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December 4, 2000
Approval: 12/11/00

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/31

10:00 a.m., March 22, 2000

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Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors

S.M. Al-Turki
A. Barro Chambrier

A.G. Carstens
R.F. Cippà
B. Esdar
A.M. Jul

K.-T. Hetrakul
V. Kelkar
W. Kiekens
O.-P. Lehmussaari
K. Lissakers
J.-C. Milleron

J.P. de Moraes
A.V. Mozhin
S. Pickford
M. Portugal
A.S. Shaalan
G.F. Taylor
Wei Benhua
J. de Beaufort Wijnholds
Y. Yoshimura

Alternate Executive Directors

A.S. Alosaimi
D. Ondo Mañe
P. Charleton

W.-D. Donecker
A.G. Zoccali
H. Vittas

A.G. Karunasena

Å. Törnqvist

G. Bauche
M. Daïri

A. Lushin
S. Collins
R. Junguito

J.N. Oh
Jin Qi

H. Toyama

A.S. Linde, Acting Secretary
Z.R. Ahmed, Assistant
C.E.L. Andersen, Assistant
P.J. Kunzel, Assistant
G. Nkhata, Assistant

Also Present

ECB: G. Grisse. WTO: J. Handcock, Trade and Finance Office. African Department: A. Basu, Deputy Director; F. Caramazza. Asia and Pacific Department: C.V.A. Collins, R.A. Elson. European I Department: J.R. Artus, Deputy Director; S.M. Thakur. External Relations Department: G. Hacche, Deputy Director; M.W. Bell, R. Chote, J.C. Hayden. Fiscal Affairs Department: P.S. Heller, Deputy Director; R. Hemming. Legal Department: R.K. Gordon, Y. Liu. Middle Eastern Department: P. Dhonte, Deputy Director; Monetary and Exchange Affairs Department: E.J. Frydl. Policy Development and Review Department: M. Allen, Deputy Director; T. Leddy, Deputy Director; L.J. Lipschitz, Deputy Director; T.J. Bond, C. Christofides, M. Fisher, G.R. Kincaid, A.T. Mourmouras. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; T.A. Bayoumi, E.R. Borensztein, L.A.V. Catao, B. Chadha, M. De Broeck, J.H. Green, M.S. Kumar, A.M; MacFarlan, B.J.A. Nystedt, L.A. Ricci, D.J. Robinson, R.M. Salgado, T.M. Sloek, A.K. Swoboda, A.N.R. Sy, A.J. Tweedie. Secretary's Department: S.J. Anjaria, Secretary; S. Bhatia, P. Gotur, A. Mountford, B.A. Sarr, S. Yeager. Treasurer's Department: E.R.D. Canetti. Western Hemisphere Department: A. Matzen, E.C. Offerdal. Office of the Managing Director: D.A. Citrin, J.A.P. Clément. Advisors to Executive Directors: M.A. Ahmed, P.A. Akatu, J.A. Chelsky, J.A. Costa, B. Couillault, A. Del Cid-Bonilla, J.C. Estrella, S.S. Farid, P.R. Fenton, A.R. Ismael, N. Jadhav, J. Jonáš, J.M. Jones, M.F. Melhem, J. Ntamatungiro, L. Palei, A.R. Palmason, J.L. Pascual, J.N. Santos, G. Schlitzer, M.R. Shojaeddini, M. Sobel, I.M. Woolford, M. Yanase, F. Zurbrugg. Assistants to Executive Directors: E. Azoulay, J.G. Borpujari, P.A. Brukoff, N. Budina, R. Burgess, S. Çakir, G. De Blasio, R. Djaafara, M.J. Fernández, E. González-Sánchez, K. Harada, I.C. Ioannou, C. Josz, A. Kapteijn, B. Kelmanson, D.H. Kranen, K. Ongley, Peh K.H., C.-P. Schollmeier, C.A.E. Sdravovich, J. Sigurgeirsson, Siti Mariam Mohd. Yusof, A. Sutt, Tong Y., Vongthier O., M. Walsh, E.S. Weisman, A.Y.T. Wong, Xu J., M. Yépez.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors considered a staff paper on prospects and policy issues related to the world economic outlook (EBS/00/31, 3/9/99; and Sup. 1, 3/31/00), together with a statistical appendix (EBS/00/32, 2/28/00) and boxes providing background material (EBS/00/33, 3/1/00). They also had before them a background paper on world economic and market developments (EBD/00/32, 3/17/00).

The Economic Counsellor and Director of the Research Department made the following statement:

This morning, I will focus primarily on the outlook and risks for the global economy after reviewing recent financial and commodity market developments, and revisions to the forecast.

So far in 2000, global equity markets have generally continued to advance. However, an increasing bifurcation can be observed in markets, with equities for the old economy—as represented by the Standard & Poors 5000 index—generally flat, and indeed down from recent peaks, whereas the technology sector—as represented by NASDAQ—has continued to advance explosively. This phenomenon is not only limited to the United States; it can also be observed in other industrial countries, including Japan, the United Kingdom and continental Europe, and even in emerging market economies. The bifurcation of markets is a new phenomenon with no obvious precedent: even at the time of the oil crisis, when oil stocks were advancing and other stocks were declining, it was not as extreme.

Another feature of recent equity market behavior has been a very substantial increase in volatility, as measured by day-to-day variability. In all major U.S. indices, volatility this year is well above what has been seen in recent years, and certainly very much above the low level of volatility that characterized the U.S. stock market at the beginning of this decade. Again, the phenomenon is not limited only to the United States. Other major indices around the world have also experienced a significant increase in volatility, as compared to their performance in recent years and to historical averages.

Another measure of volatility is the extent of stock price movements exceeding more than 3 percent in a single day—as measured by day-to-day changes. According to this measure, volatility in the NASDAQ has been very high, and a similar trend is visible in the broader market indices. Accordingly, while the equity markets have increased, there is both bifurcation and an exceptionally high level of volatility.

Long-term bond markets have also been moderately volatile, though the degree of variability has not yet exceeded levels seen in earlier periods. Long-term interest rates have generally been on a downward path since the beginning of 2000 in major industrial countries, leaving aside Japan. This downward movement has been

particularly pronounced for the U.S. 30-year bond, where treasury bill repurchases have reduced the supply of instruments available in the market. This has had the effect of depressing their yields in comparison with the broader market for U.S. treasury bills, as represented by the 10-year bond. However, as observed throughout this decade, there tends to be a fairly strong convergence of long-term interest rate movements across the major industrial countries. Japan, of course, is a special case because of its special economic and financial conditions and the zero interest rate policy.

Spreads between government bond yields and corporate bond yields in the United States have widened somewhat, although this observation is exaggerated somewhat by the use of the 30-year treasury bond as the comparison base. If the 10-year treasury bond was used instead, the increase in the spread would be less than half; however, the spread would still be meaningful. This probably reflects the changing supply situation in U.S. financial markets, where longer-term treasury debt is now being reduced, and is expected to be reduced further over the coming years. There have also been substantial net new issues of corporate debt, which is changing the relative yield situation between private and government debt. This phenomenon is also visible in the interest rate swap spread, and is clearly one of the factors that has pushed up the interest rate swap spread based on pricing against U.S. treasury securities.

Another noteworthy financial market development has taken place in foreign exchange markets. The euro has continued to depreciate against the dollar, and has been trading consistently below parity throughout March 2000. The euro also recently hit an all-time low against the Japanese yen. Meanwhile, the Japanese yen, after weakening somewhat against the dollar to around ¥110, has strengthened again to the range of ¥105-107. Furthermore, the yen is at or near an all-time high versus the euro.

There have been substantial upward movements in the equity markets of emerging economies, particularly since the beginning of 2000. As is the case in the advanced countries, however, those developments have been predominant in the technology and communications sectors of those markets, but have not been widespread across other classes of equities.

The gross financing data from the Research Department shows that external financing flows to emerging market economies have picked up since the beginning of 2000. This has been associated with a decline in the yield spread, as measured by the EMBI spread. Mr. Lushin commented in his statement that the EMBI spread is to some extent distorted because it does not accurately represent conditions for new issues. While this is true, the new issue spread is also distorted in another direction: when market conditions are difficult, only high quality issuers issue securities, which makes the new issue yield look artificially low when market conditions ease up. It is a fact, however, that the financing conditions for emerging market economies have been improving since early 2000, notwithstanding a significant monetary tightening both in the United States and in Europe.

Another important development has been taking place in world commodity markets. Commodity prices have generally continued to firm modestly, although metals prices have declined somewhat in recent months. The oil price hit a peak of over \$30 a barrel in early March 2000. Although it has fallen back since then, it is still trading in the \$30 range. The futures market continues to anticipate that oil prices will decline over the next two years. This is based on the anticipation that the OPEC supply situation will improve in the near term. A decision is expected soon as to whether there will be further increases in supply.

The staff has upgraded the growth forecast for the world economy in light of recent developments, including a 0.5 percentage point increase in the estimated growth rate for the United States, and an increase in the estimated growth rate for Europe to 3.2 percent. The forecast for Japan has been revised downward to 0.5 percent, reflecting weak growth in the fourth quarter of 1999. The staff has also upgraded the forecast for developing countries in Africa and Asia. The forecast for world growth has been increased by 0.1 percentage point to just over 4 percent.

The pattern of growth in the world economy is based on a recovery from the global slowdown in 1998 associated with the steep recession in many emerging market economies in Asia. A surprising pickup of growth to 3 1/3 percent has been estimated for 1999, and a further increase to just over 4 percent has been forecast for 2000. Countries such as the United States, which are the most advanced in the economic cycle, have been major engines of world growth. While the U.S. economy is currently experiencing a slight slowdown, growth remains above what has traditionally been perceived as the potential growth rate. Among the members of the European Union, economic growth is strengthening after a decade of disappointing average growth performance. In Japan, the modest recovery that occurred in 1999 is expected to strengthen somewhat in 2000 after the recession in 1998. Among the developing countries, a rising trend of growth has followed the steep recession in Asia in 1998, although Latin America remained in recession for much of 1999. In 2000, the staff is anticipating positive economic growth in most of the regions of the developing world, although a slight slowdown is expected in India and China, where growth has remained relatively high.

Core inflation in both North America and Europe continues to be mild. It is down just over 1 percent in Europe, and just over 2 percent in the United States. However, headline inflation has been moving up both in Europe and the United States, reflecting predominantly the effect of the rise in world energy prices. So far, that increase has not translated into either upward pressure on other goods and services prices, or upward pressure on wages. Measures of anticipated inflation, which are available from indexed bond yields for selected countries, indicate that expectations of future inflation have moderated after some upward movement during the past 6 to 12 months. Accordingly, inflation in the industrial countries continues to look subdued.

I will now turn to risks in the forecast for the United States. The 1990s have been a decade of consistently good news for the U.S. economy. There has been a record-long business-cycle expansion, which has been characterized by strong productivity growth, especially in recent years. This productivity growth reflects both increases in total factor productivity—attributable to advances in technology—and a gain in labor productivity associated with higher levels of investment, which have increased the availability of capital. The strong growth of the U.S. economy also reflects substantial gains in civilian employment, which have significantly outstripped the growth of the labor force. These developments have resulted in a remarkable decline in unemployment to a 30-year low, but also in a substantial increase in the participation rate for adult workers, particularly women. Meanwhile, inflation—particularly as indicated by the CPI—has remained remarkably subdued in the face of a strong economy and tight labor market. These results testify, albeit not exclusively, to adept management of both monetary and fiscal policy.

However, there are increasingly signs of imbalances in the U.S. economy that should be addressed before they become actual problems. One key issue is that the growth of real domestic demand has been significantly outstripping output growth over the past three years, which has resulted in a widening current account deficit, rather than in an increase in inflation. On balance, this has been positive for the United States and the world economy, especially given the fact that demand growth in the rest of the world has been quite weak in recent years. What might have constituted undesirable inflationary pressure in the United States has instead been transformed into an increase in demand for output of economies that would otherwise have been even further depressed.

However, it is doubtful whether these imbalances are sustainable in the future. So far, there has been no difficulty in financing the current account deficit, which is now reaching, and indeed exceeding, 4 percent of GDP: foreign capital flows, particularly private capital flows, but also official accumulation of reserves, have provided ample financing on favorable terms. Foreign equity holders have been particularly aggressive purchasers of U.S. equities in recent years, and that has been an important contribution to the financing flow. But in a world economy where economic growth is picking up, where investment is likely to increase in other parts of the world, thereby increasing the demand for investment capital, the sustainability of a current account deficit in the order of 4 percent of GDP, combined with a widening of the net liability position of the United States, is in question. There is accordingly a risk of a disorderly reversal of the foreign exchange value of the dollar, associated with a decline in the availability of external financing.

A decline in the personal savings rate has accompanied the rapid growth of demand in the United States. Clearly, the rise in household wealth has been an important factor driving the decline in personal savings and the increase in consumption. The rising value of corporate equities has also constituted an important factor—though not the only factor—in helping to drive the high level of investment. Indeed, issues of new equities were a very important source of corporate finance in

1999, providing nearly \$0.25 trillion of new finance to businesses in the United States.

A significant increase in the ratio of household debt to personal income has also been associated with the rise of household wealth. The figure describing debt relative to wealth is not worrying in itself, because wealth has continued to rise as well, but if a significant and sustained downward correction in asset values were to occur, these debt levels could become a factor restraining household spending. One particular debt category, namely margin debt to hold equity positions, has been rising quite rapidly recently. Relative to the value of equities, the increase has not been large, but relative to personal income, it has been substantial. If a significant downward move in equity values were to occur, this, too, could become a factor that would impact negatively on consumer spending.

Another potential imbalance is the valuation of equities in the United States. A significant part of the rise in the value of equities during the 1990s can be explained by increases in corporate profits, which have increased not only in absolute terms, but also in terms of their share of national income. While national income has been growing by 5.5 percent of GDP per year in nominal terms, corporate profits have been growing double that rate because their share of national income has been rising quite rapidly. However, that increase probably has a limit, and it appears to have leveled off recently. Nevertheless, market capitalization continues to grow, and many of the recent gains in stock market capitalization has occurred in companies that report little or no earnings at all. Accordingly, the market might be losing touch with reality.

The question is how policy makers should respond to a situation where the economy is doing very well, and where inflation remains low, but where there are increasing signs of imbalances, with demand growth significantly outstripping output growth (and potential output growth). It would be useful in these circumstances to tighten fiscal policy significantly in order to improve national saving. However, such a tightening is probably unrealistic, given the size of the current budget surplus. Fortunately, there has been no relaxation of fiscal policy either, at least at the federal level: states and localities are spending at an increasing rate.

After the easing of monetary policy in the wake of the turbulence of October-November 1998, the Federal Reserve adopted a tightening stance early last summer. Following the most recent increase in interest rates, the federal funds rate is now at 125 points basis points above its low point, and 50 basis points above its level before the turbulence of 1998. The market is anticipating two further tightening moves in the period April-June 2000. That is a reasonable expectation, provided that the U.S. economy continues to be relatively robust, and provided that inflation does not exceed the recent mild pickup in underlying inflationary pressure. There is some evidence that this scenario is currently unfolding. In such an environment, a further tightening of monetary policy by 50 basis points appears to be both reasonable and prudent. There is only little risk that such a tightening would slow the U.S. economy

more than is desirable, particularly on the demand side, or that it would create problems elsewhere in the world economy, given that the financial markets have already priced such a tightening in.

If the U.S. economy continues to be buoyant on the demand side, even if there is not much further evidence of a rise of inflationary pressures, monetary policy might need to be tightened further to 6.75 percent, or even 7 percent. However, it would be difficult to rationalize a further monetary tightening unless there is more firm evidence of inflationary pressures. The worry is that inflationary pressures have been building under the surface, and that evidence to that effect will emerge later in 2000. If that is the case, a rise in the federal funds rate above the 6.5-7 percent level could become a reality. There is also the possibility that the U.S. economy could slow more than what would be desirable if a self-generated decline in equity prices were to occur. In this situation, monetary policy would have to be eased in order to cushion any undesirable slowdown of the U.S. economy.

Other countries that are advanced in the cycle include Australia and Canada. Growth in these economies continues to be quite buoyant, and the authorities have recently tightened monetary policies. The staff estimates that the output gaps are even smaller in these economies than in the United States. In Canada, some further monetary tightening might be appropriate during the course of 2000. In Australia, the recent tightening appears to have been sufficient for the time being. The two economies are expected to continue to grow at a relatively robust pace in 2000 and 2001.

Japan remains in difficulty, and constitutes somewhat of a mystery. In the fourth quarter of 1999, all the key components of demand made negative contributions to estimated GDP growth, resulting in a 5.5 percent decline on an annualized basis. Interestingly, public demand, including public investment, made significant negative contributions to GDP growth in both the fourth and third quarters of 1999, and only a small positive contribution in the second quarter, compared to a relatively large contribution in the first quarter. On a fourth-quarter-to-fourth-quarter basis, public final demand made a negative contribution to Japanese GDP growth in 1999. Such unevenness in the stimulus provided by fiscal policy has held back a sustained economic expansion. In the first quarter of 2000, it will be important to increase public final demand to ensure positive momentum. Achieving a steady input of final public demand into the Japanese economy over the course of the coming months will be highly desirable.

The reasons behind the decline of private demand during the fourth quarter of 1999 remain largely unknown, but may have been related to the late payment of bonuses and other such factors. Business investment spending increased significantly during that same period. My own view is that the Japanese economy bottomed out in late 1998, and remained essentially stagnant during the course of 1999. While growth was up somewhat in the first half of 1999, it was not as strong as indicated by the reported GDP data. Similarly, growth was down somewhat in the second half of

1999, but not by as much as the reported GDP data showed. Based on the data of the first quarter of 2000, it is likely that a rebound will occur, and that economic recovery will follow. I am in that sense more optimistic than the staff forecast. However, I would emphasize at least as emphatically as the staff does, that policies must continue to provide support to what is clearly a weak recovery at best in the private sector, especially amongst consumers. Fiscal policy must remain supportive throughout 2000, and the zero interest rate policy should be maintained for the foreseeable future. Further quantitative measures to add liquidity ought to be pursued. If the exchange rate comes under unwarranted upward pressure, non-sterilized interventions in the foreign exchange market should be considered. There is a high degree of uncertainty with respect to the forecast for Japan, much larger than for any other country. While the forecast range has been narrowing following the availability of actual information on year-over-year growth, uncertainties remain. Nevertheless, the medium-term forecast anticipates that Japan will be returning to growth above potential in 2001.

There has been a gradual upward revision of the forecasts for Europe in 2000 over the course of recent months; economic growth is now forecast to reach more than 3 percent of GDP. Such an outcome would be somewhat above what is now the median staff forecast. A similar growth rate is expected for 2001, although growth rates might decline in some of the fastest growing economies. However, it should also be noted that growth has been picking up in the larger economies of Germany and Italy.

The European Central Bank recently tightened monetary conditions by 25 basis points. However, I would still judge that monetary conditions in the euro area remain accommodative, especially when one takes into account the depreciation of the euro. If measured by the so-called monetary conditions index, which combines short-term interest rates with the exchange rate, monetary conditions still appear to be quite supportive of economic growth. That being said, there is no immediate need for a further tightening of monetary policy by the European Central Bank. Core inflation remains quite subdued, and margins of slack for the euro area as a whole are still significant, although that is not the case in some economies. On balance, I would have preferred the ECB to wait another month before undertaking this latest tightening of 25 basis points. However, that is hardly a harsh criticism of ECB policy, which has been well managed over the course of the past 15 months.

There is a slight increase in the overall inflation index for Europe, but the inflation rate excluding energy and seasonal foodstuffs remains well below the 2 percent ceiling that the ECB is targeting. Other indicators of activity are clearly pointing upward, including the recovery in industrial production, and the increases in business and consumer confidence. Accordingly, Europe appears to be on the upswing.

There are, however, divergences between the various euro area countries. Significant output gaps persist in Germany and Italy. The output gap is smaller, but still significant, in France, and the staff anticipates that it will take at least two years

to eliminate the output gap at the present growth rate. In contrast, Spain is estimated to be at the margin of capacity despite the persistence of high unemployment rate. The Netherlands may already be operating in excess of capacity, and Ireland is currently operating well above capacity. Fiscal policy ought to play a more active role in those countries in stemming excess demand pressures.

A key challenge for the euro area as a whole will be to continue reforms of labor and product markets. When European countries are compared to the United States, two important differences can be observed. First, unemployment rates are much higher in Europe than they are and have been for the past two decades in the United States. The still high unemployment rates in Europe could be brought down as part of the process of eliminating the remaining output gaps, thereby reducing unemployment below the natural rate of unemployment. Second, participation rates are lower in Europe than in the United States. While there are a variety of cultural and other reasons why participation rates are lower in Europe, there ought to be considerable room in most European countries to increase participation. The combination of an increase in labor force participation, and a reduction of structural unemployment rates should provide sufficient room for European economies to continue to expand at a rate of at least 3 percent of GDP throughout the coming decade. While a rate of 3 percent is currently thought of as being above the long run potential of most European economies, vigorous structural reforms that exploit the possibility both for lower unemployment and for higher labor force participation, could increase the long-term growth potential significantly.

