. Although most countries have come a long way from the pervasive fiscal deficits of years ago, the recent financial crisis has, in many cases, highlighted weaknesses in public finances that need to be promptly addressed, including through improvements in the quality and efficiency of both tax systems and public spending programs. Equally necessary will be advances with “second-generation” reforms to increase transparency, accountability, and social participation, and to develop the institutions needed for the efficient functioning of market economies. Efforts are needed to reduce the unacceptably high level of poverty and income disparity that still plague Latin America in spite of its economic strides. Macroeconomic stability and more efficient markets should foster the strong and durable growth that is needed to reduce poverty. In addition, the region should strive to increase human capital—through improved education and health programs—and employment levels—through labor market reforms to increase income-earning opportunities for the poor—and also to develop well-targeted and well-financed social-support programs.

- The *Caribbean countries* have made important progress in opening up and deregulating their economies over the past several years. They need to intensify this process so as to increase competitiveness and diversify their exports in the face of the erosion of their preferential trade status. Because their access to concessional financing is also being progressively reduced, they must take steps to consolidate their fiscal positions so as to increase public savings and meet their still-sizeable investment needs. **F&D**