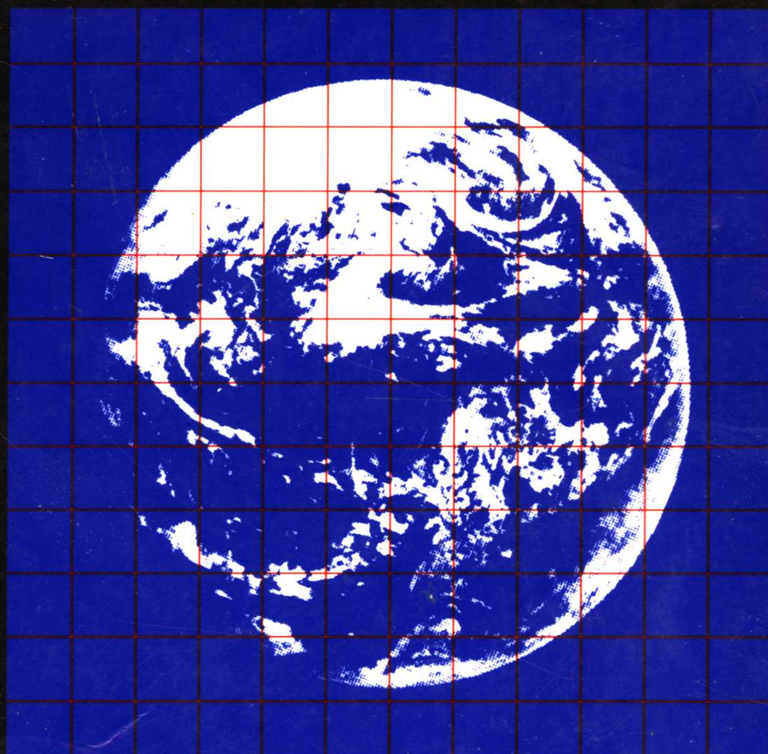
WORLD ECONOMIC AND FINANCIAL SURVEYS

Safeguarding Macroeconomic Stability at Low Inflation

WORLD ECONOMIC OUTLOOK

October 1999



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WORLD ECONOMIC OUTLOOK

October 1999

A Survey by the Staff of the International Monetary Fund

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Assumptions and Conventions

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 26–August 16, 1999 except for the bilateral rates among the European exchange rate mechanism (ERM) currencies, which are assumed to remain constant in nominal terms; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary polices in industrial countries, see Box 1.2); that the average price of oil will be $16.70 a barrel in 1999 and $18.00 a barrel in 2000, and remain unchanged in real terms over the medium term; and that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.4 percent in 1999 and 6.1 percent in 2000. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available in early September 1999.

The following conventions have been used throughout the *World Economic Outlook*:

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 1997–98 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 1997/98) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Further Information and Data

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, *www.imf.org*. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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Preface

The projections and analysis contained in the *World Economic Outlook* are an integral element of the IMF's ongoing surveillance of economic developments and policies in its member countries and of the global economic system. The IMF has published the *World Economic Outlook* annually from 1980 through 1983 and biannually since 1984.

The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department and the Fiscal Affairs Department.

The country projections are prepared by the IMF's area departments on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. For approximately 50 of the largest economies—accounting for 90 percent of world output—the projections are updated for each *World Economic Outlook* exercise. For smaller countries, the projections are based on those prepared at the time of the IMF's regular Article IV consultations with those countries or in connection with the use of IMF resources; for these countries, the projections used in the *World Economic Outlook* are incrementally adjusted to reflect changes in assumptions and global economic conditions.

The analysis in the *World Economic Outlook* draws extensively on the ongoing work of the IMF's area and specialized departments, and is coordinated in the Research Department under the general direction of Michael Mussa, Economic Counsellor and Director of Research. The *World Economic Outlook* project is directed by Flemming Larsen, Deputy Director of the Research Department, together with Graham Hacche, Assistant Director for the World Economic Studies Division.