Turning to the United Kingdom, recent evidence suggests that the inflation rate is picking up. However, that evidence stems more from expectations of future inflation than actual measured inflation. Nevertheless, the evidence has motivated several tightening moves by the Bank of England, and it is possible that some further tightening will be called for in coming months. Interestingly, growth forecasts for the U.K. economy have been adjusted upward in recent months to over 3 percent of GDP, with the economy slowing only modestly in 2001. The staff's own forecast is somewhat more pessimistic, with growth expected to reach 2 percent of GDP in 2000.

Several countries in Latin America experienced steep recessions in 1999, including Argentina, Venezuela and Colombia, where there is now evidence of economic recovery. Oil prices are assisting economic growth in Venezuela. As far as Ecuador is concerned, there is hope, but not yet much evidence of a recovery. Overall, the staff expects the three largest Latin American economies to be growing at respectable growth rates in 2000, with growth strengthening modestly in 2001.

One of the main concerns facing Latin America is access to external financing. Most countries in Latin America continue to run significant current account deficits that exceed 3 percent in a number of cases. In addition to that, these countries have large external financing requirements, which reflect not only the current account deficits, but also the need to roll over maturing debt obligations in both the public and private sectors. So far, financing conditions have improved, and

there does not appear to be a problem, despite the recent tightening of monetary policy. However, problems may arise if monetary policy in the United States is tightened further than what is currently anticipated by the financial markets. If that were to happen, Latin America, with its relatively large external financing requirements, could become vulnerable.

Emerging markets in Asia have experienced V-shaped recoveries, which I predicted in September 1997. Korea in particular has experienced a spectacular recovery, but strong recoveries are also evident in Thailand and Malaysia. Indonesia, while continuing to face difficulties after a severe recession, is nevertheless experiencing positive GDP growth. Accordingly, all Asian crisis economies are recovering. While economic growth in Korea will probably slow somewhat in 2000 compared to the 10 percent growth rate achieved in 1999, it will remain quite robust.

Before the crisis, countries such as Malaysia and Thailand were running substantial current account deficits. They now have large current account surpluses, and have no problems of external financing. Therefore, they are better insulated from any direct consequences of a more aggressive monetary tightening than currently anticipated in the industrial countries.

Exchange rates have recovered from their crisis lows, but most of the Asian currencies remain significantly depreciated in real terms compared to their levels before the Asian crisis, despite the substantial recoveries now underway both with respect to domestic demand and exports. On balance, the staff is accordingly anticipating some upward pressure on exchange rates. A gradual accommodation of that upward pressure should provide a useful means for tightening monetary conditions, while keeping interest rates comparatively low to facilitate corporate and financial restructuring. Meanwhile, fiscal policy, which has been expansionary to assist recovery, will need over time to move back toward a stance of consolidation in order to contain and eventually reverse some of the growth of public debt that has been associated particularly with the costs of recapitalizing and restructuring the banking system.

In China and India, the two largest economies in Asia measured by population, growth is slowing somewhat, but still remains quite robust. The forecast for India may need to be revised upward. Other emerging market economies are also as a general rule doing quite well. Saudi Arabia is benefiting from the rebound in energy prices, and this factor is probably also helping Egypt, although recent structural reforms also are playing a role. The Iranian economy is performing more strongly, and several of the key African economies are also expected to perform more strongly in the year 2000 than they have in recent years, though a few economies in the region have been devastated by natural or man-made disasters. Among the emerging market economies, growth prospects are also quite positive: the Polish economy is growing quite strongly, and while the current account deficit is large, it is a source of only modest concern, as financing appears to be generously available, though it is a situation that bears watching. The Czech economy is recovering after a

fairly prolonged recession. The Turkish economy is doing remarkably well under its new stabilization program, supported, of course, by a program with the Fund.

On balance, the outlook for the global economy is positive. Even in Russia and Ukraine, recent data have been quite positive. After many years of negative growth, Ukraine is set to achieve positive growth. However, there are important imbalances that need to be addressed.

Mr. Kiekens and Mr. Jonas submitted the following statement:

Probably the surest sign that the crisis in the emerging markets is over is the fact that the projections of world output growth are now being repeatedly corrected upwards. In 1997 and 1998, countries were pulling one another down in a vicious circle. Today, the process has been reversed, with strong recovery in one country promoting the recovery of other countries. Now the question is: how long will this process continue? What could derail it? What can be done to minimize the risk that this promising recovery will suddenly stop? As always, several risks exist. We would like to comment on them.

A year or so ago, we would have been seriously concerned about the regional implications of a renewed recession in Japan. But today, thanks to the strength of domestic demand in other Southeast Asian countries, and the strength of external demand in other advanced economies, Japan's continued predicament is less of a threat to the region. This being said, the repeated failures of large fiscal stimuli to bring Japan onto a path of self-sustained growth raises serious questions about whether the additional public spending was of a kind that could strengthen consumer and business confidence, and whether the authorities have succeeded in resolving the serious structural problems, particularly the debt overhang and the accompanying weakness of financial and corporate balance sheets.

In the short-term, Japan's growth outlook is not bright. Even if everything goes well from now on and the authorities make faster progress with corporate and bank restructuring, that process will probably temporarily depress labor income and consumer spending, which will delay the beginning of self-sustainable growth still longer. Until private demand takes over as the motor of economic growth, the authorities have no alternative but to continue jump-starting the economy by continued fiscal stimulus, while maintaining a zero interest rate policy. It is true that this will add to the already enormous public debt. But a public debt of 140 percent of GDP in a growing economy is better than a public debt of 130 percent of GDP in a stagnant economy. Japan should at all costs avoid continuing the mechanical implementation of new fiscal packages without making any real progress with structural reforms. Leaving Japan with a large public debt and an insufficiently restructured economy would have serious implications for its economic future.

We also think that Japan should consider explicitly targeting a low positive inflation. It is possible that this might have some effect on inflationary expectations and reduce real interest rates. Of course, there is a question whether targeting low positive inflation could be seen as credible in the present monetary policy setting. Perhaps unsterilized interventions in the foreign exchange market should be considered.

Another major potential problem is lurking on the other side of the globe: the persistent large external financing needs of Latin America at a time when the availability of private resources is still uncertain. In contrast to Southeast Asia, domestic demand did not collapse, and with a few exceptions neither did exchange rates. As a result, Latin American current accounts did not strengthen very much.

Looking ahead, it is expected that Latin America's current account deficits will increase gradually, while the outlook for better access to external financing remains cloudy. If the growth of current account deficits in the region turns out to reflect stronger growth and a larger demand for investment to be satisfied by foreign savings, market confidence could improve and the needed amounts of financing could become available. But such an outcome is far from certain. One of the most serious vulnerabilities of the region lies in its low level of domestic savings, which forces it to rely heavily on foreign savings to achieve a sufficiently rapid rate of growth. But because the availability of external savings is sensitive to domestic or external shocks, these can have an exaggerated effect on the growth performance of countries in the region. For reasons we will discuss below, we are concerned that a larger than expected rise in U.S. interest rates could turn out to be such a shock. The main policy implication of this exaggerated vulnerability to external shocks is that these countries need to increase their domestic savings, especially public sector savings, in order to reduce their dependence on external savings. Increasing domestic savings is especially urgent for countries that cannot reduce their dependence on external savings by adjusting their nominal exchange rates.

It is hardly new to observe that the U.S. economy faces the risk of overheating and rekindled inflation. The Fed is aware of this risk and has been gradually raising interest rates with a view to slowing growth to a safer pace. But despite a full percentage point of increase since the fall of 1998, as yet there are few visible signs that growth is slowing. Some say the Fed is wisely and boldly testing new limits of growth. We do not think this is a correct view of the matter. We agree that the growth rate of potential output has increased in recent years, but find it hard to believe it has reached 4 percent. It would be our guess that if the Fed had known early in 1999 that growth would get as high as it actually did, it would have tightened monetary policy more aggressively. Accordingly, we think this "testing of growth limits" was to some extent unintentional, and there must certainly be feelings of relief in the

corridors of the Federal Reserve that up to now this "testing" has not gone wrong.

We see two important factors that further complicate the conduct of U.S. monetary policy. The first is the rapid increase, in recent years, of non-debt corporate financing, both in the form of IPOs and private equity plus venture capital. Mostly used to finance the expansion of new high-growth companies, non-debt corporate financing has grown from \$87 billion in 1995 to \$230 billion in 1999. The NASDAQ stock index increased further in 1999, fueling expectations that venture capital and private equity financing will continue to grow rapidly. These changes in the composition of corporate financing have important implications for monetary policy. The increased use of non-debt financing makes monetary policy less effective as a means of slowing investment spending and economic growth. In addition, because this source of external financing is mostly available to the new high-growth companies, the effects of monetary policy will be asymmetric, bearing most heavily on the old sector companies that rely mostly on bank financing. This policy asymmetry is not necessarily a bad thing: it could speed the reallocation of capital from old, declining sectors to new companies. But it means that a larger interest rate increase could be needed to achieve the required deceleration of domestic demand, and this could have unwanted consequences. It could reduce the availability of foreign financing for emerging market economies, which would be particularly unfortunate for the vulnerable countries of the Western Hemisphere. In addition, it could trigger a significant correction in U.S. equity prices.

This brings us to the second factor complicating the conduct of U.S. monetary policy, namely, the role of asset price behavior. For various reasons, well set forth in the WEO document, asset prices are taking on a new importance for policymaking and economic development in the industrial economies. This is not surprising: years of increasing equity and real estate prices in most industrial countries have brought about an increase in the wealth held in these assets, and also have increased the exposure of financial institutions to changes in the prices of these assets. What should monetary policy do about movements in asset prices?

Here we see a parallel to the question of how monetary policy should react to movements in the exchange rate under a floating exchange rate regime. In our view, monetary policy should not target any particular level of asset prices, but should not ignore the effects of asset price changes on economic activity and inflation. The monetary authorities in small open economies with large capital flows sometimes encounter the following dilemma. The interest rate increase needed to achieve the inflation objective can, during periods of large capital inflows, make the exchange rate appreciate and ultimately bring about a competitiveness loss that causes the capital flows to reverse direction, the exchange rate to collapse, and inflation to increase.

An extreme statement of this dilemma is to express it as a choice between higher inflation now and higher inflation later. Monetary authorities in the United States, and perhaps some other industrial countries, could find themselves facing a similar dilemma involving equity prices. The interest rate increase large enough to align domestic demand growth more closely with potential output growth could bring about a large decline in equity prices, with all the consequences described in the staff's hard landing scenario. But trying to avoid this outcome by raising interest rates in small increments would probably only succeed in putting off the collapse and slowdown of economic activity until later.

Theoretically, it should be possible to use fiscal policy to slow the growth of domestic demand (and thus avoid the undesirable effect on equity prices of a monetary tightening), or else to use prudential or tax measures to slow the growth of asset prices (for example by increasing margin requirements). But a further tightening of fiscal policy when the budget is already in surplus seems politically unrealistic. In addition, as the staff points out, there is much to be said for a stable medium-term fiscal policy stance that does not change in response to economic developments (aside from automatic stabilizers). In addition, the usefulness of prudential and tax measures is limited. For example, the Fed has serious doubts whether it is useful or desirable to increase margin requirements as a way of reducing the risk to the financial sector of financing the equity market boom. Probably the best we can hope for is that there exists an interest rate path capable of achieving a soft landing for both the U.S. economy and the equity market, and that the Fed is skillful enough to find this path.

During last week's discussion of monetary and exchange rate policies in the Euro area, some Directors were concerned about the sustainability of rapid growth in Europe. While the sustainability of long-term growth might be disputed, it is broadly agreed growth in the Euro area is going to pick up in 2000, perhaps more strongly than the WEO predicts. Such a pickup will be welcome not only from a European but also from a global viewpoint, because it will contribute to a better rebalancing of growth in the world economy and lead to the correction of external imbalances and exchange rate misalignments. And although the concern may be valid that the weakness of the euro may require a larger and perhaps more disruptive correction later on, for the present it could assist in the rebalancing of growth.

However, there is still a question whether the acceleration of growth in the Euro area, and some slowing of growth in the United States, would by themselves suffice to bring about the correction of external imbalances and exchange rates misalignments. Ms. Lissakers raised an important point during last week's discussion of the Euro area, when she pointed out that capital moves from Europe to the United States not only in response to phase differences in their business cycles, but also in response to the more attractive

U.S. investment climate. The conclusion seems clear that as long as there are large differences in the investment climates of Europe and the United States, outflows of capital from Europe will probably continue, and so will differences in economic growth together with their effects on exchange rates and external imbalances. We would therefore agree that accelerating structural reforms in Europe must be seen as part of the solution to the problem of external imbalances.

Finally, we note that divergences in the growth and inflation performances of the so-called core and peripheral countries in the Euro area are becoming increasingly visible. These divergences have potentially troublesome implications. As long as monetary policy remains—correctly—focused on monetary conditions in the Euro area as a whole, accelerating growth in the peripheral countries will render the prevailing monetary conditions too easy for them, and the problem will become even more serious if inflation picks up, thereby reducing real interest rates. This monetary stimulus will be magnified by the weak euro. It is not hard to imagine this process continuing: further increases in inflation, further declines in real interest rates, further acceleration of domestic demand, and so on. It is particularly worrisome that fiscal policy in the peripheral countries was if anything rather stimulative. Given the paucity and limited effectiveness of other tools (regional labor mobility, tax regulations), we think fiscal policy must be used much more forcefully if these countries are to avoid serious overheating and economic destabilization. We also think that Fund surveillance should urgently monitor these developments and that the Fund should send, if needed, a strong signal of concern to the authorities.

Mr. Shaalan and Mrs. Farid submitted the following statement:

While we can legitimately derive substantial satisfaction from the much stronger than anticipated rebound in global economic activity following the 1997-98 slowdown, it is also difficult to set aside the accompanying feeling of unease stemming from the persistence of unsustainable imbalances that have the potential to unravel suddenly and adversely impact the global economy. Appreciating the risks lurking beneath the currently favorable situation is made all the more difficult when the forward outlook continues to be optimistic, with projections for 2000 being raised and the risks, as the staff put it, appearing to be mainly on the upside. This upbeat assessment is feasible based on what appears to be a continued strong forward momentum in the United States, the possibility that recovery in Europe might be more robust than projected, as well as on the continued success of the stabilization strategies pursued by the crisis-hit countries demonstrated by the return of confidence and the recovery of economic activity in Asia, in particular. However, as underscored by the staff, the favorable outlook does not mean that concerns are absent. Complacency, which would be the single most important danger facing the robust outlook, must be avoided, particularly

since policy makers in both the larger industrial countries and in emerging markets, are expected to be faced with delicate and difficult policy decisions, which will have a significant impact on the global economy.

Before addressing the concerns about the economic outlook identified by the staff, we would like to put forward a few propositions regarding certain key financial indicators and raise the question of what they might possibly indicate. Thus, while underlying the baseline projections in the WEO are a variety of positive factors in the major regions of the world, the behavior of a number of major financial indicators which show sharp divergences raise some concerns. On the one hand, we have equity markets at or near record levels in a number of major markets. We also are seeing emerging market spreads narrowing. These two indicators would suggest that equity and financial markets are forecasting a robust world economy. However, with regard to the latter indicator, the question can be raised whether the markets are discounting emerging market risks too rapidly, given the anticipated increase in interest rates in the U.S. and Europe. Furthermore, in contrast to these possibly positive indicators there are a number of other financial indicators that may be signaling risks ahead. In the U.S. corporate sector spreads on high grade corporate debt currently stand at relatively high levels and the default rate on junk bonds is going up. Moreover, swap spreads are today higher than at any time since the Russian crisis. Finally, the past few months have seen a sharp inversion in the yield curve, accompanied by a high degree of volatility in yields. If, as expected, the Federal Reserve were to raise interest rates further while at the same time the U.S. Treasury continues to buy back its long term obligations, this may well cause a steeper yield inversion. We would appreciate the staff's views on these thoughts and particularly whether or not these indicators have any significant bearing on the prospects for the world economy. Additionally, while the Federal Reserve has raised interest rates in the past nine months by 100 basis points, at least so far, this tightening has done little to restrain demand. Is it too early to see the impact of this tightening or could it be that the wealth effect has overwhelmed the impact of monetary policy? Again, the staff's comments would be appreciated.

Turning to what the staff has labeled "serious" concerns about the global economic outlook:

We were somewhat surprised at the placement of the increase in oil prices since early last year as one of the staff's top concerns, particularly since the analysis later in the report (p. 56) leads us to conclude that the inflationary effect of the oil price increase on the world economy can be expected to remain modest. While it may be argued that significant further increases in oil prices, if maintained over a prolonged period of time, could threaten the currently benign global inflation outlook, the present situation in the oil markets does not point in that direction. Neither the current level of oil prices

nor the apparent low probability that these prices will be maintained for a prolonged period of time, could be construed as presenting a serious threat to the momentum of global recovery. First, as the staff points out, the recent rise in oil prices represents a recovery from exceptionally weak levels in early 1999 and in fact brings them back closer to a long-run equilibrium. Second, since it is not in the interest of the major oil exporting countries to have prices remain at their current levels, it is reasonable to believe that a supply increase is forthcoming. This would be expected to lead to an easing of prices, possibly as early as this summer. The oil producing countries have always maintained that a steady nonvolatile price for oil was in the best interest of both producers and consumers alike. Third, despite the media noise in industrialized countries, the sharply reduced role of oil in the world economy in the past two decades has meant that the consequences of price increases on oil importing countries are significantly smaller than they have been in the past. These factors are particularly relevant when projecting the extent of global monetary tightening that would be needed to counteract the effect of the oil price rise on inflation. So far, the impact on inflation has been limited to the energy components of general price indices, without second round effects on wages and other costs. The staff finds that the more important impact is to be seen on real incomes and domestic demand through the terms of trade. This would imply that by directly impacting domestic demand, the oil price rise itself, particularly if there are no or little second round effects, could diminish the extent to which a tightening of monetary policy may be necessary in the U.S. For all these reasons, the risks to the world economy emanating from the recent increase in oil prices are, in our view, exaggerated. The problems emanating from the oil sector are more related to the sharp volatility in price over short periods of time. Far more serious, would be the risk of a sudden reversal of the global economic and financial imbalances that have been building for several years.

The twin concerns, the one arising from the expanding external payments imbalances between the U.S. on the one hand and Japan and the euro area on the other, and the related significant misalignments of the key currencies relative to medium-term fundamentals, continue to pose a serious risk to global economic stability. Moreover, domestic imbalances, particularly in the U.S. as reflected in the continuing high valuations of equity and asset prices and the negative household savings rate, continue to add to the fear of potentially sudden shifts in market sentiment. We fully concur with the staff that if these imbalances were allowed to increase further their potentially disruptive effects could become much more serious, while at the same time, the chances of a "soft landing" would probably diminish. In this regard, the Federal Reserve has a most delicate task ahead of it. Whether the continuation of a gradual tightening of monetary policy will slow down demand is an open question. Will a more aggressive stance be needed to slow down the economy? The latter course of action could have serious negative ramifications on the world economy. This is a difficult decision. Given these

considerations, fiscal policy in the U.S. assumes added importance in containing excess demand pressures; and we join the staff in their recommendation against a significant relaxation of the fiscal stance, including the possibility of significant tax reductions motivated by the election agenda. The pick up in growth in Europe is also very encouraging. However, euro area monetary policy should not be guided by defending the weak euro, since a premature tightening could abort the nascent recovery. Fiscal restraint would be a preferable course of action to curb demand pressures in the euro members experiencing strong growth. Here it is worth repeating that there is no good alternative to addressing the deep-rooted structural weaknesses of a number of major European economies. The successful introduction of such reforms, particularly in the labor and product markets and in the fiscal area in a number of smaller European economies has been encouraging. Meaningful action in the larger economies of Europe would sustain the recovery and help reverse the depreciation of the euro. The outlook in Japan, on the other hand, remains subdued, pointing to the need for greater progress on structural reforms while continuing to keep monetary policy as accommodative as possible, even if that were to contribute to some price pressures.

It is gratifying to see that the crisis-hit Asian economies have made stronger than expected recoveries from the 1998 recessions. Moreover, projections for 2000 indicate a continuation of the recovery, which is also expected to become more evenly balanced across the region. External vulnerabilities have been significantly reduced with the substantial reduction in short-term foreign currency liabilities, the strong turnaround in current account balances and substantial corrections in exchange rate levels. Vulnerabilities still exist however, in particular, with regard to the possible shift toward short-term debt inflows before financial systems are restructured further. Here, we would underscore the need to implement prudential and supervisory control rigorously. In the period ahead, continued progress on financial and corporate sector restructuring will be critical to the sustainability of strong growth. Addressing the paucity of bank credit to the corporate sector, particularly in the absence of other forms of financing at this time, is of utmost importance. Since maintaining interest rates at low levels will be important to facilitate banking and corporate restructuring, the move to a more neutral macroeconomic stance should therefore be borne primarily by a tightening of fiscal policy.

It is also comforting to note that the economic downturn in Latin America in 1999 was generally milder than expected, and that a broad recovery is expected to emerge in the region in 2000. The downturn was more short-lived than that of Asia, and the banking and corporate sectors were, for the most part, not devastated by the crisis. (It would be instructive if the staff could provide us with possible reasons for the differing impact between Asia and Latin America on their respective financial and corporate sectors.) However, persistently high current account deficits, high debt servicing

obligations and still limited access (though improving) to capital markets, makes countries in the region vulnerable to reversals in market sentiment and capital flows. The vulnerability associated with the current account deficits would be accentuated should a sharp drop in U.S. economic activity materialize. On the capital account, clearly the extent of further interest rate adjustment in the U.S. is particularly relevant to the regions' prospects and could be expected to impact capital inflows significantly, necessitating substantial external and domestic adjustment, particularly in cases where debt servicing requirements and current account deficits are high.

In the Middle East, following a period when oil prices reached a 15 year low in nominal terms in 1998/99, economic prospects improved for most countries in the region with strengthened budgets and external accounts. Here, it is well to note that during periods of low oil prices and the resultant rise in budget deficits, the major oil producing countries took corrective actions by restraining expenditures and introducing a number of revenue enhancing measures to ameliorate the impact of the decline in government receipts from the oil sector. Budget deficits were financed from the foreign exchange reserves accumulated during periods of high oil prices. The pursuit of this prudent policy has served the region well. It is also noteworthy that the oil producing countries of the region intend to maintain the relative restraint on public expenditure despite the recent increase in oil revenues. As the staff points out, growth prospects in other countries in the region have also improved. Strong growth with low inflation continued in Egypt and a pick up in economic activity is projected for a number of countries. While the external accounts in Egypt have been under pressure at times during the past year, the restraints placed by the authorities on credit expansion has restored relative stability in both the exchange market and the level of reserves which remain far in excess of short-term liability. The current account balance has improved considerably in 1999 compared to the previous year. In the past several months, Egypt has also completed the preparation of a sizable number of companies for their privatization in 2000. Measures, including clearing legal hurdles, are also underway in a number of countries to spur and expand the scope of private sector activities.

In Africa, it is heartening to see projections for 2000 indicate a pick up in economic growth in a number of African countries where macro-stabilization and structural adjustment are becoming ingrained as part of the reform culture. However, institutional and structural impediments to growth coupled with heavy debt burdens in many African countries still constitute inhibiting factors to growth. The combination of debt reduction, including the provision of concessional assistance, accompanied by institutional reforms would go a long way in laying a solid basis for robust and sustained growth. We, therefore, attach high importance to the timely and full implementation of the HIPC/PRGF enhanced Initiative in eligible countries. We also urge the industrial countries that still engage in protectionist measures, particularly in

the agricultural and textile sectors, to dismantle these restrictions to allow African, and developing countries generally, to increase productive capacity and exports in these sectors. Without these three ingredients, namely structural reform, debt relief, and meaningful trade liberalization; it is difficult to see how growth and a reduction in poverty can materialize.

In this connection, we particularly welcome the WEO's strong emphasis on the shortcomings of the present global trading system vis-à-vis developing countries. The report notes that while many developing countries are already advanced in their efforts to open their economies to trade, few industrial countries have allowed developing countries substantially unimpaired or unlimited access to their markets on a unilateral basis. Progress by industrial countries in opening their markets to developing countries has been largely confined to regional and bilateral trade arrangements, which benefit only selected countries. More importantly, even in such arrangements, the present system of trade preferences excludes precisely those sectors where many developing countries have the greatest potential to expand and diversify their exports, namely agriculture, textiles, and footwear. Additionally, the staff points out that the complexity, impermanence, and lack of transparency in these arrangements have discouraged the desired response in investment and trade. It is high time that meaningfully improved access to industrial country markets be placed firmly at the top of the international community's agenda and that progress in this area be made a top priority.

Mr. Barro Chambrier submitted the following statement:

Global economic and financial developments since the last WEO exercise have been rather encouraging. The downside risks that we were concerned with last September have not materialized. On the contrary, we are witnessing a more robust improvement in the economy of many countries, about which there were some doubts. We are thus encouraged by the firming of the recovery in Southeast Asia, as well as by the better performance of Latin American economies, which are recovering faster from recent regional financial crises. Economic performance in the Euro area also seems to be more buoyant than anticipated. The concerns raised as regard the sustainability of the U.S. economic expansion and correction in equity prices have not materialized. If anything, the expansion seems to have gathered momentum, with no significant increase in inflationary pressures. The economic prospects for the Middle East and Africa have also improved significantly with a few major economies registering higher than projected growth, especially due to a firming of oil and metal prices. On the other hand, the nascent economic growth in Japan does not appear to have been sustained, as preliminary estimates indicate weak growth, with the Yen remaining strong.

On the whole, the picture that emerges from the present WEO exercise should be one of broad satisfaction from the improvement in economic and

financial conditions. However, apprehensions remain as regards the magnitude of economic and financial imbalances within regions and among trade partners, and notably with the uneven pattern of growth. It is clear that in the case of the U.S. and a few other industrial countries, the external deficits have become unsustainable. The issue is how to minimize the disruptions that will follow from this correction. Similarly, the imbalances have led to the misalignment of some key currencies whose values are inconsistent with medium-term fundamentals. Moreover, there is concern about the large increase in the equity and property markets in some industrial countries.

While welcoming the broad improvements in economic performance of developing countries in general, and of African countries in particular, we note that at 4 percent real growth in 1999, this is well below the continent's potential. Moreover, one cannot but be concerned at the fact that the rising level of global prosperity is passing by a large segment of the world population, with the number of people living on less than one dollar a day remaining the same over the past decade, with no clear prospect of an improvement in their living conditions. We, therefore, welcome, the excellent analysis made by the staff on poverty and growth, and for the policy recommendation it contains.

The study clearly notes that there are a number of factors responsible for the low economic development of Africa. Some are of an economic nature, others are not. Also many of the causes are of an exogenous nature. The burden of external debt, low and inadequate inflows of capital, falling commodity prices and the difficulty to access industrial countries' markets are important factors that have handicapped the efforts of these countries to achieve a higher level of economic growth, and made it extremely difficult to service their external debt. While these countries have been undertaking comprehensive macroeconomic and structural reform programs over a number of years, progress has remained below expectations. Therefore, the PRGF and the HIPC Initiatives come at an opportune time and can help these countries get off from under the weight of the debt and improve their growth prospects, but to make a difference the reform efforts should be supplemented by additional concessional financing, and an opening of markets to these countries' exports. While the staff's study recognizes the need for financing and trade, it does not place enough emphasis on the financing part. For most sub-Saharan African countries, official development and multilateral assistance have been their main source of financing, and while these have been helpful, they have been inadequate. Developing countries that have been more successful appear to have been able to draw on a higher level of financing by both the public and private sectors. Perhaps the staff may want to comment on this issue, and especially on the prospects for "graduating" from PRGF financing. Moreover, we remain concerned at the fact that HIPC financing has not been fully ensured yet.

The HIPC countries are not the only ones where poverty is a major problem. Many countries classified as middle-income, also suffer from many of the same problems as the HIPC countries. Although their average per capita incomes are higher than the HIPC average, a large segment of their population share the same level of poverty as in the HIPC countries. Moreover, a large number of these countries are heavily indebted. Unless an appropriate debt exit strategy is put in place for these countries, one that complements their reform efforts, it is hard to see how they can break away from the cycle of poverty, and achieve any significant growth rate.

The main issue for the more advanced economies is how to achieve better-balanced and sustainable growth, one that will ensure continued global prosperity. In the US, there are still no serious signs of overheating, although concerns are being expressed at the very low unused capacity, the impact of the sharp increase in oil prices and the increase in external imbalances. There is also the issue of a misalignment of the exchange rate. Presently, the US is running a fiscal surplus, and monetary policy has been tightened slowly but gradually. Yet the economy continues to grow at a robust pace. Productivity may also be increasing at a faster rate than in the past. In the event, we would favor the present stance of policies as we think that they can help achieve a soft landing.

The sharp increase in equity prices is also an issue that raises much concern. However, a tightening of monetary policy may be the wrong instrument to use to drive the market down, because it will affect the whole economy, and many traditional industries that are not "overheating" may bear the brunt of the tightening. The strong growth in the equity markets appears to be fueled by demand for technological industries' shares, and these are being financed through non-debt creation. Increasing consumer and business confidence and expectation of high returns is driving this market. Fiscal policy and adjustment in the regulatory environment may be more appropriate tools to use to deflate possible "equity price bubbles". Tax laws may be reviewed to encourage long-term investment rather than short-term speculation, and rules as regards buying on margins may need to be reviewed.

In the Euro area, we view present monetary policies as appropriate. There is still room for growth and there are no signs of inflationary pressures building up. However, efforts will be required to bring national fiscal deficits down and to reduce the debt to GDP ratio. Also, as noted in previous discussions, the national authorities will need to focus more on structural reforms. The issue of divergences in economic performance among Euro area economies may also be a cause for the lack of confidence shown in the Euro.

As regards developments in emerging markets, these are moving in the right direction and appear to be more robust than earlier expected, indicating the increased confidence of markets in the policies being followed. However,

the steadfast pursuit of structural reforms, especially in the financial and corporate sectors, should remain the primary objective. It will be important that the authorities in these countries resist pressure for an easing of structural reforms as the economies rebound. Moreover, the faster recovery should make the authorities weary about inflation, and fiscal and monetary stimulus need to be gradually removed.

In Latin America, despite the fact that it avoided a sharp region-wide contraction during 1999, as many countries maintained prudent macroeconomic policies and pursued structural reforms, the external account position remained weak. As these economies recover, it is likely that the external deficits will increase and could increase the vulnerability of these countries. This could worsen if there is a slow down in the U.S. economy. The recent currency adjustments in several countries have been in the right direction, but more efforts will be needed to reduce the fiscal deficit and improve the savings ratio.

As regards the impact of oil prices, it may have a larger adverse impact on the economy of the euro countries than on the U.S. due to their higher dependency on imported oil and the rigidity in wage determination. Similarly, the growth and financial prospects of emerging and developing countries are likely to suffer from continued high oil prices. It is an exogenous shock that will affect the reform efforts of many developing countries. On the other hand, we note that the recent increase in prices have contributed significantly towards improving fiscal and external current account positions of oil exporters, most of which are developing countries, and whose economies and finances had suffered much during the sharp fall in oil prices in 1998 and the early part of 1999. While we agree that a prolonged period of unusually high prices can adversely affect global economic growth, we are also of the view that prices close to the long-term equilibrium are in the best interest of all.

Finally, we found the section on "The World Economy in the 20th Century" very interesting, as it helped to place the whole process of economic development in the right perspective. We noted some of the issues on which the 20th century failed, and we agree that the major challenge that we face at the dawn of the new millennium is to ensure the stability of the international financial system and "to raise the productive capacity and incomes of the fifth of the world population (some one billion people), who remain in the grip of poverty and whose command of goods and services has hardly increased."

Mr. Bernes and Mr. Fenton submitted the following statement:

The staff has again written an excellent report. And we find ourselves in broad agreement with the major policy recommendations. We also welcome the staff's commitment to provide updated projections taking account of recent developments in world oil prices.

The world economic situation has definitely improved in the past year. And one of the most welcome features of the improvement is its widespread nature—most regions of the world, including those that have recently suffered severe economic setbacks, are experiencing stronger growth. The improvement in the world economy notwithstanding, the need for continued skillful economic management has, if anything increased. This somewhat paradoxical situation is owing to the fact that some countries are now charting new territory, operating near or above conventional estimates of potential output, while other countries, which are experiencing a pick-up in growth, have not undertaken the deep structural reforms needed to support such growth on a sustained basis.

We agree with the staff that the widening internal and external imbalances in the U.S. economy, with the attendant danger of a disruptive adjustment process, are a major worry for the world conjuncture. But it is important to emphasize that the responsibility for the resolution of this risk does not reside solely with the United States. Other countries, particularly Japan and the major countries in the euro area, must sustain a faster rate of growth than they have managed in recent years.

Near-term growth prospects for the Japanese economy have been revised down since the October 1999 World Economic Outlook. Although some rebound is expected at the beginning of 2000, owing to the implementation of previously announced fiscal measures, there are still no signs of a sustained recovery in private domestic demand. And there are many factors that will tend to depress aggregate demand in Japan over the near term. These include the past appreciation of the yen, the ongoing restructuring in the industrial and financial sectors, and the oil price shock. In this context, the staff's forecast for growth in Japan in 2000 may still be optimistic.

Accordingly, we would recommend more strongly than the staff does that Japanese authorities act to ease monetary conditions to ensure that a self-sustaining recovery finally emerges. In particular, the Bank of Japan should consider larger injections of liquidity. Larger injections of liquidity may help to ease monetary conditions in two ways; they may lead to lower interest rates further along the yield curve and they may lead to a lower value of the yen, which in current circumstances would be acceptable. The adoption of an explicit inflation target might also help anchor inflation expectations and lower real interest rates. We recognize that further increases in liquidity will not necessarily translate into increased lending in an environment where banks are reluctant to lend and many corporations are not in a position to borrow. Strengthening the domestic financial sector remains key to restoring confidence and alleviating the "credit crunch" that is reflected in the continuing declines in bank lending and low growth of the money supply (M2+CD). While there are encouraging signs of restructuring in the banking and corporate sectors, such as the various mergers of several banks and the

purchase of the Long-Term Credit Bank by a foreign consortium, further reforms are needed. More generally, the government should proceed as quickly as possible with reforms on a broad front including the financial sector, the corporate sector, the labor market and agricultural policy. We would also recommend that fiscal policy continue to be supportive of expansion in the near term. But it is important to recognize that stimulative fiscal policy is fast approaching its useful limit. Debt buildup in Japan has become a concern, especially in light of its relatively older population.

Growth in the euro area picked up in the latter part of 1999 and a moderate pace of expansion is expected over the near term. Nevertheless, the economy is expected to remain in excess supply in the near term, and core inflation should remain well below the ECB target over the next two years, although the rise in world energy prices will provide a temporary boost to headline inflation this year. In that context, we would reinforce the staff's recommendation that the ECB should not raise official interest rates too hastily. We find the increase in the discount rate on March 16 to be questionable, coming as it does on top of a 75 basis point increase in recent months. Europe would be better served with a policy mix of tighter fiscal policy and a neutral stance of monetary policy.

We strongly agree with the staff's analysis that structural reforms and continued improvement in structural fiscal deficits are needed to enhance medium-term growth prospects in the euro area. With regard to fiscal policy, the performance of the euro area as a whole has to be characterized as disappointing. Despite the improvement in economic circumstances, 1999 marked the second consecutive year of little adjustment effort as measured by the sum of the reductions in the deficit and the tax burden. It is imperative that the larger members of the EMU, in particular, take advantage of the current economic conjuncture to put the public finances on a sustainable footing and to reduce the high tax burden, especially on labor. In this regard, the plans to cut taxes announced by France, Germany, and Italy are welcome, but it is important that they be appropriately balanced with reductions in government expenditures.

The performance of many members of the EMU, particularly some of the larger countries, also continues to be disappointing with regard to structural policies. There has been some progress, but not enough. The successful functioning of a common currency area with members that experience idiosyncratic economic shocks requires flexible factor and product markets. Some members of EMU are not doing enough to enhance the flexibility of their labor markets, especially the flexibility of wages for workers with lower skills or less work experience. This is important for the viability of the euro; it is also important for the growth prospects of these countries. The comparatively strong growth performance of countries such as Denmark, Finland, Ireland, the Netherlands and the United Kingdom, which

have done more to increase the flexibility of their markets in general and their labor markets in particular, should serve as a lesson for other countries of the value of undertaking structural reforms.

For their part, the U.S. authorities need to facilitate a slower and therefore more stable growth rate in the U.S. economy without triggering an abrupt correction or hard landing. Along with persistent excess demand, there are a number of other imbalances—including a growing deficit in the external accounts, a low private savings rate, and possibly overvalued stock markets—that potentially threaten the stability of the U.S. economy. Moreover, these imbalances tend to reinforce each other over time. To date there is no evidence that the required slowing in the economy is in progress. To bring this about, monetary policy will have to strike a fine balance. A timely rise in official interest rates is needed. Although there is a risk that the adjustment might be more abrupt than desired, postponing it could prove considerably more costly. As well, the authorities should eschew stimulative fiscal policy measures in favor of addressing longer-term financial requirements of an aging population.

The juxtaposition of the Latin American and East Asian economies in the report is useful in pointing out how the two regions reacted differently to the emerging market financial crisis. However, we are left to wonder why, for example, Latin America managed to avoid the sharp economic downturns observed in East Asia? Was it differences in the policy reaction to the crisis between the regions, or a difference in the severity of the crisis in each region, or fundamental differences in the structure of the economies or the strength of the financial sectors in each region?

Also, in our view, the staff's list of downside risks to the outlook in Latin America does not go far enough. While important labor and fiscal reforms have been undertaken in key economies, such as Brazil and Argentina, the prospects for fiscal slippage remain high. Also, unless the proposals for structural reforms translate into concrete actions, economies will remain particularly vulnerable to external shocks.

We agree with the staff that fiscal policy has provided important support for recovery in Asia, and should continue to do so where necessary until growth is firmly established. But as recoveries in these economies strengthen, some tightening of fiscal and monetary policies will be needed to avoid overheating. While some Asian countries have taken major steps in financial and corporate sector restructuring, progress remains mixed and much remains to be done.

One lesson that is very obvious from the report is that countries that have undertaken substantial structural reform have generally enjoyed better economic performance than countries that have not. The evidence is clear for

literally any continent one might care to look at. Consequently, we strongly agree with the staff's recommendation that countries such as China, India, and the Russian Federation, as well as most of the economies of Africa should pursue structural reforms with greater determination.

The staff has raised the issue of the importance that should be attached to asset prices in the formulation of monetary policy. In this regard, we believe that asset price developments should be monitored along with a variety of other inflation indicators. Nevertheless, the policy target should remain goods and services prices. The Canadian experience suggests that certain asset prices contain indirect evidence about expectations. Early in the inflationary surges of the 1970s and 1980s, real estate prices increased rapidly, and long-term bond yields rose. Similarly, the yield differential between conventional and real return bonds, in countries where they exist, should be sensitive to any major change in inflation expectations.

On page 114, the staff mentions circumstances in which pre-emptive monetary policy actions should be taken in regard to asset price movements. We wish to emphasize that such circumstances are exceedingly rare. As the staff points out, models of asset prices rely on unobservable variables so there is always a fairly large confidence interval around any estimate of an equilibrium asset price, and authorities should proceed with caution when using this information. A current example reinforces this point. Many observers think that U.S. equity prices are overvalued and monetary policy should be used to gently prick this bubble. Many of these observers made the same point in 1997, however, and we wonder if, with the benefit of hindsight, they still think that equity prices were indeed overvalued then. We also want to reinforce the point that it is important that countries maintain their regulatory and supervisory frameworks up to date so that, should an asset price bubble occur, it does not result in a serious bad loan problem for the banking system.

The chapter "How Can the Poorest Countries Catch Up" provides a useful review of the evidence on the main impediments to growth in developing countries where poverty rates remain high. We agree that it is difficult to identify statistically a single model for growth in these countries. Nevertheless, successful developing economies seem to share policy characteristics such as macroeconomic stability, good institutional infrastructure, and openness to international trade. Similarly, poor education and health, ineffective or corrupt governance and weak rule of law often characterize economies with chronic poor performance. These observations, together with the realization that unsustainable debt has become a barrier to growth and poverty reduction in some countries, provide the basis for a strategy for improving economic performance in poor countries.

Mr. Al-Turki submitted the following statement:

The world economy appears poised for faster growth this year followed by a slight moderation in 2001. The improved overall growth prospect across all regions is a welcome departure from concerns in the fall 1999 World Economic Outlook over global deflation and recession. Partly an expected outcome of improved policies, it is clearly still too early to seek a full accounting of what else has gone right. Indeed, the uncertainty is mostly over whether the growth moderation in the major cyclically advanced economies will be "soft" or "hard". Here, I am encouraged that even the staff's alternative scenario points to a somewhat mild adverse impact mostly limited to the United States. That said, the wide divergence of growth within the regions and the persistence of poverty in many countries are concerns demanding attention. I therefore welcome the staff's focus on identification of the world economy's vulnerabilities and policy imperatives at this juncture.