Primary contributors to the current issue include Francesco Caramazza, John H. Green, Maitland MacFarlan, Peter Sturm, Luis Catão, Mark De Broeck, Luca Ricci, Ranil Salgado, Cathy Wright, and Harm Zebregs; and Robert Sharer, Marc Auboin, and Bradley McDonald of the Trade Policy Division of the Policy Development and Review Department who prepared Chapter V. Other contributors include Sanjeev Gupta, Richard Hemming, Kalpana Kochhar, Arvind Subramanian, Steven Symansky, Subhash Thakur, and Andrew Tweedie. The Fiscal Analysis Division of the Fiscal Affairs Department computed the structural budget and fiscal impulse measures. Gretchen Byrne, Mandy Hemmati, Yutong Li, and Anthony G. Turner provided research assistance. Allen Cobler, Nicholas Dopuch, Isabella Dymarskia, Yasoma Liyanarchchi, Olga Plagie, and Irim Siddiqui processed the data and managed the computer systems. Susan Duff, Caroline Bagworth, and Lisa Nugent were responsible for word processing. James McEuen of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the *World Economic Outlook* on September 1 and 3, 1999 (see Annex). However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

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I

World Economic Outlook and the Challenges of Global Adjustment

Global economic and financial conditions have improved markedly after the turbulence in emerging markets in 1997–98, which gave rise to fears of a widespread credit crunch and global recession, and most of the economies recently in crisis have begun to recover. But many challenges remain to be addressed to ensure that these recoveries are sustainable, and to foster stronger and more stable growth in the world economy in the next decade. There is particular reason for concern about the unbalanced pattern of growth observed recently among the major industrial countries and about the economic and financial consequences worldwide if the eventual demand slowdown in the United States turns out to be sharper than is generally expected at present. While the return to broad price stability remains an important policy achievement, macroeconomic instability has persisted in much of the world economy, continuing to pose challenges for, and in many ways making new demands on, economic policies.

The world economy appears to be on the mend following the global slowdown in 1998 in the wake of the Asian crisis and the further bouts of financial turbulence and contagion associated with the Russian and Brazilian crises. Financial market confidence has been returning in most of the emerging market economies affected by the crises, allowing monetary conditions to ease and setting the stage for economic recovery. For all the Asian crisis economies, growth projections for 1999 have been revised up significantly, and the economic downturns in Brazil and Russia have been shallower than expected earlier. Oil prices have recovered, and declines in many other commodity prices have been arrested, providing relief for some commodity-exporting countries affected by the ripple effects of the slowdown. There has also been an upward revision of growth in Japan, where there was a significant rise in activity in the first half of 1999 following the steep contraction during 1997–98. And the projected strengthening of growth in Europe seems to be materializing, while the impressive U.S. expansion has continued, amid few signs of emerging price or wage pressures.

The many upward revisions to the earlier projections now point to global growth of about 3 percent in 1999, ¾ of 1 percentage point higher than in the May 1999 *World Economic Outlook* (Table 1.1). Global growth thus appears to have bottomed out at 2½ percent in 1998, in what the projections suggest will have been the mildest of the four slowdowns in the world economy in the past three decades, even though some countries have suffered particularly severe recessions (Figure 1.1).

However, a great deal of uncertainty still attaches to the world economic outlook for the next couple of years. It is clear that the U.S. expansion has played a critically important role in moderating the global slowdown;[1] but it is also clear that to forestall a build-up of domestic inflationary pressures and to contain the external current account deficit, the rate of growth in the United States will need to slow. The staff's baseline projections assume a "soft landing"—a slowing of growth to sustainable rates with little friction or disruption—but this cannot be taken for granted. The generously valued stock market, the sharp decline in household saving in recent years into negative territory, high business capital outlays, the heavy reliance on foreign saving, and the high exchange value of the dollar relative to medium-term fundamentals all point to strains and imbalances that may lead to a more abrupt slowing of domestic demand. This in turn raises the question of whether demand in Japan and the euro area will strengthen sufficiently to compensate for a slowdown in the United States and to support activity at home and globally. A strengthening of economic conditions outside the United States would help to improve the U.S. current account balance, but it would also tend to reduce international investors' appetite for dollar-denominated assets; it might thus increase the risk of a sharp correction in the dollar relative to the other major currencies, a risk arising from the imbalances in current accounts among the United States, Japan, and the euro area (Table 1.2). These imbalances might also further increase trade tensions.

If growth were to weaken significantly in the United States without offsets in Japan and Europe, there would also be reason for concern about the sustainability of the recoveries underway in the Asian economies recently in crisis, and much of Latin America would be particularly vulnerable under such a scenario. While conditions in emerging financial markets have im-

[1]If real domestic demand in the United States had expanded in line with potential growth in 1998–99 (rather than at the 5.3 percent rate registered in 1998 and the 4.9 percent increase projected for 1999) world growth would have been about ½ of 1 percentage point weaker in both years.