Turning first to the recent oil price spurt, I noticed a dichotomy between the staff's summary statement and the detailed analysis in the main report. The report's mention of the inflation generating potential of oil is appropriately hedged. Thus, the substantial reduction of oil's significance to global production costs because of technological changes and the sharp drop in the real price of oil during the last quarter century are duly highlighted. There is also an appreciation that the recent rise in oil prices is in large part a result of temporary inventory mismatches and unexpectedly strong global demand. These market developments again underscore the importance of avoiding such volatility and ensuring a measure of stability in oil prices in the interest of producers as well as consumers. Oil producers of course have a vital interest in protecting the global economic outlook. Meanwhile, on the consumer side, a helpful move at the present juncture would be to temporarily roll back the high tax burden that energy products are subjected to in many countries.

Regarding the broader vulnerabilities, the report rightly notes that the leading mature economies are facing "a series of economic and financial imbalances that have been building for years." Attention is also drawn to lessons from experience pointing to unsustainability of the world economy's current mix of persistent growth and payments imbalances, misaligned exchange rates, and asset price inflation. However, the basic underlying question still relates to the timing, depth, and duration of a slowdown in the U.S. and the likelihood that the slack will be offset by an upturn in the rest of the world, especially the euro Area and Japan. This poses a difficult policy dilemma.

While sustainability of the current U.S. upswing may indeed be too good to be true, the concern is also legitimate that premature preemptive action could lead to an unduly early slowdown. Meanwhile, the evidence on

productivity growth confirms earlier impressions that the U.S. economy's inflation barrier may have shifted farther than is commonly recognized. Besides, the global consequences of the risk that the staff outlines in Box 1.1 are somewhat mild, being limited to a rather brief slowdown in the U.S. with less intense adverse effects elsewhere, except perhaps in Latin America. Considering also the stop-go recovery in Japan and the early stage of the upturn in Europe, I continue to believe that the best option for the U.S. still is to remain cautious in taking preemptive action in view of the conflicting signals of pressures on the economy.

Regarding containment of asset price inflation in the U.S., attention should be given to whether a general monetary tightening is too broad an instrument in the absence of convincing evidence on a general aggravation of inflationary pressures in the economy as a whole. Thus, given the substantial incidence of highly leveraged equity financing, a suitably differentiated correction could be considered through, for instance, increased margin requirements for such investments. On U.S. fiscal policy, I endorse the staff's caution against an undue dissipation of the emerging surplus in procyclical revenue and spending measures. This could aggravate demand pressures and thus jeopardize the macroeconomic environment. It is also crucial not to forfeit the opportunity that the surplus offers to provide for unfunded fiscal liabilities related to the aging population.

Turning to Europe, the United Kingdom is showing some signs of rising inflation. However, the evidence is not yet strong enough to warrant preemptive action. The focus should therefore remain on a close scrutiny of a range of indicators as well as efforts to raise the economy's growth potential. Meanwhile, positioning the euro area economy for sustained high growth is clearly crucial for not only the countries concerned but also the rest of the world. In view of the external payments imbalances among the major currency blocks, the focus should be on stepped up structural reform to boost domestic demand and market confidence on the economy's potential for non-inflationary growth. This would warrant increased attention to product and labor market flexibility as well as an end to the remaining restrictions on trade. The maintenance of a broadly accommodative monetary stance is also important, given the radically changed outlook for inflation and the still high unemployment levels. That said, it is important to emphasize that the cyclical positions of euro area countries differ so that the accommodative monetary stance may require appropriate offsets in individual countries—for instance, a suitable tightening of fiscal policy in individual countries.

Japan's stop-go recovery remains a major depressant to regional as well as global prospects. With limits of fiscal flexibility approaching and the monetary stance already highly accommodative, the macroeconomic policy onus is falling increasingly on a more proactive approach to stimulation of credit. The burden for effective policy measures remains, however, on

implementation of long overdue structural reforms. Addressing the widespread structural impediments to growth through banking reforms, corporate restructuring and economic deregulation is critical for the economy's sustained revival.

A particularly welcome aspect of the global turnaround is the inclusion of almost all developing regions in a broad-based upsurge through next year. Commodity prices, which have risen for many but not all primary exports, have contributed widely to the upturn. However, as the staff points out, credit should also be given to the widespread macroeconomic and structural policy improvements that have increased the economies' ability to take advantage of the improved commodity markets. However, growth variance within the regions is considerable. Besides, output has actually declined in several countries, especially in Africa and Latin America.

The general impression of close association between growth performance and receptivity to adjustment and reform underscores the importance of more uniform policy activism suitable to local conditions. Thus, Latin America's recovery has reflected strong adjustment and reform efforts in the major regional economies, including Argentina, Brazil, Chile, and Mexico. The overall performance was weighed down, however, by cases of policy slippage and natural disasters in several countries. The slow response of financial inflows to the region's improving fundamentals can indeed pose a serious threat to the recovery. Policies conducive to increased mobilization of domestic savings are therefore crucial. In Africa also, the regional economy is picking up on the strength of commodity price gains as well as a legacy of adjustments and reforms in most countries.

In the Middle East, the outlook has improved following substantial adjustment and reform as well as the recent recovery in oil prices. The favorable trends are expected to pick up with ongoing fiscal consolidation and structural reform. Meanwhile, Asia provides a particularly encouraging picture as performance in the economies emerging from crises has exceeded market expectations. Mostly export led, the upsurge has also reflected an upsurge in domestic demand. A similar pattern of export and domestic demand growth has helped China and India to maintain their relatively high growth rates. Fiscal stimulation has clearly played a constructive role in recovery of Asia's crisis economies and timing of withdrawal is an empirical matter that can only be decided on a close reading of the recovery's strength. Meanwhile, focus should be on stepping up structural reforms.

Like elsewhere, the transition economies have broadly followed a predictable path of growth divergence linked to differing starting positions as well as adjustment and reform efforts. Whereas Russia and other Commonwealth of Independent States (CIS) countries have lagged in launching market-oriented policies and institutions, those in the Baltic Region

and central Europe with aspirations of European Union membership have pressed ahead. In Russia, notwithstanding recent improvements that followed the oil price rise and continued compression of imports, lasting gains can only come from forceful implementation of the still pending market-friendly reforms. Indeed, the transition countries in general need to heed the lessons of success and failure that are now evident from the experiences of individual countries.

Regarding poverty reduction, the staff has provided a very helpful and fairly comprehensive summary of the Fund's role in addressing this extremely important challenge in pp. 36-37 and pp. 161-167. However, the rest of the nearly 50 pages of text is precisely the kind of poverty analysis that the Fund should not undertake. Given the role that the staff rightly defines for the Fund on poverty issues, reporting to the Board should be accordingly limited. Indeed, the broader issues of poverty's origin and cure are not only highly peripheral to the Fund's agreed agenda on poverty reduction but also too broad to be addressed in the format for today's discussion.

The staff's question on distributional issues presents income redistribution as "a substitute for stronger efforts to raise economic growth." However, the two can also be complementary. Indeed, there is a considerable literature showing how reduction of inequality can actually induce growth geared to the consumption of the poor. Regarding the questions about the debt burden and poverty, the answer is affirmative. The Fund's HIPC and subsequent initiatives are recognition that unsustainable indebtedness is a central impediment to growth.

The staff has made a very pertinent observation in linking persistence of global poverty to trade policies in advanced countries. Thus, on p. 36, the staff stresses how global poverty can be reduced through elimination of trade protection in advanced countries against agricultural products and textiles in which the world's poor have a comparative advantage. More work on this area is clearly promising for opening of avenues for global poverty reduction.

Finally, I have a question regarding the new Purchasing Power Parity (PPP) weights that are of significance to the Fund's assessment of growth rates, as described in Box A1. While PPPs may be analytically superior to raw market exchange rates (MERs) for international comparisons of GDP, it is important to also ensure that the PPPs used are statistically at least as robust and reliable as MERs. This is of particular interest since the WEO PPP weights are being changed. Here, I will appreciate the staff's views on the statistical reliability of developing country PPPs and the effect, if any, of the changes in PPP weights on staff's estimated global growth rates for 2000 and 2001.

Mr. Schlitzer submitted the following statement:

I am grateful to the staff for preparing a very interesting report. The prospects and challenges facing the world economy are analyzed with the usual depth, and the selected issues are well chosen. The section on asset prices sheds light on a topic that is very central to our discussion today, while the others, providing a retrospective on the 20th century, are insightful about the benefits and challenges of economic integration and globalization. My comments will be limited to the short and medium-term prospects.

Since our last WEO meeting global economic and financial conditions have continued to improve. World growth for this year is now projected at 4.0 percent—more than half of 1 percent higher than our October baseline projection—and a similar rate is expected for the year 2001. The reasons for the upward revision are quite simple. First, the crisis in emerging markets is proving to be shorter in duration, as most crisis-hit-economies are undergoing V-shaped recoveries. Second, among the main industrial countries the U.S. economy continues to be buoyant, though we expected a slowdown by more than a full percentage point (from 3.7 to 2.6 percent). This more than compensates for the fact that economic conditions in Japan are not improving as fast as hoped. Another important feature of this improved outlook is the expected acceleration in trade flows, which in real terms should increase this year by more than 7 percent, fairly high by historical standards.

While there are many positive features in this higher-than-expected growth outlook, it must be recognized that it has not allowed the elimination of some imbalances; in fact, some of these have been exacerbated. Hence, there remain considerable downward risks, which are heightened by the recent increase in oil prices. In the industrial countries the risk of an overheating and an abrupt correction in asset prices has become greater. In the U.S., in particular, stock valuations have reached record highs. Chart 8 in the WEMD paper shows clearly that there has never been such a wide divergence between market capitalization and corporate profits (as a share of GDP/GNP) over the last 30 years. Moreover, current account imbalances between the major economic areas remain large and unlikely to be sustainable in the medium term. Among the emerging countries the situations are quite varied, but there remain major sources of vulnerability.

One of the main purposes of the WEO is to outline the possible scenarios for the world economy and suggest policy recommendations. Last year's WEO envisaged, besides the baseline scenario, two alternatives: a Hard Landing scenario and a Higher Growth (or Accelerated Adjustment) scenario. This year we are left with only one alternative: the Hard Landing. This simple fact is indicative of the greater potential risk that the current outlook entails. We are in fact already in a higher growth situation, but this has resulted from a better outcome in the U.S. instead of Japan, thus, it has not absorbed the main

existing imbalances (in other words, it does not carry with it any “accelerated adjustment”).

I fully agree with the staff that a downward scenario is the only sensible alternative to be considered at present. Perhaps the specific realization of it being proposed by the staff (see Box 1.1, An Alternative Scenario) is somewhat pessimistic. It would entail a correction of US equity prices of 25 percent and a depreciation of the dollar of 20 percent. In this sense it appears an extreme characterization of the hard landing. Yet, while perhaps improbable, such an alternative scenario cannot be hastily dismissed. There are a number of trigger mechanisms that can cause such an abrupt reversal: a significant increase in U.S. interest rates due to a tightening of monetary policy; the direct effect of higher inflation expectations (in the U.S.) on earnings expectations, or the simple realization by investors at some point in time that the valuation of stocks is truly excessive. In this respect the clear message sent by the WEO that “..It is therefore becoming a matter of urgency to secure a smoother transition to a more sustainable pattern of growth...” (page 7) is fully appropriate.

The baseline scenario is, as usual, a more reasonable characterization than any of its alternatives. However, from the point of view of surveillance it should be viewed as an objective, rather than as the most likely outcome. Its realization, in fact, requires that the financial policies in the main economic areas continue to be prudently calibrated to their business cycles and, at the same time, to their medium-term objectives and that in emerging market economies the needed structural reforms be fully carried out. Let me consider these challenges in that order.

The U.S. economy continues to sustain a powerful momentum, with the discrepancy between demand and supply being mostly reflected in a widening current account deficit. The burden to assure a soft landing falls primarily on monetary policy, which should remain geared around traditional indicators of inflation while not ignoring the behavior of asset prices. The difficulty here is in interpreting the signals of inflationary pressures, which are quite mixed and influenced by the rise in oil prices. My reading is that inflation is indeed creeping up especially at the intermediate product level. A gradual further tightening of monetary policy to ensure a more moderate pace of economic growth seems therefore appropriate. In fact, consistent with market expectations, the outlook assumes a rise of U.S. official rates by 0.75 percent within the next six months. This should also help cool down somewhat the equity market and foster a recovery of the private saving rate, which has fallen to historical lows. My only concern is that the spread with EU interest rates—which in the WEO are assumed to rise 0.5 percent (half of which has already taken place)—would rise, and this could lead to a further appreciation of the dollar, which could limit the degree of adjustment in the US current account imbalance. The staff’s comments are welcome.

In Japan, the data for the last two quarters of 1999 were quite disappointing. In this connection I am somewhat puzzled by supplementary Chart 10 (WEMD report, page 17), showing that the contribution to growth of public demand has been negative in both the third and fourth quarters. It thus seems that public expenditure has had a strongly procyclical pattern. Staff clarifications would be welcome. Albeit several indicators point to a bouncing back of growth (see chart 11 of WEMD on private orders, the Tankan survey, and housing starts), it is most unlikely at this stage that Japan will surprise us with a strong economic recovery, which would have certainly helped reduce the current account imbalances. Monetary and fiscal policies must remain accommodative in the current circumstances, but it is becoming clear that they have reached a limit and that the future of Japan's economy lies only in structural reforms. It is therefore essential that the authorities maintain the resolve that they have demonstrated so far.

In the euro area the pace of recovery is now quite strong and the growth rate in 2000 may well exceed 3.0 percent. The recent ECB increase in interest rates was thus appropriate and further increases will have to be considered carefully through a balancing of area-wide and individual countries' developments. The Italian economy, which together with Germany's has been lagging behind, is expected to grow by 2.5 percent this year according to the last update of the government's forecasts. The contribution to growth of net external demand will be nil since the rise of domestic demand will trigger a sharp rebound in imports. The increase in wages and salaries in Italy is expected to be moderate: the contracts coming due for renewal during the year concern only a small proportion of employees in manufacturing and services.

While conditions in the world economy continue to be determined primarily by the main industrial countries, the emerging market economies play a larger and larger role in this. Compared to only five years ago, the weight of the non-advanced economies in world exports has risen from less than 30 to almost 33 percent. The current outlook looks quite favorable, a condition that owes much to the policy responses to the recent crises. For the group of developing countries growth is expected to rise in 2000 above 5 percent (3.7 percent in 1999) with the highest increase being recorded in Latin America. For the transition countries the improvement is less visible in the average rate of growth (from 2.4 to 2.6 percent) yet more evident in the median value (from 2.7 to 4.0 percent). The downward trend in inflation is going to continue markedly.

The downward risks to the present outlook vary from region to region. In Latin America the current account deficit is relatively large and capital market access remains difficult, especially in view of the increasing interest rates in industrial countries. While a further widening of the deficit is expected as a reflection of the recovery, it should not be allowed to grow

excessively. This means that these countries should be ready to respond with stronger fiscal policies. Clearly, in the case of a hard landing in the US, the effect on this region would be dramatic. In Asia the degree of external vulnerability has decreased significantly and the task for the local authorities is now to put policies, which have been quite supportive of the recovery, on a more neutral stance to preempt inflationary pressures and further accumulation of public debt.

It is well known that by far the greatest challenges for these economies remain in the area of structural reforms. Here is also where the major risk lies and, by symmetry, where the Fund's role is greatest. The risk is that authorities, led by the improved conditions in their economies, assume a complacent attitude toward their reform agendas.

Mr. Törnqvist and Mr. Sutt submitted the following statement:

We found the WEO to be well balanced and comprehensive. In particular, the in-depth coverage of linkages between asset price movements and the business cycle is timely. We are in general agreement with the staff's assessment on the outlook for the global economy, as well as with the policy prescriptions. Indeed, the pick-up in world growth has been even stronger than one would have expected six months ago, and the growth rates in the U.S., the euro area and Japan are in somewhat better balance now. On the whole, the situation has improved markedly since the last WEO. As always, there are uncertainties. We agree with the staff's assessment that the most critical one is the prospects for a soft landing of the U.S. economy.

The United States economy continues to show extraordinary strength. While overall inflation has remained under control, concerns about overheating have intensified. In view of the booming domestic demand and the record current account deficit, further tightening of monetary policy is warranted. It would send a reassuring signal to the markets that the Federal Reserve is doing all it can to facilitate a soft landing. With many countries experiencing increased momentum in growth, additional preemptive tightening of U.S. monetary policy would not be likely to endanger global recovery. As to fiscal policy, we fully agree with the staff recommendation to maintain surpluses in the general government budget for both cyclical and structural reasons.

The recovery in the euro area has gained momentum since last summer. Recent leading indicators such as business and consumer confidence point to a further acceleration of growth in the area. As the staff report rightly points out, there are still significant, albeit narrowing, differences in growth rates between the rapidly growing smaller countries on the periphery and two of the larger countries in the center, namely Germany and Italy, which have just started to recover. The current level of short-term interest rates appears to

be too low for the faster growing euro area economies. We agree that a somewhat less accommodating monetary policy stance is warranted if there are signs of accelerating core inflation. However, as the ECB's monetary policy continues to focus on the monetary conditions of the euro zone as whole, it is important that efforts to consolidate public sector finances are also continued in countries which already show budget surpluses. Our concern is that improved cyclical conditions might lead some member states, in particular those which enjoy budget surpluses, to relax their adjustment efforts before the consolidation is completed.

It is disappointing that the recovery of the Japanese economy has failed to gain strength in spite of the expansionary fiscal and monetary policies of the past few years. We broadly agree with the staff that, while the continuation of expansionary policies is warranted in the immediate future, the room for a prolonged fiscal stimulus is shrinking rapidly due to the exceptionally high level of public debt and the Japanese households' persistent reluctance to spend. There is a case for further emphasis on the need to improve the quality of public spending and target it so as to ease precautionary savings. We also support the recommendation to implement additional steps to ease liquidity, and would like to add that this could be paired with a clearly stated target for price stability, which would help create the right inflation expectations. Owing to the sustained strength of the yen and no inflation, there remains ample room for the Bank of Japan to continue its "zero interest rate" policy. While economic policies should remain supportive at this stage, we agree with the staff that the Japanese authorities must continue the structural reforms in the financial and corporate sectors. This might hamper growth in the short term but, in the longer term, it will enable Japan to return to a healthy expansion.

Indeed, in many industrial countries, equity and property prices have reached levels which, for many observers, seem far out of line with fundamentals. According to the empirical evidence presented, asset price fluctuations are highly correlated with business cycles. This would, on the one hand, suggest that there is no need for policy actions specifically aimed at smoothing asset price fluctuations. On the other hand, there are clearly situations where policy actions, either through fiscal, monetary or prudential policy measures are called for. With respect to prudential measures, there still seems to be room for improving risk assessment of financial institutions. The detrimental effects that sharply fluctuating asset prices can have on private sector balance sheets and financial sector stability should not be underestimated. Although it is difficult to determine at what level an asset price becomes unsustainable, a comparison with long-term levels is informative. We find it appropriate for authorities to try to prevent wide asset price fluctuations from spilling over to goods and services prices and thereby jeopardizing macroeconomic stability. In case of a crash or a major correction,

authorities must be prepared to implement policies which alleviate the extent of damage to economic and financial stability.

The outlook in the emerging market economies in Asia has continued to improve, and the prospects for the major countries in Latin America also look decidedly better. There is no doubt that this positive outcome is the result of the strong adjustment measures which were undertaken by the authorities in the crisis countries with the assistance of international financial institutions. The return of confidence is reflected in the surge of equity prices, stabilization of exchange rates and falling interest rates, i.e., in factors which could lessen the authorities' determination to continue with prudent macroeconomic policies and structural reforms. We fully agree with the staff in its concern that the recovery must not weaken reform efforts. In particular, we would underline the importance of strengthening the financial and corporate sector restructuring in Asia and the public sector finances in Latin America. Owing to persistent current account deficits, Latin America remains vulnerable to external shocks. Therefore, the continuation of fiscal consolidation to increase national savings is of utmost importance.

While the more advanced transition economies are considered by the European Commission to fulfil the fundamental economic and political criteria for EU accession, they still face some adjustment challenges in specific areas. This, in particular, concerns the so-called 'second generation reforms' (e.g., pension system, health care, labor market) which have to be accompanied by a rise in administrative capacity. The persistent high current account deficit is, in many ways, unavoidable in the transition phase but, unless it is financed by long-term capital, and preferably FDI, it can be considered as a possible source of vulnerability. Strengthening the fiscal balance and measures to increase private savings (e.g., pension reforms) are steps in the right direction. Also, Fund arrangements with the accession countries should be geared towards their accession efforts.

The oil price increase has improved the debt-servicing situation in Russia, but reform efforts need to be continued with determination. Otherwise, the current recovery is unlikely to be sustainable and the likelihood of severe economic shocks in the future will not disappear.

The oil price developments constitute a major factor of uncertainty surrounding the recovery in emerging markets. High oil prices might dampen the expansion in most of the crisis countries in Asia and aggravate an incipient inflation problem.

Higher growth is of utmost importance in the poorest countries. Peace, political stability, education, infrastructure and targeted investments must be high-ranking priorities. Macroeconomic stability is also significant. A more

even income distribution reduces political polarization and facilitates growth-enhancing domestic policies.

It is imperative that the debt overhang be removed for the poorest countries to help them improve their situation. Equally important are the conditions for debt relief, namely that the countries will undertake macroeconomic and structural reforms. However, the advanced economies must not forget the need to give the poorest countries a fair chance by opening their markets. This is one reason why the current stalemate in the trade negotiations is so unfortunate.

Finally, we note that Mr. Flemming Larsen, after having completed his 30th WEO, is leaving Washington to head the IMF office in Paris. We would like to express our appreciation for his major contribution to the high standards of the WEO and to thank him for his unfailing willingness to engage in stimulating discussions about the world economy. We wish him every success in his important new position.

Mr. Yoshimura and Toyama submitted the following statement:

The Japanese economy saw strong growth during the first half of last year, followed by decline over the second half. The annual growth rate was 0.3 percent for FY 2000. The recently published fourth quarter GDP dropped by 5.5 percent at annual rate, mainly due to temporary factors such as weak consumption caused by cuts in bonus payments and restrained spending over the Y2K period, as well as precipitated imports in advance of the century changeover. Business fixed investment, however, showed signs of recovery and jumped by 19.8 percent.

Economic activity so far this year has been showing modest recovery. Personal consumption is recovering moderately, and unemployment appears to have stabilized at about 4.5 to 4.7 percent. With continuing fiscal and monetary policies geared to supporting economic recovery, the Japanese economy is more than likely to return to a recovery path led by domestic demand in the second half of FY 2000, and to achieve the government's projection of 1 percent growth of GDP for FY 2000.

As mentioned above, personal consumption is recovering at a modest pace, and the unemployment rate appears to have stabilized. Investments could continue to recover, as corporate profits and business sentiment have improved. Buoyant information technology (IT) related investments are shoring up overall business investments. Industrial production has recorded an increase from last year for seven consecutive months (July 1999 to January 2000). Notwithstanding the staff's remark on the continuing dependence of domestic demand on fiscal stimulus, a sign of self-sustaining recovery is now apparent, particularly in business fixed investment. While the staff paper refers to the Tankan survey as indicating that restructuring may continue to

weigh on business investment, indicators following that survey of last December shows recovery of business fixed investment. Investment in conventional areas other than IT may not pick up for some time, but it is the minority's view that overall investment will remain sluggish.

On the fiscal policy front, the expenditures for social infrastructure investment approved by the second supplementary budget of last year are estimated to have an impact of 1.6 percent of GDP on a real basis over the course of 12 months. The FY 2000 budget is also stimulative in nature. Orderly implementation of these budgets will help the Japanese economy return to a recovery track led by private demand in the second half of FY 2000. At the same time, Japan's fiscal position is deteriorating rapidly, as pointed out in the staff paper. Gross public debt is estimated to exceed 120 percent of GDP as of March 2000. While priority in fiscal policy is being given to economic recovery at this point, sweeping measures should be taken by reviewing fiscal and tax policies in line with the overviews of the Japanese economy and society in the 21st century, as soon as recovery is firmly established.

Regarding monetary policy, the staff paper takes the position that additional steps to ease liquidity seem appropriate. However, this does not appear consistent with an assertion in Chapter III that monetary policy loses much of its effectiveness as a counter-cyclical instrument when the interest rate is zero percent. The Bank of Japan has announced it will maintain the "zero interest policy" until the deflationary concerns are dispelled.

The authorities remain concerned about the potential impact of the yen appreciation on the Japanese economy. As economic recovery is not yet solid, excessive appreciation of the yen would undermine confidence in recovery.

It is essential to promote structural reforms, including restructuring of the financial sector, to achieve self-sustaining recovery led by private demand, and thus paving the way for medium- to long-term recovery. On the financial front, the authorities continue to promote the disposal of non-performing loans and financial sector restructuring. Last December, the government announced the extension of a blanket guarantee of deposits for one year. This move was not a backsliding of financial sector restructuring, nor was it intended to support large banks, which will proceed with restructuring as scheduled. The extension was meant to ensure the stability and soundness of smaller cooperative depository institutions.

The so-called Japanese Big Bang is in its final stage, with almost all the necessary measures having already been implemented. Against this background, Japan's financial sector restructuring is entering a new phase. First, consolidation of major banks has accelerated. This trend is now spreading to the insurance sector. Second, foreign financial institutions are

increasing their presence in Japan by expanding their branch network or by buying out Japanese financial institutions. Third, non-financial institutions are showing increased interest in entering the banking business. These dramatic moves by domestic as well as foreign institutions will help facilitate the restructuring and strengthening of the Japanese financial sector.

The authorities have emphasized structural reforms in tandem with a series of economic stimulus measures, with the hope of achieving self-sustaining recovery led by private demand. This constitutes the case for restructuring of the Fiscal Investment and Loan Program. In place of the current system of receiving postal savings and public pension funds, and then lending these funds to public corporations, market-based fund raising and lending will be introduced beginning in FY 2001, with an emphasis on disclosure of operations. The staff's view that this reform is less ambitious than many expected does not have ground. The Cabinet has submitted the bill to the Diet for the introduction of defined contribution pension schemes, while intensive preparation is in progress for the introduction of consolidated tax reform.

The supportive macro-economic policies described at the outset are also aimed at alleviating the short-term impact associated with structural reforms, including financial sector restructuring; an essential for achieving sustained medium- to long-term growth.

The U.S. economy continues its remarkable performance. The unemployment rate is historically low without inviting inflation. Stock prices, despite some corrections, are at a high level. One of the major reasons for this sustained growth may be increased labor productivity due to IT-related investment beginning in the 1990s. In particular, improvements in labor productivity for retailers, durable goods manufacturers, and banks and insurance companies, have accelerated since the late 1990s.

Notwithstanding continued IT-related investment, however, improvements in labor productivity will eventually halt unless technological innovation that is meaningful to labor productivity continues to be generated. If this takes place, it is likely that inflation caused by a tightened labor market will occur. In addition, it is suggested that increased current deficits may jeopardize confidence in the U.S. dollar, which in turn would result in inflation through increased import prices. The staff points out the possibility that the current stock prices reflect excessively optimistic prospects for future growth. If the above risks materialize, the current virtuous cycle in which high stock prices lead to increased consumption and investment, and to the expansion of economic activities will come to an end. A hard landing of the U.S. economy will hit the world economy at large.

The authorities are required to conduct fiscal and monetary policies cautiously, taking into account these risks. It is warranted that the Federal Reserve has moved to a tighter monetary stance, as pointed out in the staff paper. On the fiscal policy front, the fiscal surplus should be reserved for correcting imbalances, rather than used up through expenditures or tax cuts. Such prudent macroeconomic policies would be critical for sustaining growth.

The euro economy has shed its temporary slump and returned to the recovery path. Given the longstanding issue of high unemployment rates and the substantial depreciation of the euro since its introduction, the authorities are faced with the task of formulating macroeconomic policy to tackle these issues while realizing sustainable growth without inflation.

The ECB has moved to a less accommodative stance by raising interest rates last November, and this February and March, aimed at containment of inflationary pressures. Indeed, it is not likely that an increase in oil prices will trigger a substantial increase in prices in general, given the longstanding trend of calming inflation in the area. However, inflationary pressures from the depreciation of the euro should not be underestimated. In addition, the increase in asset prices in some countries should be carefully monitored, as it may reflect an increase in expected inflation rates in the future.

For correction of the euro depreciation, structural reforms would provide important momentum by regaining investor confidence in the area. We hope markets share the view that the ECB's policy would lead to sustained growth, thereby increasing confidence in the euro.

The Asian countries hit by the crisis, including Korea, Thailand, Indonesia, Malaysia and the Philippines, saw increased recovery momentum in 1999. While the initial driving forces of recovery were supportive fiscal expenditures and increased exports through the depreciation of local currencies, private demand, such as consumption and investment, now shows signs of recovery in general, realizing more balanced growth led by both domestic and external demand.

External vulnerability has been alleviated as shown in increased foreign reserves due to the improvement in external balances and the more stable maturity structure of external debts. The continuous efforts toward bank and corporate restructuring would further strengthen external confidence. The authorities are urged to deal with these issues with firm resolution. Having committed itself to supporting recovery in Asia, including through implementation of the New Miyazawa Initiative, Japan will do its utmost to support structural reforms of Asian countries.

China's participation in WTO will drastically and rapidly open Chinese markets and give substantial benefits to consumers through strengthened competition due to increased high-quality imports being sold at reasonable prices. Structural reforms, including restructuring of state owned enterprises, must be accelerated. In the short run, however, unemployment rates may increase in the agricultural and other protected sectors. On the other hand, increased imports may weaken external balances. Formulation of macroeconomic policies will need to strike a delicate balance between these considerations.

The medium- to long-term growth potential of Russia is high in view of a possible increase in labor productivity with strengthened capital stocks, possible capital inflows, the current level of economic activities, and the existence of abundant and quality production factors, including natural resources.

On the other hand, the staff points out that the recent economic improvement is built on a not necessarily sustainable base, including higher prices of energy exports, ongoing import compression, and increases in industrial production driven mainly by import substitution. Russian economic performance would significantly improve if abundant production factors could be reflected in efficient production. As pointed out by staff, the Russian authorities should actively deal with structural reforms to create a better environment for investment and to reduce capital flight. In particular, it is critical to induce foreign capital investments in Russia and to have corporate profits generated in Russia to be reinvested there. In this regard, this chair expects the Fund and the World Bank to play a major role in supporting Russia's structural reforms.

The staff paper is a well-done survey of the impacts of large asset price fluctuations on an economy and possible policy reactions to contain it. The creation of the bubble economy and its burst since the late 1980s have left serious impacts on the Japanese economy and has given the authorities some valuable lessons. This chair would like to comment on the paper based on Japan's experience.

The staff clarifies the mechanism by which increased asset prices induce excessive individual consumption and corporate investment, and proceeds to conclude that, since the fall of asset prices incurred by a change in expectations results in a serious impact on a country's economy through a deteriorated function of the financial sector and so forth, the authorities should monitor the movement of asset prices and pay due attention to their excessive swings.

While it is not appropriate to set as a goal of monetary policy stable asset prices, information about an increase of asset prices should be factored

into the formulation of monetary policy, since it may reflect excessively optimistic expectation of growth, which can lead to general inflation, staff argues.

This staff analysis is broadly legitimate. The authorities should carefully analyze information about expectation of growth provided by fluctuation of asset prices, and respond to that no later than when a significant impact on the general economy is revealed. As was evident in the analysis of the previous WEO on imbalances of business cycles among countries and the volatility of asset prices caused by international capital flows, capital flows into a country with good economic performances may increase its asset prices and further stimulate its economy through a wealth effect associated with it. At the same time, it may decrease import prices through the appreciation of its currency and thereby restrict inflationary pressures from economic expansion, and as a result, realize a virtuous cycle in which non-inflationary economic expansion materializes while asset prices are hiked. Due consideration should be paid, however, to the increasing possibility of sudden adjustment when such a virtuous cycle becomes unsustainable.

The years 1986 to 1988 in Japan saw non-inflationary economic expansion under which consumer prices were stable through the then appreciation of the yen. Asset prices recorded a rapid increase during this period, reflecting expectation of high growth. The policymakers turned to a tight monetary policy in 1989 against the rapid expansion of real economy and an increase in monetary aggregates. Interest rates had to be raised three times until the tighter monetary condition changed public expectations and asset prices began to fall. The government introduced regulations to control real estate related loans. Once expectations began to change, perceived future risks also began to grow and the market suddenly started to fall. A self-feeding process evolved between a weakening market and increasing risk premium, resulting in a sharp decline in asset prices, deteriorated balance sheets of financial and corporate sectors, and a prolonged recession in general.

Japan's experience suggests that asset prices can significantly change thorough changes in public expectations and that the policy response can become extremely difficult once a self-feeding process is ignited. It is thus essential for policymakers to warn the public of the possibility of inflationary pressures and impacts on the real economy implied by increased asset prices and to issue a policy response in short order. In order for such a warning to become effective, confidence in its legitimacy is required, which in turn shed lights on the importance of establishing confidence in policymakers through successful policy performance in their regular course of business.

Regarding the U.S. economy, there is the view that its expansion has the legitimate backing of technological innovation and does not reflect any speculative move. Considering the decline in household saving rates, the

widening of imbalances where the 1999 current surplus amounted to 340 billion U.S. dollars or 3.7 percent of GDP, and the large impact of wealth effects on consumption and investment, however, further cautious macroeconomic policy should be required to pull down growth to a level consistent with potential and to avoid a sudden adjustment.

The staff paper categorizes low and middle-income countries into four groups respectively, according to their per capita growth from 1970 to 1997 and analyzes what factor is relevant to the difference in growth rates. In conclusion, such factors as macroeconomic stability, capital investment, savings, education, healthcare, governance, and free trade, seem to have relevance.

It is understandable that these factors form the basis for economic development for these countries, although the casual relationship is hard to be examined. What is paramount for developing countries is to efficiently create these underpinnings for economic development with strong ownership. In this regard, the fact that Japan's support to developing countries mostly takes the form of loans rather than grants is partly aimed at providing incentives to developing countries to strengthen ownership.

It is certain that debt relief would contribute to economic development and poverty reduction to the extent that it can enhance the incentive of individuals and corporations for earning income, as they do not have to repay the generated income to creditors. However, debt relief itself cannot be the final solution. It is essential that developing countries create underpinnings for economic development with strong ownership. It is therefore appropriate that under the enhanced HIPC Initiative debtor countries are required to elaborate and implement a plan for economic development and poverty reduction.

While the staff's analysis on income distribution and other poverty related issues is noteworthy, the fundamental involvement of the Fund on these issues should be to give advice in areas that have macroeconomic relevance. Any role beyond that should be played by the World Bank.

Last year, the Japanese government announced its Medium-Term Policy on Official Development Assistance. Under this policy, the government made it clear that assistance would be concentrated in areas such as poverty, social development, and human resources, which were essential for developing countries' future sustainable growth. Furthermore, to improve the efficiency of this assistance, the Japanese government also decided to enhance and strengthen the practices of assessment and monitoring.

Mr. Lushin submitted the following statement:

It is encouraging to see that global economic and financial conditions

have improved substantially in 1999 and that projections for 2000 now look better than during our previous WEO discussions. This remarkable turnaround from an uncertain outlook that prevailed a year ago is a testimony to the prudent policies and resolute actions undertaken by member countries to address the threat of a global recession. The staff admits that downside risks to the strengthened global outlook still do exist and these risks are already well known—trade imbalances and exchange rate misalignments among the principal currency arrears and the very high stock market valuations in industrial countries. We agree with the staff that these risks should be taken seriously, despite the fact they have already been around for some time. However, we believe that with a substantially stronger global economic environment chances are higher for these imbalances to be resolved in an orderly manner.

The U.S. economy continues to demonstrate remarkable strength with high growth, practically non-existent inflation, an outstanding level of employment and a budget in surplus. Of course, the accumulated imbalances also look impressive, predominantly the size of the current account deficit and its counterpart in the form of (net) national savings. Although the signs of overheating are abundant in the US economy, with price inflation remaining low it is not easy to decide on an appropriate policy mix to slow the economy down. The situation is also complicated by the existence of a stock market with "some degree of overvaluation", according to a cautious staff's definition. Under such circumstances, searching for a soft landing strategy for both the economy and the equity market comes to the forefront. Specifically, the selection of appropriate monetary policy responses, especially setting interest rates optimally, is currently a very difficult task. Following Mr. Kiekens and Mr. Jonas, we can only hope that such an optimal interest rate path exists and that Fed will succeed in finding it.

The recovery in Japan remains fragile due to the weakness in private domestic demand. Choosing the appropriate policy mix in Japan is complicated by the fact that the potential of monetary and fiscal stimuli seem to have already been fully utilized. However, currently we see no other option for Japan but to continue with an expansionary fiscal stance and monetary policy being as accommodative as possible. At the same time, it is necessary to adhere strictly to the implementation of already announced structural reforms, with a special emphasis being placed on addressing the banking system problems and weaknesses of the corporate sector.

It is encouraging that growth has strengthened in the euro area economies, given the need for Europe to take over the lead in global economic growth from the U.S. We believe that currently monetary policy in Europe should be appropriately accommodating in order not to hold back the ongoing recovery. Large divergences in cyclical positions across the euro area countries is a matter of concern, since they complicate the utilization of a

unified monetary policy. Under such circumstances, overheating concerns in some smaller European economies may be addressed through more ambitious policies of fiscal consolidation. A significant undervaluation of the euro against the dollar creates a major misalignment between the world's two major currencies. This carries the risk of sharp and disorderly corrections and exacerbates the current pattern of trade imbalances. The euro's weakness is to a large extent due to continuing differences in cyclical positions of the European countries and the U.S. However, it may also be connected to markets' perception of narrow limits for non-inflationary growth in the euro land due to the existing structural rigidities. Therefore, the most credible way to make the euro's upward potential realize is to forcefully promote growth-enhancing structural reforms.

Despite visible improvements in the economic position of emerging market countries, the attitude of financial markets still remains very watchful. Since the fall of 1999, there has been some narrowing of spreads on the emerging markets external debt. However, overall improvement in the secondary market conditions has not been accompanied by narrowing in average spreads for new issues at launch. The latter are more reliable indicators of the market sentiment since lower secondary market spreads are partly determined by countries with no access to the primary market. Gross private financing flows to emerging markets increased only marginally in 1999, mostly due to equity issues, while net private flows remained broadly the same in 1999 as in 1998.

Table 2.2 indicates another interesting development in 1999, notably, a switching of the combined current account position of the emerging market economies from a deficit of \$51 billion in 1998 to a surplus of \$9 billion in 1999. As a result, the sum of net private and official inflows in 1999 roughly corresponds to the increase of reserves in these countries, and the same pattern is projected to occur in 2000 as well. Of course, the totals hide a significantly diverse situation across different regions (for example, in Latin America all net private inflows go to finance current account deficits), but, in general, emerging markets as a group appear to become "self-sufficient". It is interesting to compare these observations with data in Table 27 of Statistical Appendix, which shows that between 1998 and 1999 the current account deficit of industrial countries rose from \$24 to \$168 billion. With emerging markets being practically in balance on current account transactions, one may wonder where from the funds arrive to finance this deficit. The answer comes from "errors and omissions item" (or "Total" line of Table 27), which demonstrates an increase from (-)\$73 billion in 1998 to (-)\$154 billion in 1999. We would appreciate if the staff could elaborate on possible options to resolve the tension in the rising current account discrepancy. Specifically, could it indicate that improvements in current account positions of emerging markets might have been under-recorded?

Recoveries in emerging markets can be influenced by the dynamics of oil prices. So far, the real price of crude oil is well below its historic peaks. Taking into account that the world economy, in general, has become less dependent on oil than it was before, the recent increase of the oil price may have much smaller consequences for oil-importing countries than in the past. This general picture, however, masks important differences. The oil-importing emerging economies are far more dependent on oil than the industrial countries. According to *The Economist*, as a group, they use four times as much energy per unit of GDP as the industrial countries. Also, their share in the world oil consumption rose from about 30 percent in 1973 to above 40 percent today. It means that their new oil-import bills at current price level will be much larger in terms of a share of GDP than those for the industrial countries. Provided that the recovery takes hold, this may imply a larger pressure on their current accounts, and correspondingly, more need for external financing. To some extent these impacts of higher oil prices can be moderated by the increased demand of oil exporters, which may be expected to spend a larger part of their increased revenues.

The increase in oil prices will have different consequences among various industrial countries as well. Here the terms-of-trade effect may be larger for Japan, since it is more dependent on imported oil and exports less to OPEC countries than other advanced economies. The price effect in terms of higher inflation may be larger in Europe, where more rigid labor markets can faster transmit price rises into wage increases. For the U.S. economy, paradoxically, rising oil prices might be even beneficial since they reduce real incomes, and hence, spending by firms and households, thus making a case for monetary tightening less pressing. Of course, this is true to the extent that the increase in oil prices is not large enough to trigger a significant inflationary impulse.