Table 1.1. Overview of the *World Economic Outlook* Projections
(Annual percent change unless otherwise noted)

			Current Projections		Differences from May 1999 Projections	
	1997	1998	1999	2000	1999	2000
World output	**4.2**	**2.5**	**3.0**	**3.5**	**0.7**	**0.1**
Advanced economies	3.2	2.2	2.8	2.7	0.8	0.4
Major industrial countries	2.9	2.2	2.6	2.4	0.7	0.4
United States	3.9	3.9	3.7	2.6	0.4	0.4
Japan	1.4	–2.8	1.0	1.5	2.4	1.2
Germany	1.8	2.3	1.4	2.5	–0.1	–0.3
France	2.3	3.2	2.5	3.0	0.3	0.1
Italy	1.5	1.3	1.2	2.4	–0.3	0.0
United Kingdom	3.5	2.2	1.1	2.4	0.4	0.3
Canada	4.0	3.1	3.6	2.6	1.0	0.1
Other advanced economies	4.2	2.1	3.5	3.6	1.0	0.2
Memorandum						
Industrial countries	3.0	2.4	2.6	2.5	0.6	0.3
Euro area	2.4	2.8	2.1	2.8	0.1	–0.1
Newly industrialized Asian economies	5.8	–1.8	5.2	5.1	3.1	0.6
Developing countries	5.8	3.2	3.5	4.8	0.4	–0.1
Africa	3.1	3.4	3.1	5.0	–0.1	–0.1
Asia	6.6	3.7	5.3	5.4	0.6	–0.3
China	8.8	7.8	6.6	6.0	0.0	–1.0
India	5.5	5.8	5.7	5.5	0.5	0.4
ASEAN-4[1]	3.6	–9.8	1.4	3.6	2.5	0.6
Middle East and Europe	4.5	3.2	1.8	3.1	–0.2	–0.2
Western Hemisphere	5.3	2.2	0.1	3.9	0.6	0.4
Brazil	3.7	0.1	–1.0	4.0	2.8	0.3
Countries in transition	2.2	–0.2	0.8	2.8	1.7	0.3
Central and eastern Europe	3.0	2.2	1.0	3.3	–1.0	–0.4
Excluding Belarus and Ukraine	3.4	2.3	1.7	4.0	–1.3	–0.6
Russia	0.9	–4.6	0.0	2.0	7.0	2.0
Transcaucasus and central Asia	2.5	2.2	2.0	2.9	0.2	–0.2
World trade volume (goods and services)	**9.9**	**3.6**	**3.7**	**6.2**	**–0.1**	**0.4**
Imports						
Advanced economies	9.2	4.8	5.9	5.9	0.9	0.2
Developing countries	11.4	–1.3	1.1	7.2	–1.5	0.4
Countries in transition	7.0	2.9	–2.7	8.2	–2.5	2.0
Exports						
Advanced economies	10.3	3.2	3.0	6.2	0.2	0.6
Developing countries	11.4	4.9	2.4	5.6	–2.2	0.1
Countries in transition	5.0	5.9	2.7	7.2	–3.7	0.6
Commodity prices						
Oil[2]						
In SDRs	–0.2	–31.2	27.2	7.4	36.4	–6.0
In U.S. dollars	–5.4	–32.1	27.7	7.8	36.0	–5.6
Nonfuel[3]						
In SDRs	2.0	–13.5	–7.6	3.0	–2.7	1.1
In U.S. dollars	–3.3	–14.8	–7.2	3.4	–3.2	1.6
Consumer prices						
Advanced economies	2.1	1.5	1.4	1.8	0.0	0.1
Developing countries	9.2	10.3	6.7	5.8	–1.9	–1.7
Countries in transition	28.2	20.9	39.3	18.1	–1.6	5.7
Six-month LIBOR (in percent)[4]						
On U.S. dollar deposits	5.8	5.5	5.4	6.1	0.2	0.9
On Japanese yen deposits	0.7	0.6	0.2	0.2	0.0	–0.1
On euro deposits	3.5	3.7	3.0	3.5	0.0	0.4

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 26–August 16, 1999.

[1]Indonesia, Malaysia, the Philippines, and Thailand.

[2]Simple average of spot prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $13.07 in 1998; the assumed price is $16.70 in 1999 and $18.00 in 2000.

[3]Average, based on world commodity export weights.

[4]London interbank offered rate.

proved since the Brazilian crisis, some emerging market economies remain fragile and vulnerable to shifts in market sentiment. In fact, sentiment toward emerging markets has remained more adverse than in most of 1996–97 and much of 1998, with yield spreads remaining wide and volatile for many countries, reflecting the greater recognition of the risks attached to emerging market investments (Figure 1.2).