It is difficult to disagree that Russia's economic performance in 1999 appeared to be much stronger than had been previously expected. Suffice it to mention that in the May 1999 WEO the projection of Russia's GDP growth for 1999 was minus 7 percent, while the actual growth turned out to be positive at above 3 percent. Better than anticipated outcomes have also been reported for the fiscal position, inflation and the current account surplus. One more development in 1999 is also worth mentioning—for the first time during the transition period real investment rose, albeit modestly. This strong performance continued into 2000 as well, with industrial production having increased by 13 percent y-o-y in January-February. By March 10, 2000, gross international reserves grew by \$1.8 billion against the end-1999 level, or more than over the whole past year. Private market forecasts for GDP growth in 2000 are between 2 and 5 percent, while more cautious official estimates fall within a range of 1.5-3 percent.

The 1999 economic recovery in Russia was based largely on two factors: higher oil prices and import substitution due to a sizeable depreciation of the ruble. Both of these factors will continue to play a role in 2000 as well. As a deficiency of the ongoing recovery in Russia the staff notes a limited rebound of export volumes after the depreciation, "unlike in Asia and Latin America". However, as clear from Figure 2.8, exports of five crisis-hit Asian countries stagnated in 1998 (the first year following the crisis) and the rebound occurred only in 1999. In the same vein, Russia's exports in 1999 (the first post-crisis year) were broadly the same as in 1998 (\$74.3 and \$74.7 billion correspondingly) and a rebound of about 11 percent is expected (including by the staff) to take place in 2000.

Positive developments notwithstanding, we concur with the staff that the recovery still remains fragile and needs to be supported by additional policy measures to become sustained. Import substitution and higher energy prices are not necessarily a solid base for the recovery, but they have provided a strong start-up for the Russian economy. The staff rightly emphasizes that for a durable recovery to emerge, the existing structural faults should be tackled forcefully, including through the tax and banking sector reform and creating institutional and legal underpinnings of a market economy. In the atmosphere of political uncertainty of 1999 and in the run-up to the presidential elections of 2000 limited progress has been achieved in the structural area. However, following the ongoing strengthening of the federal authority in Russia conditions for addressing the structural agenda will be better than any that have existed since the disintegration of the Soviet Union.

Mr. Portugal and Mori submitted the following statement:

We wish to congratulate the staff for another excellent and informative set of papers with very interesting and stimulating analysis.

The recent developments in the world economy are encouraging. In the mature economies, the United States continues to sustain a high level of activity, while the major economies in the euro area have shown clear signals of more robust growth, and the Japanese economy is in a recovery trend. In emerging market countries, the Asian economies are recovering strongly, especially some of the crisis-hit countries and, in Latin America, the slowdown in growth was shorter and shallower than expected, while the prospects are generally favorable. The high level of activity in mature economies as a whole, combined with recovery in commodity prices will contribute to stimulate growth in developing and transition economies in general.

These promising prospects can be attributed to the prompt actions taken by the international community, with the Fund playing a key role, to contain the steep liquidity contraction in the international capital markets in

1998, as well as the adjustment efforts carried out by the authorities in the crises-hit economies. The outcome has been a higher global growth rate, and an increase in global trade as capital flows, ultimately, finance international trade.

We agree with the Woe's conclusion on mature economies that, in the current juncture, the priorities for a smooth transition to a more sustainable pattern of growth are (i) to contain excess demand pressures in the United States with avoidance of relaxation in the fiscal stance either by raising spending or cutting taxes, and (ii) to promote robust and durable economic expansions in Japan and Europe. The staff seems to focus more on monetary policy as the main instrument to manage the adjustment, and perhaps this would be the alternative available in the short-run. Our view is that reliance on monetary policy has been disproportionate in the recent past. Preferably, more might have been done using fiscal policy, structural reforms, and regulatory policies.

The staff argues that part of the policy challenge needs to be met through asymmetric adjustments of monetary stances. In the short term, the bulk of the monetary firming would occur in the United States, while the euro area may have more room to maintain relatively easy monetary policies until recovery is on a sufficiently strong footing; and there may still be a need for further monetary easing in Japan to help the recovery gain momentum. But the combined net effect of a contractionary policy in the United States and an easier stance in the euro area and Japan seems ambiguous in a context of free capital mobility among large economies issuers of reserve currency. One possible outcome of such combination of policies is that, once more, capital may move from economies with easier monetary stance to the United States. With stronger growth in Europe and recovery in Japan, this movement would be less intense than in the recent past but, if the difference in monetary stance among major currency areas becomes substantive, one cannot ignore the possibility of increasing capital flows into the United States.

If this is the case, an easier monetary policy, instead of fostering the absorption of existing slack in the euro area and Japan, could continue to feed a high level of activity and to sustain asset prices in the United States. Capital flows may benefit the export sector in economies with a lower level of activity as they finance the trade partners external current account. The recovery of the rest of the economy, however, would still be hindered by structural problems. Greater progress on structural reforms remains critical to sustaining and strengthening growth in Japan and Europe. Although these reforms refer to the medium-term perspective, a much faster pace in their implementation is desirable.

Therefore, relying mostly on monetary policy may not produce the desired results. The staff notes in Box 3.2 that the relationship of liquidity to

asset prices has been little studied in an international context. Our knowledge is limited regarding the economic effects of transactions that shift liquidity among financial centers, such as short-term trade financing and leveraged operations like "carry trades". In a globalized world, we need to have a much better understanding of the cross-border transmission mechanisms. A monetary policy stance presumably appropriate in the case of a less integrated economy may be less so in a globalized economy.

For instance, the staff mentions a series of developments in the United States—namely a falling household saving ratio, private debt at record levels, rising asset prices, deterioration of the current account—all of which may be symptoms of over-consumption, over-investment and overheating of the economy. The source of part of these imbalances may be external. As the staff notes the "international shifts in portfolio and capital inflows in the United States fostered by the emerging market crises of 1997 and 1998 as well as by recession in Japan and slow growth in Europe have helped fuel domestic liquidity". The pattern may seem similar to that observed in emerging market economies when monetary policy was eased in the United States in the early 1990s and later on in Japan. A flexible exchange rate, a well-regulated financial system, absence of structural problems, and a rich flow of information, seem not to prevent internal and external imbalances from developing even in the United States.

The staff points to the fact that, in certain cases, monetary policy may be either ineffective or an effective but blunt instrument to defuse macroeconomic imbalances stemming from asset market excesses. This applies to the case of monetary unions, but we may perhaps generalize the observation even for economies with more flexible foreign exchange regimes, as this framework does not prevent asset inflation. We concur with the staff that, in such cases, besides fiscal policy, regulatory policy may have an important role to play. Financial sector supervision and regulation, prudential measures such as raising provisioning requirements, margin requirements, and enhanced monitoring of lending standards may all have a role to play.

In Asia, we are pleased to note that the economic recovery materialized in the region as a whole, especially in the crisis-hit countries, with solid growth in Korea and Thailand, while a notable turnaround from the steep recession is observed in Indonesia. An expansionary fiscal stance and restoration of external capital associated with official financial support, in the first phase, allowed stabilization and, then, recovery of growth followed through by further stimulus provided by exports, reflecting more widespread growth in mature economies. The crisis-hit economies still have an unfinished agenda of financial and corporate restructuring to normalize the relationship between creditors and debtors and of structural reforms to set the basis for a stronger and steady growth path.

In Latin America, recessions have been generally short-lived and recoveries are under way. The staff pointed out that the recessions did not lead the authorities to relax macroeconomic policies and, we can say, some even reinforced those policies. Many countries in the region have continued their processes of improving fiscal and monetary policy frameworks and implementing strong structural reforms, both of which were being carried out throughout the 1990s even before the global crisis. Fiscal and pension reforms were introduced in a range of countries, and in some cases advanced significantly. Policy efforts to strengthen financial systems were maintained or intensified. Still, we agree that there is a need for these economies to further their efforts to safeguard macroeconomic stability, increase national saving, and attain sustained growth through increases in efficiency and productivity.

Indeed, external conditions will affect growth in Latin America. The pick up in growth in mature economies will tend to tighten global financial conditions, but will also produce stronger world demand and better commodity prices. In a favorable scenario, a less accommodative monetary stance in the euro area and Japan may indicate that potential growth in these countries was fully restored while a tighter monetary condition in the United States may indicate success in leading the economy to a more sustainable path.

Therefore, even with tighter global financial conditions and resulting reduced capital flows to the region, a pick up in exports and increases in commodity prices supported by the general strengthening in the regional and global economy will ease external financing conditions. But a close monitoring of developments in domestic demand is required and, whenever imbalances occur, appropriate and timely actions should be taken.

Nevertheless, one cannot disregard a downside risk if the tightening of global credit conditions reflects financial turbulence resulting from adjustments in asset prices, accompanied by weakening of growth in mature economies. In any event, countries in the region need to persevere in pursuing their policy objectives especially in the fiscal area through better expenditure controls, reforms to the structure of spending and taxes, as well as structural reforms with the objective of increasing national saving rates and improving export competitiveness.

Poverty is a complex problem and the specifics differ from country to country, as pointed out by the staff. Besides deficiencies inherent to underdevelopment in terms of functioning of institutions and policies, exacerbated by insufficient human capital, external factors often contribute to the problem through frequent negative terms of trade shocks in commodity exporting countries and a shortage of foreign capital. In addition, the staff correctly notes that the propensity of donor countries is to favor projects that benefit their own exporters of goods and services, more than to meet the needs

of the recipients. Unprofitable investments and loans for unproductive purposes have benefited exporters, producers, and workers in general of creditor-exporting countries in the first place, as goods and services that otherwise would not have been produced were traded, but have also led to large debt burdens for poor countries.

We concur with the staff's recommendations. Poor countries need to tackle their institutional and policy deficiencies, but well-targeted assistance and easing of financing constraints are also required. On the mature economies' side, we agree that it is essential (a) to quickly reverse the downward trend in some advanced countries' official development assistance and to ensure that development aid is provided and used more effectively; (b) to reform trade policies in areas that discriminate against the poorest countries; and (c) to ensure a meaningful debt reduction undertaken in a strong policy framework, as well as increased development assistance and reductions in protection.

Ms. Lissakers and Mr. Weisman submitted the following statement:

The spring 2000 World Economic Outlook presents an update of the global economic environment, examines the implications of asset valuation for macroeconomic policy, and analyzes global poverty reduction efforts and outcomes. We will focus our remarks on the first topic, while briefly addressing narrow concerns of the second and third issues.

The global economy has continued to improve since the last WEO, driven primarily by continued strong growth in the U.S., a pick up of activity in Europe, and accelerated recovery in Asia. And while the prospects for the near-term are positive, to insure sustained growth over the longer horizon adjustments will have to occur with respect to regional global imbalances in terms of domestic demand and current account balances. Specifically, U.S. domestic demand and external deficit will need to decline, while Europe and Japan pick up the slack. The question that arises is how best to accomplish this task.

The policy debate in the U.S. has shifted markedly over the past decade, from worries of high unemployment, low productivity, and mounting fiscal deficits and national debt, to current concerns of labor shortages, the nature of productivity gains, and how to manage fiscal surpluses. This remarkable turnaround results from a virtual plethora of factors, the most notable of which include the development of a highly competitive financial sector, labor and product market flexibility, fiscal prudence, and maintenance of an open economy.

From the current U.S. perspective, the global imbalance reflects the gap in growth between the United States and the rest of world, accelerating

productivity gains, and relatively high investment in our productive potential. The move from fiscal deficits to substantial surpluses has helped increase U.S. national savings, but that increase has been outstripped by the acceleration in U.S. private investment.

Nonetheless, the rising current account deficit merits close scrutiny. While easily manageable at present, in the medium term it is clearly preferable that we approach a more balanced composition to domestic demand. Perhaps the most effective way for the U.S. to do its part is to continue to increase national savings by pursuing prudent fiscal policies, while simultaneously promoting private savings. But these efforts alone will not suffice to bring greater balance to the global economy. Other regions of the world also must contribute to a rebalancing of global conditions.

In the shorter term, the Federal Reserve continues to tighten monetary policy citing concerns that increases in demand, over time, will continue to exceed the growth in potential supply, even accounting for the considerable rise in productivity growth. Such trends could foster inflationary imbalances that threaten to undermine the U.S. economy's record economic expansion. Against the background of its long-run goals of price stability and sustainable economic growth and of the information available, the Fed has indicated that the risks are weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future.

Economic prospects for the EU have brightened recently, with projections of stronger growth in the near term. But the region continues to under-perform due to lackluster support for structural reforms, though those euro members that have taken more aggressive action on structural reforms have seen relatively greater job creation, more investment opportunities, and higher rates of growth. The investment figures are illuminating, shedding light on the pattern of global capital flows and current account balances: fixed investment in the euro-area has increased by a mere 10 percent in real terms since 1991, compared to almost 100 percent in the U.S. The recent progress in product and labor market reforms and greater market competition is certainly a welcome development. But much more restructuring needs to be done, through proactive and aggressive policy implementation. Otherwise, the lack of sustained robust domestic demand in Europe overall and the weakness of the euro will worsen global imbalances.

These structural rigidities constrain the ECB's options in attempting to maintain price stability while not choking off output and employment before they reach full potential. Complicating the situation is the ongoing debate concerning the nature of the recent increase in inflation. Some analysts argue that the rise of headline euro-area inflation to 1.7 percent at the end of 1999 (and the further rise to 2 percent in January 2000) is more than just a small increase from the rate of less than 1 percent at the end of 1998, and that the

higher headline inflation may be incorporated into larger wage increases, thus leading to a rise in core inflation. We would emphasize, though, that core inflation remains low, and the recent increases in the CPI are unlikely to be incorporated into expectations, given the fact that those increases were driven by oil prices increases that are expected to be temporary.

Moreover, in light of Europe's high unemployment rate and the "new economy" that may have blossomed elsewhere in the world, we believe that the output gap in Europe is markedly negative. Thus, we would like to ask Mr. Mussa for his views on whether there should be scope for monetary policy to be somewhat more accommodative than would otherwise be the case and whether recent monetary tightening is supported by the underlying data.

While the differences in growth among the big three euro-area countries, and between them and the smaller countries still holds to some extent, the more interesting story is that the differences in growth rates in the euro-area began to narrow in the second half of last year and look set to narrow further. In particular, it is worth noting the extent to which forward-looking sentiment indicators (especially business sentiment) show further convergence of Italy and Germany to the faster growth pace exhibited by France. This seeming convergence may pave the way for a more confident execution of monetary policy, allowing for greater focus on structural reform implementation.

The fourth quarter GDP data show that Japan fell back into recession in the second half of last year, reversing the growth posted in the first half of 1999 and leaving output back at its 1998 cyclical trough. We recognize the Japanese authorities' arguments that the downturn reflected one-time factors, and that many analysts question the reliability of Japanese GDP data given flaws in the personal consumption series. However one might qualify the fourth quarter GDP figure, it is not good news. The Japanese economy may be headed for recovery, but it clearly is not there yet.

The weak economic data underline the importance of maintaining a supportive macroeconomic policy environment until recovery is firmly on track. While fiscal consolidation will clearly be needed over the medium-term, still-low net public sector debt levels leave ample room to avoid a sharp fiscal contraction, with its risk of yet another slide back into recession in the short-run. In that regard, we would be interested in hearing the Japanese authorities' plans for responding to the coming fiscal contraction as spending from last year's supplemental budget is exhausted later this year. The monetary authorities should maintain the zero-interest rate policy and consider additional measures to ease monetary policy, perhaps in the context of an inflation-targeting framework. We would appreciate staff's view of the appropriate policy mix given the most recent economic indicators.

Looking beyond demand management policies, Japan should intensify its deregulation and structural reform agenda to increase the potential growth rate. In particular, the authorities should look for ways to maintain the momentum of financial sector reforms, the key to the long-term health of the banking system. A related priority is the effort to improve corporate governance and enhance financial disclosure.

We support the commitment by many Asian countries to pursue more flexible exchange rates, so as to help avoid the moral hazard associated with an implicit commitment to the exchange rate. However, we note that in 1999 and the beginning of 2000, policy in much of the region was marked by heavy intervention in foreign exchange markets, illustrated by the rapid accumulation of foreign exchange reserves. While we recognize the need for these countries to rebuild their reserve positions following the sharp declines in 1997 and 1998, reserve levels currently cover more than 100 percent of short-term liabilities for the countries severely affected by the crisis, excluding Indonesia.

Looking ahead, many observers expect continued large current account surpluses as well as a return to private capital inflows, suggesting further upward pressure on exchange rates. We believe it would be a mistake to respond to this pressure with continued heavy intervention designed to prevent any movement in exchange rates. In the short term, this policy can only reduce the perceived commitment to flexible rates and may distort the incentives for capital flows. Over the longer term, this prescription can also lead to the excessive buildup of foreign liabilities and create vulnerabilities similar to those that existed prior to the 1997-1998 crisis.

While a sudden appreciation of the currencies (driven by large current account surpluses and capital inflows) may not be desirable, a better policy mix might include greater appreciation than currently allowed by authorities, an ensuing easing of monetary policy if less sterilized intervention is performed, a more gradual build-up of reserves, and a faster move to a two-sided exchange rate flexibility. Could Mr. Mussa offer his views on this assessment and indicate whether he thinks any countries are particularly worthy of mention?

Economic recovery is taking hold across most of Latin America, reflecting improved global economic and financial conditions and, in most cases, sound economic policies in the region. To sustain confidence in the future, Latin America will need monetary and exchange rate regimes that can command the trust of domestic citizens and of foreign investors, accommodate regional and global integration, and remain resilient over time. There is a growing consensus that countries involved in the world capital market will need to avoid the "middle ground" of pegged exchange rates combined with discretionary monetary policies. It is noteworthy that over the

last year four Latin American countries with pegged arrangements have adopted flexible exchange rate regimes, while another chose to dollarize.

Over the longer horizon, priorities for the region include continued financial sector strengthening and modernization as well as strong macroeconomic policies. Reforms to spur greater trade integration with the rest of the world should also be high on the priority list not only for the efficiency gains that such integration offers, but also for the flexibility that large export flows provide for current account adjustment when required. In that regard, Argentina and Brazil stand out as having among the smallest export sectors in relation to GDP in the region. We encourage those countries to aggressively pursue trade liberalization.

The staff asserts that a decline in private saving, a rise in investment share, and a deteriorating external deficit necessarily signal an asset bubble. While this may be the case, such changes would also accompany an asset market boom driven by actual changes in fundamental factors, such as a sustained pickup in productivity growth accompanied by a major increase in government saving. Given this uncertainty about whether a rise in asset prices represents a bubble or a supply-led boom, policymakers might be safer waiting for more reliable signs of macroeconomic imbalance, such as an actual pickup in price inflation.

The staff also argues that because the authorities should be concerned about the expectations of future goal variables, and asset prices provide some information about such future expectations, asset prices should be included in the monetary policy reaction function. Following this line of reasoning, a fall in asset prices today would lead to an immediate loosening of policy, even if the output gap and inflation were unaffected contemporaneously. But staff fail to observe that if an asset decline was expected to cause output to fall rapidly below potential in future periods (even if output didn't immediately adjust), a rational bond market would realize that the monetary authorities would lower interest rates sharply in future periods. This would cause long-term interest rates to fall immediately, thus stabilizing aggregate demand by the time the shock actually took effect. Can staff please comment on this issue? Moreover, given that it is difficult to extract the information about future output gap variation that is implicit in asset prices, it is not difficult to imagine that including asset prices in the reaction function would in fact be destabilizing.

The staff correctly points out that the convergence of real per-capita income since the early 1970s is much faster if per-capita incomes are weighted by population. This weighting seems to be a more relevant measure when the stated policy goal is to reduce global poverty and human suffering. Moreover, we agree with the statement that poverty is a multi-dimensional phenomenon, and that when issues such as life expectancy and access to

education are taken into account, the convergence in the standards of living since 1970 has been much faster than that in per-capita incomes.

Having said this, there is a long way to go in raising the one fifth of the world's population out of poverty. The HIPC and enhanced HIPC initiatives provide the incentive and opportunity to kick start this effort by facilitating greater investment in human capital within a broadly defined social consensus, while lowering the external debt burden.

Mrs. Hetrakul and Mrs. Siti submitted the following statement:

As usual, the staff has produced an excellent and interesting piece of work. While the challenges facing the world economy are not much different from those discussed in the last meeting, staff has shed further light and provided a more in-depth analysis of the relevant issues. We broadly share the concerns raised and appreciate staff's effort in providing a helpful perspective to the complex problems highlighted in the paper.