An additional risk factor relates to potential financial market reactions to actual or perceived Y2K compliance problems in emerging markets (see the Appendix to this Chapter). To contain the risk of capital flow reversals triggered by uncertainty about potential Y2K-related difficulties, it is essential that countries be fully transparent both about their preparedness and about contingency plans to cope with any system failure in sensitive areas.

Many problems and risks therefore remain. Global adjustment of uneven growth and payments imbalances is now perhaps the key challenge, and it is the theme running through much of this report. The achievement of a soft landing in the United States, sustained recoveries in the emerging market economies recently in crisis and in Japan, and a sustained strengthening of growth in Europe, as in the staff's baseline projections, are clearly feasible, but there is also a serious risk of worse scenarios. Economic policies will have an important bearing on the outcome and on the degree of macroeconomic and financial stability that will be associated with the adjustment process.

Macroeconomic Stability and the Forces of Globalization: Lessons from the 1990s

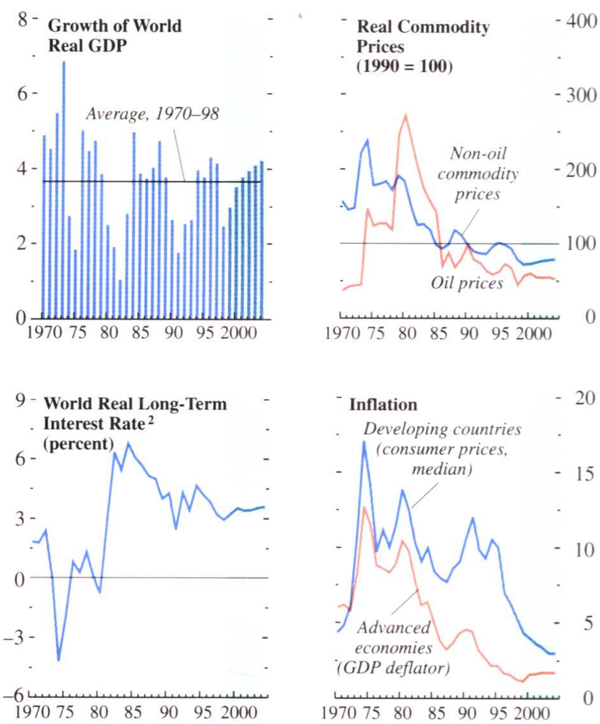
The current global adjustment challenge has its roots in the uneven and, in many countries, highly unstable macroeconomic conditions that have characterized much of the 1990s. Globally, macroeconomic instability has been reflected in two significant slowdowns in less than a decade—in 1991–93 and again in 1998–99—and in an average growth rate of world output in the 1990s of only 3 percent, below the average growth rates of the 1980s (3½ percent) and the 1970s (4½ percent).

The instability has included a large number of currency crises (from the ERM crises to the Mexican, Asian, Russian, and Brazilian crises); substantial swings in exchange rates among the major currencies, especially the yen/dollar rate; run-ups in asset prices followed by pronounced asset price deflations (notably in Japan, the Nordic countries, and the Asian emerging markets); and banking crises in almost all regions of the world—often, though not always, linked to asset price collapses. The U.S. economy is perhaps the most striking, though not the only, exception to the instability of the past decade: the U.S. recession in 1990–91 was unusually mild and the subse-

Figure 1.1. Global Indicators[1]

(Annual percent change unless otherwise noted)

For the world economy as a whole, the recent slowdown in growth appears to have been the mildest of the four that have occurred in the past three decades.



[1]Shaded areas indicate IMF staff projections. Aggregates are computed on the basis of purchasing-power-parity (PPP) weights unless otherwise indicated.

[2]GDP-weighted average of ten-year (or nearest maturity) government bond yields less inflation rates for the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada. Excluding Italy prior to 1972.

Table 1.2. Selected Economies: Current Account Positions
(Percent of GDP)

	1997	1998	1999	2000
Advanced economies				
United States	–1.8	–2.6	–3.5	–3.5
Japan	2.2	3.2	3.4	3.1
Germany	–0.1	–0.2	–0.0	0.2
France	2.8	2.8	2.6	2.8
Italy	2.8	1.7	1.6	1.7
United Kingdom	0.8	0.2	–1.3	–1.6
Canada	–1.6	–1.8	–1.0	–0.9
Australia	–3.1	–4.8	–6.0	–5.2
Austria	–2.4	–2.1	–1.8	–1.5
Finland	5.6	5.8	5.3	5.4
Greece	–2.6	–2.7	–2.3	–2.4
Hong Kong SAR[1]	–3.2	0.7	1.5	2.4
Ireland	2.5	0.9	0.6	0.4
Israel	–3.4	–0.7	–2.6	–2.8
Korea	–1.7	12.5	5.9	3.4
New Zealand	–7.1	–6.1	–6.7	–5.8
Norway	5.2	–0.8	0.6	3.2
Singapore	15.7	20.9	21.1	20.4
Spain	0.4	–0.2	–0.6	–0.7
Sweden	2.8	1.9	1.1	1.4
Switzerland	8.9	8.4	8.0	8.3
Taiwan Province of China	2.7	1.3	2.6	3.0
Memorandum				
Euro area	1.7	1.3	1.2	1.4
Developing countries				
Algeria	7.2	–1.9	–0.1	0.8
Argentina	–4.1	–4.9	–4.0	–3.6
Brazil	–4.1	–4.3	–3.8	–3.1
Cameroon	–2.8	–2.7	–4.3	–3.3
Chile	–5.4	–6.2	–2.6	–3.7
China	3.8	3.4	1.3	1.1
Côte d'Ivoire	–4.8	–4.5	–3.6	–3.5
Egypt	0.2	–3.0	–3.5	–3.7
India	–1.3	–1.0	–1.3	–1.5
Indonesia	–1.8	4.0	2.4	0.7
Malaysia	–5.1	12.9	11.7	5.1
Mexico	–1.9	–3.8	–2.3	–3.0
Nigeria	4.9	–8.4	–14.3	–5.5
Pakistan	–5.6	–2.7	–2.7	–1.7
Philippines	–5.3	2.0	2.2	0.8
Saudi Arabia	0.2	–11.1	–4.6	–4.6
South Africa	–1.5	–1.6	–0.6	–0.8
Thailand	–2.0	12.8	8.8	5.9
Turkey	–1.4	0.9	–0.6	–1.8
Uganda	–0.9	–2.0	–3.7	–2.7
Countries in transition				
Czech Republic	–6.0	–1.9	–1.5	–1.9
Estonia	–13.3	–8.7	–8.2	–9.2
Hungary	–2.1	–4.8	–5.5	–5.1
Latvia	–5.1	–9.5	–8.4	–7.7
Lithuania	–10.2	–12.1	–11.1	–9.9
Poland[2]	–3.0	–4.2	–6.5	–6.5
Russia	–0.7	0.8	7.8	4.8
Slovak Republic	–10.1	–10.1	–4.9	–2.3
Ukraine	–2.7	–3.0	–2.3	–1.8

[1]Data include only goods and nonfactor services.
[2]Based on data for the current balance, including a surplus on unrecorded trade transactions, as estimated by IMF staff.

quent expansion will become the country's longest period of sustained growth on record if it continues through early next year. Other economies have also enjoyed comparatively strong and stable growth in the 1990s, including Australia (see Box 1.1), China, India, Ireland, the Netherlands, Norway, and Taiwan Province of China. Nevertheless, in surprisingly many industrial and emerging market countries, economic performance in the 1990s has tended to be weak or unstable or both.

It is unclear whether macroeconomic instability generally has been increasing. However, the mere fact that it has remained pervasive may be considered surprising given the general improvement in macroeconomic policies in most countries compared with the two preceding decades—suggested, in particular, by declines in inflation and better containment of fiscal imbalances—and the substantial progress worldwide with structural reforms that have increased the scope for market forces to guide the allocation of resources within and across countries. Why, then, has the frequency of crises and episodes of macroeconomic instability not clearly diminished?

Analysis of the role of any particular factors in contributing to changes in economic performance is generally difficult because typically many changes occur simultaneously, and this has been the case in the 1990s. The global economic and financial system today is dramatically different in many respects from that of the 1980s or any earlier period. Four of the most significant changes are the following:

First, as a major policy achievement, world inflation has been brought down to its lowest level in 40 years. Associated with this, the dispersion of inflation rates across countries has also diminished. These developments reflect the strengthened international consensus among monetary authorities on the need to focus on the goal of low inflation—a consensus fostered by experience of the alternative and also by peer pressure and demonstration effects among countries. The strengthening of fiscal discipline in many countries has also contributed to monetary discipline and the decline in actual and expected inflation. Although hard to substantiate or measure, it seems likely that factors such as trade liberalization, extensive deregulation in many industries, the privatization of many state-owned enterprises, the reduced willingness of governments to bail out uncompetitive enterprises and sectors, and enhanced information about price developments across countries have also been contributing to the general convergence toward price stability worldwide.