Notwithstanding the uncertainties ahead, it is encouraging to note the speedy recovery of the emerging markets, including the crisis-hit economies in East Asia. To be sure, the V-shaped recovery reflects in part the serious recession that these economies have experienced not too long ago. But more importantly, the pick-up in economic activities is to a significant extent supported by the appropriate policy response of the authorities, as in the implementation of wide-ranging structural reforms. Favorable external environment has also provided the added impetus to the recovery process, with exports chalking up new highs, resulting in large surpluses on the current accounts.

The authorities are committed in building a strong basis for sound and sustainable growth where the continuation of reform efforts is deemed critical. Emphasis on the implementation of structural reforms will remain even as growth recovers. Corporate restructuring in Malaysia remains high on the agenda; bankruptcy laws have taken center stage in Thailand's reform consideration; and Indonesia will further its bank restructuring efforts. At this juncture, it is still too early to consider the dangers of overheating (though probably not in the case of Korea), with the economies still trying to achieve a stronger footing on the recovery threshold. But policy makers in these economies are well aware that short-term memories will come at a price. Signs of overheating will be closely monitored and appropriate measures taken to keep inflation in check. We also agree with staff on the importance of monitoring the composition of capital inflows given the potential adverse impact of short-term debt on the stability of the financial system.

While the outlook of East Asian economies appears reasonably positive, supported by staff's assessment that emerging markets are unlikely

to enter a similar crisis in the near future, there remains serious downside risks arising from the current imbalances among the three major economic regions. We are of the view that the imbalances are unsustainable and the outcome may even be worse than the alternative harder landing scenario painted by staff in Box 1.1, especially if the U.S. equity market were to suffer a severe and protracted correction. The main challenge would be to engineer a soft landing for the U.S. economy while promoting faster growth in the two alternative engines of growth, namely Japan and Europe.

The management of the booming U.S. economy is perhaps the most critical and challenging. While the recent Federal Reserve survey indicates that rising wages and other compensation costs have not led to higher prices, the looming threat of inflationary pressures remains a serious concern, especially when the long-awaited slowdown is still nowhere in sight even after four interest rate increases over the past year. The Federal Reserve has again raised another 25 basis points yesterday. Whether consumer confidence which has been exuberant, spurred by ever increasing equity prices, would be dampened remains to be seen. The balance that the authorities must strike between keeping inflationary pressures in check and avoiding a drastic correction in assets markets is a most difficult one. We would favor a gradual rate increase by the Federal Reserve rather than adopting a more aggressive stance, which could trigger a worse-than-expected plunge in the asset prices. As staff has well analyzed, the equity markets in the U.S. are overvalued and given the strong link between equity prices and output growth in the U.S., any severe correction in the former could bring to halt the record long economic expansion. The staff has mentioned the four channels through which macroeconomic and regulatory policies could affect asset prices. We would appreciate the staff's comments on the role regulatory and market-specific measures could play in augmenting the traditional interest rate policy, and in this connection, the most appropriate policy response of the Federal Reserve in the coming months.

The other two on the balancing scale is the upbeat outlook for the Euro area and to a lesser extent the Japanese economy. For the former, a fine balancing act is in order that is to put on the brakes ever so lightly on an economic up-trend without igniting inflationary concerns. After having contracted for last two quarters of 1999, the Japanese economy appears to have regained its momentum, as indicated in the recent rise in its all-industries index in January 2000.

We welcome the inclusion of a section on poverty alleviation in the WEO. It is clear that the causes of poverty are complex and multi-dimensional. While some factors are economic in nature, socio-political instability and the lack of political will to break the vicious circle of low growth and persistent poverty are, in our view, the main contributors to the low level of economic development. We concur that income redistribution

while justified in its own right, cannot be a substitute for stronger efforts to raise economic growth. We also agree that debt overhang has been a central impediment to growth in the heavily indebted countries. However, debt relief is not a panacea and will not suffice without the implementation of reforms that will tackle the causes of the debt buildup in the first place. Notwithstanding the tough challenges faced by developing countries, we share the staff's optimism that these economies could make the grade as shown, for example, by the success of the newly industrialized economies. The final chapter provides a useful perspective of how the world economy has developed since the 1750 industrial revolution and gives a glimpse of what lies ahead in the new century.

Mr. Cippà submitted the following statement:

The significant improvement of the overall situation of the world economy since our last discussion is most welcome. As the upward revisions of output forecasts for this year show, the main factors driving this development are the continuing robust growth of the U.S. economy and the more rapid recovery in the Asian emerging market economies. While in Europe economic growth has become more robust, Japan is still struggling to reach the path of self-sustained recovery. Notwithstanding this positive picture of the global economy, the staff is right in reiterating, even at the risk of being repetitious, the risks associated with the continuing build up of internal and external imbalances in the United States.

The discussions over the last few years underscore the difficulties of predicting the turning point of the business cycle in the U.S.. Many of us believed to have identified some signs of a slowdown last year, since some of the transitional factors stimulating the U.S. economy were fading and pressures on the supply side were increasing. However, notwithstanding a tight labor market and rising commodity prices, inflationary pressures are still not an issue and private domestic demand remains very buoyant. This development has been positive for global output, but has increased the existing imbalances, such as the size of the current account deficit, the low level of household savings, the strength of the currency, and the level of equity and property prices.

More than ever, the main challenge is how to achieve a "soft landing". While I agree that the staff's benign baseline scenario is the most probable, it was very helpful to present an alternative scenario. The outcome of this scenario hinges on the projected impact of higher growth on equity prices and the exchange rate. While choosing corrections of 25 percent and 20 percent respectively could seem audacious, the impact could be even larger. The staff's detailed analysis of the determinants of equity prices in general and particularly in the context of major technological innovations is extremely interesting. It underscores the difficulties in assessing the sustainability of the

current historically high stock valuations in some industries. I have no doubt that the new technologies contain a huge potential, however, I fear that some prices, to a large extent, reflect illusions. If allocation of capital has really been based on irrational growth potential and profit expectations, a turn of events could provoke a more significant downward correction of equity markets than forecast under the alternative scenario.

By most accounts, the introduction of the euro has been successful. The recovery has progressed and there are signs of sustained and above-average growth for the coming years. Despite the picking up of economic activity, core inflation has remained subdued and the harmonized index of consumer prices lies within the ECB's defined range of price stability. Since this inflation rate is still largely determined by monetary policy actions taken before the start of EMU, the main issue is the course of action over the next months. The staff argues that the ECB should avoid unduly constraining the ongoing recovery through a too rapid tightening of the policy stance. While the dampening effect of the large output gap and the increased competitive pressures on inflation must be taken into account, I think it is important to consider that the ECB, as a new and still untested central bank, should avoid conveying the impression of not taking inflation seriously. Furthermore, current levels of real short-term interest rates are such that a more pronounced monetary tightening than envisaged by the staff should not undermine economic recovery in the Euro area.

After several years of recession and despite a zero-interest rate policy of the Bank of Japan and several fiscal programs the Japanese economy still remains rather unstable. The severe contraction of GDP in the fourth trimester of 1999 is not reassuring, although some indicators point to some improvement. As the economy has not yet reached a self-sustained growth path, further action is necessary. The Japanese authorities are confronted with a difficult choice in the area of fiscal policy. On the one hand, further fiscal programs are essential to stimulate the economy and, on the other hand, the fiscal position has worsened dramatically over the last years. This development is even more severe, as Japan will be one of the first countries that will face the challenge of an aging population. In my view, the fiscal position has deteriorated to a point at which further support through fiscal impulses should be avoided. I sincerely hope that the expansive budget for FY2000 will be sufficient to put the Japanese economy on a sustainable recovery path. In addition, monetary policy must continue to be relaxed in order to prevent a revival of deflationary pressures and to counter the appreciation of the yen. Macroeconomic policy actions should, of course, be accompanied by structural reforms that are necessary to stimulate domestic demand.

Economic development varied considerably among emerging market economies in Latin America in 1999. Mexico's GDP continued to grow

whereas Argentina and particularly Colombia and Venezuela experienced deep recessions. I agree with the staff's assessment that recovery for this and next year will be more widespread, since the external environment will continue to be beneficial for the region and investor confidence is bolstered by the fact that many countries are successfully implementing sound macroeconomic and structural policies. In contrast to the past, most emerging market economies of the region pursued prudent macroeconomic policies despite the recessionary environment. Many have taken serious measures to reduce their fiscal deficits to more sustainable levels. I am confident that the region will be able to make considerable progress in the fiscal area. This should help bolster domestic saving, which in turn will contribute to contain external financing requirements.

I agree with the staff that the enormous external financing requirements constitute the principal vulnerability of the region, since Latin America's economic development depends to a high degree on capital inflows. To further decrease the dependency on external capital it will be necessary to reduce the traditionally high current account deficits of many Latin American countries. Measures to improve international competitiveness, to open up the economies, and to expand non-commodity exports more forcefully will be crucial in this respect.

While the recovery in Korea and Thailand has been truly impressive, in Indonesia the situation—albeit improved—is still more fragile. I agree with the staff's assessment of the factors that contributed to the regained growth. However, when assessing the growth rates we should not forget the exceptional slack that was present in 1998. Sustaining high growth rates in the coming years will be much more difficult and will depend on the progress in economic reforms.

We should not underestimate the risk that the economic upturn could lead to complacency with regard to structural reform in all three countries. These reforms are far from concluded and only full implementation will ensure more resilient economies in the future. However, several factors suggest that there are good chances that the authorities will continue their reforms. First, the economic problems were underscored so vividly during the last crisis will not be forgotten so soon. Furthermore, it is easier to continue reforms once they have begun than to start them anew. Finally, economic growth makes it easier to compensate those who are worse off after the reforms and thereby broadens the support for reform measures.

In all three crisis countries, macroeconomic stimulus will have to be withdrawn for cyclical reasons in the near future. I fully concur with the staff that fiscal policy should bear most of the adjustment to allow interest rates to remain low and thereby facilitate banking and corporate restructuring. Moreover, fiscal consolidation will also be necessary to stabilize the level of

public debt. The path of fiscal adjustment must be carefully chosen and the authorities will have to stand ready to reduce the fiscal stance beyond what will be achieved through automatic stabilizers.

I welcome the inclusion of a chapter devoted to the issue of growth and poverty alleviation. It provides a good background to the forthcoming discussions on the progress of the enhanced HIPC Initiative and the implementation of the adaptations to the Fund's concessional lending. The persistence of high levels of poverty in large parts of the world is indeed a very disturbing aspect of global economic development over the last decades, which have been marked by rapid growth of per-capita income and a substantial rise in the living standards in large parts of the world.

The staff offers a concise and well-balanced overview of the empirical work that seeks to explain the differences in growth rates across countries. As the overview makes clear, it is difficult to come to a general conclusion as to the precise causes of low growth and poverty. However, while it may be difficult to isolate a limited set of variables that strongly enhance or inhibit growth in a econometrically satisfactory way, it is clear that there are a number of factors that critically influence growth and development, which should be targeted by national authorities and the donor community.

The influence of some of these factors, such as macroeconomic stability and good governance, is straightforward. The effect of others is less clear. One such factor is the inequality of income or wealth distribution. On this, the staff still seems to support the conventional text book argument that redistribution is detrimental to incentives and therefore to growth. This disregards a number of recent findings that challenge this view. Indeed, a number of cross-country regressions of GDP growth on income inequality find a negative correlation between the average rate of growth and certain measures of inequality. Although such regressions are subject to the same general qualifications that the staff mentions, they nevertheless point to the fact that greater inequality can lead to slower rates of growth. An intuitive explanation is straightforward: inequality may not, as conventional wisdom will have it, lead to increased saving, but to dissaving and unproductive investment by the upper income segments.

Concerning the debt issue, I fully agree that the removal of unsustainable debt levels is a pre-condition for growth and poverty alleviation. However, debt relief under the HIPC Initiative will not be sufficient. Sustained efforts of developing countries will be necessary to create and maintain macroeconomic stability and an environment conducive to private investment and enterprise. Efforts by the developed countries will also be required. For one, aid flows to countries with sound policy records should be increased. Aid should not, as is currently often the case, be decreased in post-stabilization countries. The efficiency of aid in terms of poverty reduction is

higher in post-adjustment environments. Aid should thus taper in with reform. This would also give the right signaling effect to private foreign investment.

Mr. Morais submitted the following statement:

This version of the World Economic Outlook makes very interesting reading. Not only does it focus on recent economic developments and prospects for the medium term, but it also provides valuable insights into the economic history of the past century. The picture that emerges is that we have come very far in the 20th century, but there is no doubt that significant challenges lie ahead, principal among which is finding a solution to the scourge of poverty that afflicts a significant part of humankind. I commend the staff for its effort.

The global economy seems to be on a firm rebound, with most regions of the world experiencing strong growth. It shows that, by and large, the policies being implemented are on the right track. The key player has been the U.S. economy, where an environment of low inflation has created room for implementing monetary policy that supported strong growth. However, there are growing concerns about overheating in the United States. In the circumstances, there is need for stronger growth in other regions to keep the global economy on an even keel.

The outlook for the world economy assumes that there is no rapid stock market correction in the United States; but the fact remains that prices are at historically very high levels. The general tightening of the monetary stance to deal with the situation could lead to a premature slowdown in the economy. This is an area where prudential or regulatory measures might be appropriate to keep the market in check.

The Japanese economy is continuing to experience difficulty in getting on a sustained path of recovery. This suggests the need for continued emphasis on structural reform, giving the declining margin for fiscal policy to be used as a means to stimulate domestic demand. The authorities should also keep monetary policy appropriately accommodative.

As for the euro area, there is a possibility for stronger growth, given the competitive exchange rate and supportive macroeconomic policies. However, as the staff has emphasized in the past, structural reform of labor and product markets is essential to improving the medium-term growth and employment prospects.

The emerging market economies have to continue with firm macroeconomic policies and structural reform, especially as regards the financial sector and cooperate restructuring.

The situation in Africa is encouraging, with economic growth projected at 4 percent in 2000. However, this performance falls far short of what is needed to make a significant dent in poverty and to deal with the high levels of unemployment in the region. The issues mentioned in the staff paper that relate to the low level of development in Africa are not new. Perhaps, the reason is that despite all the effort toward economic reform and adjustment, the African economic scene remains largely unchanged. Economic reform and adjustment have not led to transformation in the economic structure similar to what has been seen in countries that have experienced a "take off". In this regard, one notes the observation of the staff in its analysis on income growth and poverty reduction that the improvement in human living conditions over the past 100 years has been brought about by unprecedented technological and economic transformation. African countries, for the most part, are far from this point, evidenced by the continued high reliance on a few primary commodities subject to a secular decline in prices and the low level of technological capacity. Making steady progress towards economic transformation is a major challenge for Africa in the decades ahead.

African countries and the international community have to make a concerted effort on various fronts. The new approach to poverty reduction is a step in the right direction. The HIPC Initiative is also very important, and we would urge that it be fully financed and implemented for all the eligible countries in a timely manner. But it should be stressed that this Initiative needs to be complemented by additional concessional financing, particularly to support infrastructure and the development of human capacity. There is also a need to develop an appropriate debt strategy for middle-income countries. More open markets in industrial countries is also essential. At the same time, countries in the region should continue to deal with the problem of instability and to improve governance and the allocation of resources.

It is evident that there can be no single approach to creating conditions for rapid development. However, the staff has identified some critical elements which are needed, among which are capital accumulation, efficiency of production and technological progress. These are areas where the private sector can have the greatest impact; hence the need for low income countries to implement policies and develop programs that improve the environment for private entrepreneurship and innovation.

Ms. Jul and Mr. Costa submitted the following statement:

This issue of the WEO presents us with an array of insightful topics and a historical perspective that would demand more time than the usually available in order to give it the attention it deserves. The choice of Asset Prices and the Business Cycle as the central theme is quite timely since it sheds light on an area on which, in our view, hinge important economic and financial developments in today's world.

We welcome in the first place the fact that world growth prospects are being continuously revised upward. Y2K related problems went unnoticed, price stability still remains unshaken despite the sharp increase in oil prices, the actual and expected tightening in monetary policy by the U.S. FED is increasingly viewed and discounted by many as the welcome ingredient necessary to maintain the strength of global growth while avoiding overheating. All in all, these are unquestionably good times. What matters most, however, is to identify all the necessary conditions to keep the good times rolling. It would also be desirable that such a growth should encompass all major countries and regions in the world with variations in intensity only to help reach a more balanced pattern, as the one depicted in the soft-landing scenario.

The above scenario calls for a slowdown in the U.S. economy accompanied by a more intense rebounding of other regions particularly in Europe and Japan. To this end, a menu of macroeconomic policies is presented calling for further tightening of monetary policy in the U.S., while preserving the progress reached in fiscal adjustment, and for stimulus policies in Europe and Japan. In our view, however, it is time to reverse the emphasis in these two areas and give preeminence to structural factors. In any event, we are now facing positive growth projections for most regions of the world, although with only a lackluster performance in the case of Japan. This simultaneous type of recovery invites the question of which is the underlying force, or forces, behind this positive outlook. We can think of several explanatory factors: the quality of macroeconomic and structural policies being implemented by many countries, the impact of the so-called new economy based on the productivity enhancing features of the new information technology, and, the less comforting one, the impact of the surge in global liquidity in recent years.

Despite the fact that it is not clear the weight the staff gives to each of those factors, it transpires from the topics chosen, particularly in Chapter III in the paper and in Box 3.2, that the staff in fact gives particular importance to the last factor mentioned. Notwithstanding the comprehensive analytical treatment in Chapter III on the variables that drive asset prices, one is left with the impression that something is missing in the analysis. If we keep in mind that one important element driving growth may have been the surge in global liquidity as clearly stated in page 5 of the paper, it is somewhat surprising that among the factors discussed in Chapter III to answer the question of what drives asset prices this fundamental aspect is somewhat lost in the analytics of risk-free interest rates, the risk-premium and the expectations of earnings growth, in the case of stocks. Certainly, accommodative monetary policies become reflected in lower risk-free interest rates but two very different scenarios can be depicted if we present low real interest rates as the result of sound macroeconomic policies as done in paragraph 3 of page 84, or as the result of the surge in global liquidity as done in the third paragraph of page 5.

If in fact the latter is the predominant influence behind the surge in asset prices, then the causal relationship between changes in asset prices and output growth, raised in pages 98 and 99 of the paper, would become easier to disentangle: increases in asset prices impact output growth through the wealth effect and its associated consequences in terms of greater confidence and aggregate spending. In sum, Chapter III presents a comprehensive view of the factors to be taken into account, but we do not see there a clear conclusion on which are the prevalent ones.

Moreover, if we were to agree that asset prices have reached the point in which they are basically liquidity driven, then the already conventional view that central banks in advanced countries are to be congratulated because of their sound monetary policies would be questioned since those apparently sound policies were in fact feeding an asset price bubble through excessively low interest rates. The latter would, incidentally, also question the conclusion of the historical chapter which concludes its point on the role and development of the international monetary system in page 198 with the description of a new paradigm in which central banks would have learned their lessons as a consequence of the dismal experience of unbridled monetary policies implemented during the 1970s.

Leaving this aspect aside, the critical question in this new scenario is how to reign in liquidity to prevent an unwarranted build up in asset prices, that may very well reverse, without at the same time hurting growth. There is no easy answer to this latter question since markets appear divided into a sector which seems immune to monetary policy tightening, and another which is more sensitive to changes in monetary policy. If one wants to hit the average of the two, one may need to use an overdose for the latter, risking a more serious slowdown than desired. As a matter of fact, the tightening already implemented by the U.S. Fed and the one already anticipated seem to have had relatively little impact on the growth of asset prices in general. Several voices have been risen, therefore, suggesting the need for resorting to other policy instruments besides rising the interest rates, such as increasing margins or reserves requirements. Irrespective of the effectiveness of these measures, there seems to be also a need for intensifying regulations and supervision in the U.S. banking system in particular and elsewhere, so as to exert some control to the building up of speculative positions that may turn to be the downfall of the system if a sharp reversal of values takes place. As the paper states, the apparently sound balance sheet positions of households and the banking system would present a radically different look if the high value of their assets, on which they are presently based would turn drastically down.

Growth in Europe is projected to accelerate during the present year although we note with some concern that in Germany growth has recently been lagging vis-à-vis early expectations despite the very supportive monetary conditions prevalent in the region.