The effect on inflation of this last set of factors—which operate essentially on the price level rather than its rate of change—may be expected to wane over time, and it remains to be seen if price stability will be maintained on a lasting basis. But at least for the moment, low inflation has reduced the risk of one potential source of cyclical instability—the emergence of price pressures in the late stages of an economic upswing that ultimately necessitate a significant tightening of monetary conditions. In fact, the concerns of monetary authorities in some countries recently—for example, China and Japan—have focused on the risk of *falling* prices, or deflation (see Box 4.3). This may also add to macroeconomic instability, partly owing to the reduced ability of monetary policy to stabilize output at negative inflation rates because of the difficulties of pushing nominal interest rates below zero.

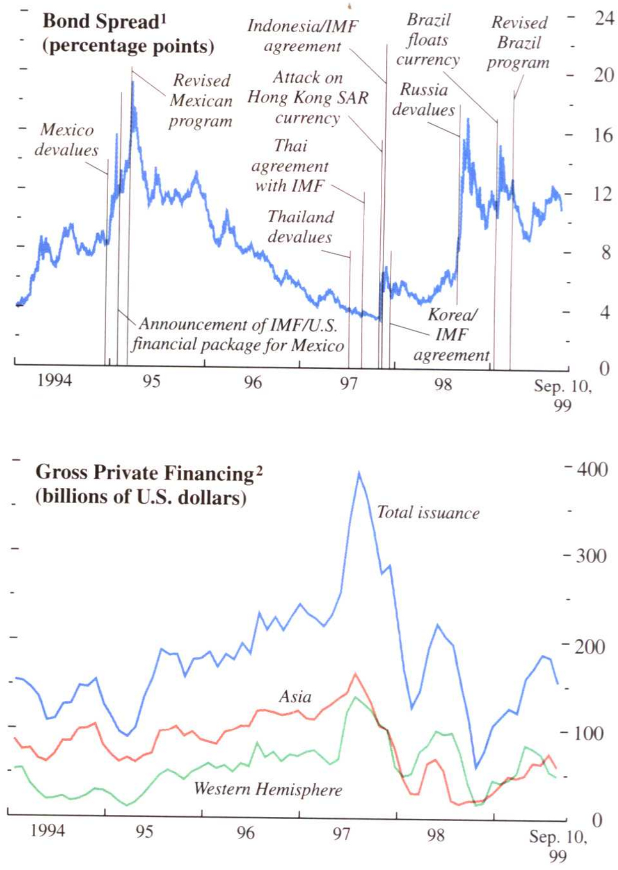
But even while inflation in product markets (for example, CPI inflation) has been very subdued, asset prices have continued to display considerable volatility, with a number of significant spikes since the mid-1980s. This volatility in asset prices (especially stock market and real estate prices) has contributed significantly to macroeconomic instability in several countries, raising anew questions about the weight monetary authorities should attach in their policy decisions to asset market developments.

The second striking development of the 1990s is the rapid international integration of financial markets that has followed the general trend toward financial market liberalization in the industrial countries in the 1970s and 1980s and the reduction in capital and exchange controls in emerging market countries more recently. As a result, the 1990s have witnessed private capital flows to emerging market countries unprecedented in scale (relative to economic activity) at least since the first world war. The secular rise in *gross* capital flows can be explained to a large extent by market integration and the appetite of international investors for high yields and portfolio diversification. However, the large flows into emerging market countries during the buildup to the recent emerging market crises, in *gross* and, more particularly, *net* terms, also reflected, in part, unsustainable developments in the recipient countries (including explicit and implicit exchange rate guarantees), together with a low demand for capital in Japan and western Europe associated with the weakness of activity in those economies in much of the 1990s. Following the Asian crisis, a growing share of Japan's and Europe's saving surpluses has flowed into the United States. This suggests, somewhat paradoxically, that strong cyclical recoveries in Europe, Japan, and the Asian emerging market economies might make it more difficult for the U.S. expansion to sustain its momentum.

Third, as illustrated by the last point, economic and financial linkages and policy transmission mechanisms across countries have become more complex in the 1990s, warranting a further reassessment of key relationships. Historically, the developing countries' economic cycle was mostly positively correlated with that of the industrial countries due to the impulses transmitted through trade and commodity prices. In the early 1990s, however, when the industrial countries went through successive episodes of cyclical weakness, growth actually accelerated in many emerg-

Figure 1.2. Financing Conditions for Emerging Markets

Financing conditions for emerging markets have improved since the Brazilian crisis, but they remain less favorable than prior to the Russian crisis.



Sources: Bloomberg Financial Markets, LP; and IMF staff estimates.

[1]J.P. Morgan's Emerging Market Bond Index (EMBI) spread relative to the theoretical U.S. zero-coupon yield curve, and secondary market yield spreads on U.S. dollar-denominated Eurobonds.

[2]Excludes interbank flows. Three-month moving averages; annualized.

Box 1.1. Australia and New Zealand: Divergences, Prospects, and Vulnerabilities

Economic performance differed sharply between Australia and New Zealand in 1998, the former growing at a strong 5 percent rate while the latter slipped briefly into recession, with output falling by ¼ of 1 percent in the year as a whole. This divergence may at first seem surprising, given the strong trade and financial links between these countries and the fact that their economic fundamentals are similar in many respects: their common strengths include low and declining levels of public debt, low inflation, sound financial systems, and good records of structural reforms; while on the negative side, both countries have very low household saving rates, relatively wide current account deficits, and substantial trade exposures to the crisis-affected economies of Asia.

The explanation for the divergence between the two economies in 1998 lies partly in some notable differences in economic performance in the lead-up to the Asian crises. Exports grew much more strongly in Australia than in New Zealand during 1995–97, by 9 percent a year (in volume terms) in the former compared with 3½ percent in the latter. Australia's relatively strong export performance, combined with the renegotiation of export contracts by some commodity suppliers at relatively favorable prices before the crisis broke, provided Australia with a cushion against the subsequent slowdown in trade that New Zealand lacked. Also contributing to the economic slowdown in New Zealand was a severe drought, which led to a substantial fall in agricultural output in 1998. Another important factor was the conduct of monetary policy. Following an extended period of substantial inflationary pressure stemming from strong output growth, immigration inflows, and buoyant residential real estate markets, the Reserve Bank of New Zealand eased monetary conditions only gradually in 1996–97. In Australia, by contrast, with asset prices rising at a more moderate pace and inflation subdued, the central bank eased monetary policy more substantially in 1996. Partly reflecting these developments, private consumption and investment picked up strongly in Australia after 1996, but weakened in New Zealand. For example, residential construction in Australia increased in 1997 and 1998 after declining in the two previous years, whereas construction declined sharply in New Zealand in 1998. Also notable is the substantial appreciation in the real exchange rate in New Zealand, of almost 30 percent between 1993 and mid-1997, which worsened net exports. Furthermore, share prices in Australia largely maintained their earlier gains during and after 1997, supporting private sector confidence and demand, while in New Zealand, the stock market fell sharply after mid-1997—losing around one-third of its value in the following year before a more recent correction.

Looking ahead, output in Australia is projected to grow by 4 percent in 1999 and 3 percent in 2000. The slowdown in 1999 is attributable mainly to weaker private investment, especially in the mining sector as a result of low commodity prices, and also to a much-reduced contribution from stockbuilding (which provided 1.7 percentage points of growth in 1998). The further slowing in 2000 reflects a broader-based decrease in consumption growth, partly offset by a pickup in exports (especially tourism receipts, including for the 2000 Olympic Games). An increase is expected in inflation in 2000 associated with the introduction of a new value added-type goods and services tax (GST), but inflation excluding the GST effect is expected to be around the middle of the Reserve Bank of Australia's medium-term target of 2–3 percent.

In New Zealand, growth has resumed after the recession in the first half of 1998—supported by a substantial easing in monetary conditions—and is projected to reach around 2½ percent in 1999 and 3¼ percent in 2000. Improvements in household and business confidence have contributed to a pickup in consumption and investment, while export growth has been underpinned by improvements in export markets and the 20 percent decline in the real effective exchange rate since mid-1997. Inflation is expected to remain below 2 percent.

The main area of vulnerability in both economies is in their external imbalances. Current account deficits are projected to increase to about 6 percent of GDP in Australia in 1999, and closer to 7 percent in New Zealand, before declining in 2000 (see figure). Persistent deficits have generated a high level of net external liabilities—amounting to around 60 percent of GDP in Australia and nearly 100 percent of GDP in New Zealand. Reflecting this, net investment income outflows have been equivalent to around 3–4 percent of GDP in Australia in recent years, and 7–8 percent of GDP in New

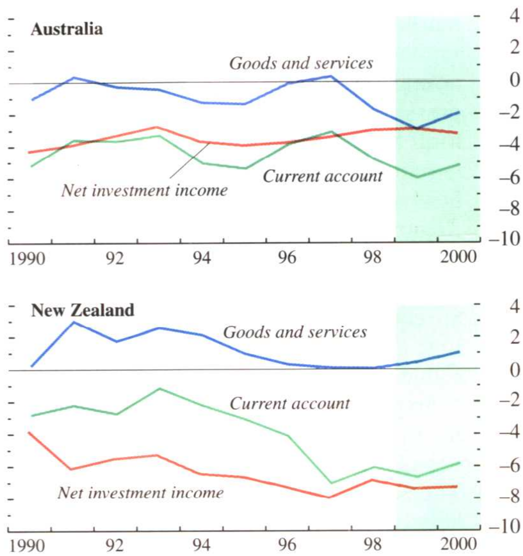
ing market economies, fueled by the rapid growth of trade among them (especially in Asia) as well as by substantial capital inflows.

More recently, in the wake of the Asian crisis, all industrial countries with significant trade links with Asia would have been expected to experience adverse effects on growth. In fact, however, while Japan and, to a lesser extent, Europe were negatively affected, the United States' economic expansion appears to have gained further momentum. A flight to dollar-denominated assets helped to sustain the U.S. expansion by boosting domestic demand through lower interest rates and the dampening effect on prices of an appreciating dollar, notwithstanding the negative impact on U.S. exports.

In both examples, the integration of financial markets appears to have contributed to a tendency for global financial resources to move to whichever countries and regions are relatively dynamic at the time. In principle, such reallocations of financial resources are beneficial for the recipient countries and also for global growth and efficiency. However, as experience shows, large net capital flows into strongly expanding economies may exacerbate risks of overheating and

Current Account Developments[1]

(Percent of GDP)



[1]Shaded areas indicate IMF staff projections.

Zealand; in the latter case, these outflows have tended to move procyclically, and account for much of the deficit's recent change.

Assessing the sustainability of these deficits is not straightforward.[1] For example, potential mitigating factors include the high level of foreign direct investment in each country—amounting to 27 percent of foreign liabilities in Australia and nearly 50 percent in New Zealand. FDI is a relatively stable form of foreign financing (as shown by recent experiences in emerging markets), and also tends to produce a flow of reinvested earnings. There are other important considerations: much of the debt (around 40 percent in Australia and 50 percent in New Zealand) is denominated in the local currency; and a large share of short-term debt is owed by banks, which have high credit ratings and, in the case of New Zealand, significant foreign ownership. Both countries' strong records with macroeconomic and structural policies have provided them with another important buffer against the recent turmoil in international financial markets. Reflecting this, market sentiment has remained favorable, there has been a significant narrowing since the mid-1990s in spreads on long-term bond yields over comparable U.S. yields, and Standard and Poor's has recently upgraded Australia's credit rating to AA+ (the same as for New Zealand).

Nevertheless, high and rising foreign indebtedness significantly increases the exposure of Australia and New Zealand to external shocks. While there appears to be little risk at present of a significant downturn in investor sentiment, the possibility of future reversals should not be entirely discounted. Were they to occur, such reversals could well be sharp rather than smooth, and cause substantial exchange rate depreciations. But the structure of foreign liabilities in both countries would probably make such an adjustment much less disruptive than that seen, for example, in some of the Asian crisis nations. Current account deficits are projected to decline in Australia and New Zealand over the medium term, supported by recent depreciations in real effective exchange rates, rising budget surpluses, and the expected recovery in commodity prices and in trading partners' imports. This adjustment may well take place over an extended time period, however. Hence, further efforts to increase national saving are needed over the medium term in order to reduce risks of a change in market sentiment. Reforms in the social welfare system (such as those currently underway in New Zealand) could help in this regard, as could changes in the tax system to raise the share of indirect taxation (as in the recent tax package in Australia).

[1]See, for example, the discussions of current account sustainability in the *World Economic Outlook* of May 1998 (Box 8, pp. 86–87) and May 1999 (pp. 38–44).

asset market bubbles, while rapid reversals of such flows can severely strain weak financial systems and lead to destabilizing currency movements.

And fourth, flexible exchange rates have become increasingly prevalent. During the 1990s, a number of key emerging market currencies have been floated, often to resolve crises associated in part with unsustainable exchange rate pegs. While the adoption of a single currency in the euro area together with a handful of quite successful currency board arrangements (those in Argentina and Hong Kong SAR being the most prominent) stand out as exceptions, the trend worldwide since the breakdown of the Bretton Woods system has been toward exchange rate flexibility. As a result, exchange rates have been allowed to reflect more clearly differences in policies and investment opportunities. In the 1990s, short-term exchange rate volatility has remained high with no clear trend, which is somewhat surprising in view of the decline in worldwide inflation. But while the need for *nominal* exchange rate fluctuations to compensate for international differences in inflation has diminished as inflation rates have converged toward low levels, forces making for movements in *real* exchange rates—such as cyclical diver-