The sharp depreciation of the euro has dramatically increased external competitiveness, while the level of the real interest rates is the lowest in a very long time. Headline inflation has already reached the ECB's inflation limit. Although driven by rising energy prices and the weak euro that are viewed as temporary factors the danger is, however, that it may negatively impact the wage negotiations currently under way in several countries. Moreover, countries of the euro area at a more advanced stage in the cycle are showing clear signs of overheating with inflation rates that are well above the ECB target. This not only calls for the ECB to become less accommodative, but it also reflects the inability or unwillingness of those countries to make full use of fiscal policy to compensate for the excessively loose monetary conditions prevalent in the area as a whole. In any event, in our view, growth prospects in Europe depend, as already stated, on the progress in the structural front rather than on the degree of monetary relaxation. In other words, without a sound structural underpinning predicated on flexible labor and product markets, monetary stimulus may easily turn into inflationary pressures rather than into growth support.

Japan is a more dramatic example of the limitations of macroeconomic policies to jump start growth in the presence of structural rigidities. At this stage of the Japanese struggle to overcome the recessionary consequences of past problems, little doubt should remain that the so-called trade-off between short-term growth performance and vigorously advancing the much needed structural reforms should not be given any major weight in defining policies. While the staff clearly highlights this point, its call to further easing liquidity conditions as an appropriate way to provide support to activity is less convincing, particularly given the "zero interest rate" policy already in place. Moreover, the discussion in Box 3.2 clearly highlights the risks stemming from excessive liquidity in one major reserve currency country spilling over to other regions with potentially deleterious effects if conditions change abruptly. Being in the financial heart of Asia, the loose monetary policy in Japan clearly embeds that risk, as has been pointed out by many commentators when discussing the causes of the recent Asian crisis, that we now seem to have forgotten.

The economic outlook in East Asia has certainly improved with a strong recovery of output and the strengthening of external positions in the wake of a robust export growth, the rebuilding of official foreign exchange reserves and more appreciated currencies that still maintain a substantial competitiveness gain with respect to pre-crisis values. To make a balanced assessment of this impressive turn about it is important to look at the different factors that came into play. In the first place, the continuous strength of the US economy has offered ample markets for the region exports supported also by the effective real depreciation of their currencies. The appreciation of the Japanese yen was also conducive to important competitive gains. In the second place, the dynamism of aggregated demand was not only supported by

strong export growth but also by markedly stimulative macroeconomic policies that translated into very low real interest rates, in some cases even lower than pre-crisis levels, and in unprecedented high budget deficits. In the third place, the fact that the rebound in activity took place in an environment in which structural reforms, particularly in the restructuring of banks and corporations, generally failed to show clear progress poses a real danger of complacency.

From the above we can point out some areas of particular concern regarding the East Asian countries prospects for sustained growth. Leaving aside developments in the world economy and in Japan in particular which are critical but out of the purview of policy makers in the area, one immediate concern for the authorities is the exchange rate regime adopted which if allowed to play out may end up undermining, through nominal appreciation, the competitive gains recently obtained. A second concern has to do with the substantial growth of public debt as a result of the budget deficits which in turn reflect the very large cost of banking systems' restructuring. Since this restructuring, along with that of corporations, is by no means completed we can only wonder which will be the final cost for the public sector of this critical task lying ahead for the authorities. Finally, the question of falling into complacency should be in fact reformulated as the need to show the political will to take stock of losses and assign them in an equitable manner. This is in the last analysis what makes structural reforms so difficult.

Economic prospects in Latin America have also strengthened, underpinned by sound macroeconomic policies and structural reform efforts, particularly among the largest countries in the region, along with an improved outlook for commodity prices. The staff highlights, however, the vulnerability of the region due to sizable external financing requirements originated in large and persistent current account deficits, associated in turn to low saving rates. The degree of Latin America's vulnerability seems in our view somehow overstated. There is, of course, the fact that a debt overhang may create an autonomous burden on the external accounts which could be compounded in a scenario of higher international interest rates and the consequent impact of pull factors. To this we could say that, in general, debt levels are not high by international standards in Latin America. Moreover, in the event of a crisis scenario, the consequences would reach far beyond individual countries or the Latin American region as a whole. We would be in a crisis of systemic proportions that would require commensurate measures. On the other hand, in the more benign outlook presently projected, there seems to be no serious risks that the external financing requirements for Latin America would be unmet. Overall, those requirements are lower this year than in 1999, a year characterized by a retrenchment of international financing, coupled with economic, political, and even with the technological uncertainties of the infamous Y2K problem. If financing requirements were met in 1999 despite those unfavorable conditions there is no obvious reason why this year could

present particular difficulties in this regard when growth prospects are up, spreads are falling, commodity prices are improving, and the exchange rates more stable.

Chapter IV on "How can the Poorest Countries Catch Up" presents a message that appears simple: in order to overcome poverty a concerted effort is needed involving both poor and donor countries working together in the development and implementation of a comprehensive macroeconomic, structural and institutional plan aimed at creating the right incentive structures including through the rule of law for people to work, save and invest while directly addressing the needs for health, housing and education of the most needy. However, it should be clear on the part of donors that it is not only a matter of condoning debts but also of boosting development aid which has lately been shrinking. Moreover, they should hear the call in the paper to expand market access to poor countries' products such as agricultural goods, textiles and footwear which are usually, and ironically, excluded from trade opening agreements. Developing countries on their part should be willing to undertake a further revamping of their still weak institutional structures aimed at fostering greater political stability and at a drastic curtailment of the opportunities for corruption, which in some cases represent a major hindrance to growth. Finally, it should be made clear that good policies are mutually reinforcing and that is therefore necessary to implement a package encompassing a broad range of measures so as to ensure its success. All very easy to say but very hard to bring about.

Mr. Ahmed submitted the following statement:

Much in the global economic and financial landscape is heartening. Indeed, the staff indicates that there has been a "dramatic strengthening" of global economic and financial conditions during the past year. The continued impressive expansion of the U.S. economy, the much-improved outlook for Europe, the sharper-than-expected recovery of the emerging economies in Asia, and the broadening recovery in Latin America, Africa, and elsewhere, all point to evidence of a robust global rebound that is anchored on sound macroeconomic policies and the implementation of wide-ranging structural reforms in a large cross-section of the world economies.

Yet, as the WEO papers note, underlying these impressive achievements is a gathering sense of unease about the outlook. The many economic and financial imbalances, which have been building up in recent years and have been the subject of previous issues of the WEO, remain unaddressed, raising anew the risk of an abrupt and discordant readjustment. The staff is right to stress that we should avoid the temptation of thinking that just because the imbalances have not posed obvious difficulties so far, "they may not be a problem after all." Clearly, urgent action is needed to ensure a smooth

transition to a more sustainable pattern of global growth and payments balances and a realignment of key currencies.

We broadly support the areas highlighted by the staff that require priority attention in the period immediately ahead, i.e., containing domestic demand pressures in the United States, promoting robust expansion in Europe, building investor confidence in Latin America so as to attenuate the costs associated with large financing requirements, underpinning improved economic prospects for many transition- and developing countries by building on the progress attained through macroeconomic stabilization, and implementing policy reforms that help to alleviate structural impediments to growth, etc.. However, we wish to make two comments: first, we are concerned by a seeming loss of policy instruments in some countries and the consequent challenges this poses for policymakers. This is most evident in the case of Japan where monetary policy has already reached its limits, once interest rates approach zero. The WEO papers note, however, that “with the government debt ratio continuing to spiral upwards, fiscal policy is rapidly reaching its limits” as well. With the exchange rate beyond the authorities’ control under the present circumstances, the staff’s suggestion to take “additional steps to ease liquidity” does not seem very convincing. This chair has argued in the past for a stronger framework for exchange rate policy coordination that would, at the minimum, dent the assumption of a rising yen—a factor that has played a role in disarming policies in Japan. Consideration of the efficacy of this suggestion seems to be warranted by the country’s continued economic difficulties and the urgent need to direct its economy onto a more durable growth track.

A similar situation exists in the euro area where, with exchange rates fixed and monetary policy set on a euro-wide basis, the principal macroeconomic instrument that is left with the authorities of individual governments is fiscal policy. The staff is concerned that the current policy stance implies little change in structural budget positions and that it is “particularly unfortunate that more progress is not being made by some of the dynamic economies on the European periphery.” The staff’s call for the need for fiscal policy to play a greater role in helping to reduce regional cyclical divergences and to set more ambitious medium-term goals, including spending restraint to allow tax levels to be reduced while maintaining fiscal prudence, is therefore well-placed.

Second, a major feature of the evolving global economy is the emergence of strong speculative forces in asset markets. The WEO document draws welcome attention to this phenomenon in Chapter III in relation to equity and property markets in North America and Europe. It notes that “asset price inflation can be particularly destabilizing” by encouraging households and business firms to over-consume and over-invest and by the dangers it presents for the financial system, which “may become vulnerable to an

eventual downward correction.” Apart from reflecting overly optimistic assumptions and unrealistic expectations of future profitability and “the ample growth in global liquidity in recent years”—which has been the driving force behind the increase in demand for financial assets in many countries—there could well be a generalized explanation for the relatively wide sweep of speculative phenomenon. The simple fact that foreign exchange markets can transact a turnover of one- and-a-half trillion dollars daily does suggest an enormous amount of position-taking that could hardly be on a fully-covered basis. The LTCM experience is perhaps only the tip of an iceberg in financial markets that should raise some queries as to whether the pendulum may have swung too far in favor of free and open markets that may be generating the features of a “casino” global economy. The resistance being encountered to suggestions for private sector involvement in financial crisis management is indicative of the powerful forces arrayed by the financial services industry against effective regulatory oversight of speculative activities in a range of markets. Perhaps it is time to look into the whole set of rules and incentives under the present market system to ensure that a major shock does not hit the world economy when least expected. The staff mentions the contribution that more effective financial sector supervision and regulation can lead to mitigating asset price booms and busts through, for example, raising provisioning requirements for consumer and real estate loans, margin requirements, enhanced monitoring of lending standards, and greater disclosure requirements for banks with regard to their loan risk management and internal control policies and practices, etc.. However, it is unclear where the impetus for broad-based, meaningful reform will emanate from.

The staff is to be commended for using the occasion of the arrival of a new century to look at the major trends of the century just ended. Their recalling of the words of the former Managing Director that the gulf between the most affluent and the most impoverished nations is “morally outrageous, economically wasteful and potentially socially explosive” is appropriate. It is important, however, to examine income and asset inequities within each country as well as to explore what could be done to reduce them as part of our struggle for greater stability in the world society. Perhaps this is too large a task for our institution. Yet we seem to be set upon that road in the HIPC and PRGF framework. It is essential to remind ourselves that the problems of poverty are not restricted to HIPC countries alone. In that respect, the staff’s call for addressing the “debilitating debt service problem with much greater resolve,” “to quickly reverse the downward trend in ODA,” and to foster major efforts to reform trade policies that adversely affect the poorest countries is worthy of our fullest support.

Mr. Yoshimura remarked that several concerns with respect to the Japanese economy had been raised by Executive Directors and the Economic Counsellor. GDP growth had remained erratic, although some progress had been achieved. For instance, investment had recovered, and stock prices were increasing. However, domestic consumption remained

stagnant. There was accordingly no evidence of a traditional recovery pattern, whereby consumption usually recovered first, followed by investment. The reversed recovery pattern probably reflected structural changes that were currently taking place in the Japanese economy, including in manufacturing and in the traditional service industries. As a result of the structural changes, some factories had closed, affecting the part of the labor force that was employed in the old economy. In the so-called new economy, including information technology, health care, and other new service industries, employment was increasing, but at a slower rate, given the uncertain nature of venture capitalism. Therefore, uncertainty regarding the future continued to guide a number of consumers, as they chose to save rather than spend. That trend probably also explained why investment had been increasing. Similarly, the stock market had been reacting to the increase in investment in the new economy.

Slow growth might not in itself constitute a serious issue, Mr. Yoshimura continued. Achieving progress in restructuring the Japanese economy remained a more important task. In that respect, a traditional output gap analysis might not be relevant because the potential output itself was undergoing change, as was the vertical structure of the economy. Therefore, slower growth might be expected in the future—a projection that contrasted with that of the Economic Counsellor.

While Ms. Lissakers had expressed the view that Japan's low outstanding net debt allowed for further fiscal stimulus, it was important to bear in mind that Japan was facing among the most serious challenges of an aging population in the world, Mr. Yoshimura noted. The increasing level of public debt therefore constituted a serious concern. Furthermore, a continued expansion of the fiscal deficit would result in higher long-term interest rates, thereby hampering economic recovery. While the need for fiscal consolidation had been recognized by almost all Directors, a delayed economic recovery would further postpone that process. The previous period of fiscal consolidation had been achieved during the late 1980s, where rapid economic growth had resulted in the disappearance of the fiscal deficit. However, that situation had proved to be unsustainable in the long run. It was hoped that the United States would not repeat that mistake.

However, the marginal benefits of fiscal stimulus remained larger at the current stage than the marginal costs, Mr. Yoshimura continued. The government would accordingly take appropriate action when the stimulus effects of the current fiscal package were exhausted. In that regard, the government would also have to take into account the political situation, as general elections were to be held in 2000. However, as had been pointed out by Mr. Bernes, fiscal policy was rapidly reaching its limits.

Many Directors had pointed to the need to inject further liquidity into the economy, Mr. Yoshimura noted. However, liquidity remained abundant in the Japanese short-term money market: more than a ¥1 trillion had been deposited into commercial bank accounts with the Bank of Japan. While the Bank of Japan could inject further liquidity, thereby doubling or tripling its outstanding debt surplus, the effect on the economy in general, and on price development in particular, remained uncertain, as consumer expectations were unlikely

to change. It should be noted that the Bank of Japan no longer was constrained by the difference between sterilized and non-sterilized interventions.

There were also risks related to accumulating liquidity, as had been pointed out by Ms. Jul in her preliminary statement, Mr. Yoshimura said. If a sudden change in consumer perceptions were to occur, a large amount of liquidity could have a serious impact, not only on the domestic economy, but also internationally. In order to change price expectations, extraordinary monetary policy measures might be considered. For instance, unlimited intervention in the foreign exchange markets, or the acquisition by the Bank of Japan of long-term bonds or even property, would probably change consumer expectations. However, there were no guarantees concerning the lasting consequences of such actions. Accordingly, such extreme measures would not be undertaken, despite the slow pace of economic recovery.

The authorities remained reluctant to adopt inflation targeting, as they were unsure whether it would be successful in changing price expectations, Mr. Yoshimura remarked. The authorities did not currently have at their disposal an effective instrument with which to induce moderate price increases without losing control over price developments in the economy; if inflation targeting was introduced, and the authorities failed to reach the announced inflation target, the credibility of the Bank of Japan would be put in serious jeopardy.

The authorities remained concerned about the appreciation of the yen, Mr. Yoshimura stated. However, in terms of volume, Japan's current account surplus was currently declining, and imports were increasing at a faster rate than exports owing both to the economic recovery and the recent increase in oil prices, while exports remained subdued as a result of the appreciation of the yen. Accordingly, the staff might be mistaken in expecting an increase of the current account surplus in 2000.

Consolidation in the financial sector continued, Mr. Yoshimura noted. Financial institutions were disposing of bad assets, and debt held by the corporate sector was being consolidated, as financial institutions decreased their exposure to individual companies. However, there was a risk that the current fiscal and monetary policies might prolong the problems of debt overhang. The continued fiscal stimulus had helped debt-ridden construction companies to survive, and the zero interest rate policy had reduced the cost of servicing debt for the corporate sector.

While structural reform was important, it remained a long-term process, Mr. Yoshimura concluded.

Mr. Kiekens agreed with Mr. Yoshimura that caution ought to be applied when considering whether to increase further the burden of public debt in a rapidly aging society such as that of Japan. The observation that expansionary fiscal and monetary policies were delaying restructuring of the economy had been particularly interesting in that respect.

Ms. Lissakers remarked that policymakers in Japan were faced with a dilemma when it came to deciding whether to continue the policy of fiscal stimulus in light of the build-up

of public debt. However, Japan's debt dynamics would deteriorate further in the event of little or no economic growth. Appropriate fiscal stimulus would accordingly help bridge the path toward a situation with self-generating domestic demand. Mr. Yoshimura's suggestion that expansionary fiscal and monetary policies might be counterproductive from a structural point of view by creating disincentives for a more rapid reorganization of the private sector had, however, been enlightening.

Mr. Kiekens wondered why the staff had forecast economic growth of only 1.5 percent of GDP for Russia in 2000 despite a growth rate of 3.2 percent of GDP in 1999.

Mr. Pickford stated that, while he agreed that it was essential for Japan to press ahead with structural reforms, including corporate financial restructuring, it was important to recognize that important reforms had already been undertaken, and that investors were moving out of sunset industries and into sunrise industries. The key was to encourage that process while avoiding dislocation. The uncertainty resulting from the process of restructuring was one of the reasons why consumption had continued to stagnate. Labor market flexibility should be encouraged as a means to increase mobility between the various economic sectors, combined with offers of developing new skills. There were a large number of discouraged workers, which were holding back the long-term potential growth rate of the economy; re-deploying those resources into useful employment ought to be a priority.

While it was widely recognized that there were limits to further fiscal and monetary stimulus in Japan, the efficacy of such measures might also be declining: while policies ought to remain supportive of economic growth, a real risk remained that there would be no recovery in private sector confidence in the short term, Mr. Pickford continued. The question was which policies to adopt instead. In that respect, shifting the focus of fiscal policy from further expenditure measures toward restructuring the tax system through a front-loading of income tax reductions might be beneficial. Such measures could be supplemented by an increase in consumption tax.

The argument that inflation targeting would not be introduced for fear of damaging the reputation of the Bank of Japan if it failed to meet its targets was not totally convincing, Mr. Pickford remarked. The purpose of introducing inflation targeting in the first place was precisely to increase credibility, thereby making it easier, not harder, to reach the desired inflation path.

Mr. Kelkar stated that he agreed with Mr. Yoshimura that the limits of what could be achieved through fiscal policy would probably soon be reached. Consumer spending might have stagnated in response to rising public debt and the possibility of an increase in taxes. What was required was accordingly a change in consumer perception. Non-sterilized interventions in the foreign exchange markets might have precisely that effect, and might therefore be worth considering. They might furthermore stimulate investment, especially in the service sector. Mr. Pickford's suggestion concerning tax reform might also be beneficial in terms of stimulating consumption.

Mr. Törnqvist said he agreed with Mr. Pickford's comments on inflation targeting. He wondered why Mr. Yoshimura doubted the central bank's ability to achieve a specific inflation target.

Mr. Yoshimura replied that the Bank of Japan was concerned mainly with deflation whereas other central banks were concerned mainly with inflation. However, it was also true that the current policy of injecting liquidity and maintaining interest rates at zero percent had not yet yielded the desired increase in prices.

Mrs. Hetrakul stated that the U.S. chair had cautioned South East Asian countries, including Thailand, against intervening in foreign exchange markets during 1999 and early 2000. The Thai authorities had decided to intervene in June 1999 because they were worried that the baht might appreciate too rapidly, given the size of the current account surplus at that time. After June 1999, the exchange rate had been set by the markets only. In Indonesia, there had been some intervention in the foreign exchange markets during the first nine months of 1999. However, those had ceased in September 1999. In Malaysia, the authorities had intervened in order to defend the fixed exchange rate regime. Capital portfolio inflows had increased markedly during that same period, as had foreign exchange reserves.

Mr. Carstens made the following statement:

I commend the staff for a comprehensive and analytically solid WEO. I also praise the topical content of the document. In particular, I find quite appropriate the inclusion of chapter IV on how the poorest countries can catch up and the testimonial in the last chapter about the striking developments and policy lessons in the world economy in the 20th century.

I also agree with the thrust of the evaluation on the state of the world economy and in broad terms on the policy recommendations. Having said that, I would like to make some comments on particular issues.

I would have liked to see the analysis of different policy mixes tackling the complex challenges that the U.S. authorities face in the near future. The staff seems to be content with the recommendation to contain excess demand, reduce the external imbalance and depreciate the US dollar through a tighter monetary policy, avoiding a significant relaxation in the fiscal stance.

I certainly would feel more comfortable with more weight in the adjustment being given to a tighter fiscal policy and reduce the burden on the adjustment of monetary policy. A tighter fiscal policy would have a clear impact on aggregate demand, and in reducing the current account deficit. On the other hand, I see risks in trying to achieve the same through monetary policy bursting the stock market bubble and then inducing a currency depreciation. With the latter process, I have the concern that a tighter monetary policy in the U.S., coupled with accommodative monetary policy in

Europe and Japan, will only exacerbate capital inflows to the US and appreciate further the U.S. dollar, with the concomitant worsening of the current account deficit.

In addition, relying more on fiscal policy would reduce pressures on the world capital markets and the risk of spillover effects of tighter monetary policy on the world economy would be reduced.

This should not be interpreted that the U.S. has followed an irresponsible fiscal policy. On the contrary. But that does not mean that there is no space for further fiscal tightening, specially in light of the coming pressures derived from an aging population. A tighter fiscal policy would reduce growth and this would tend to mitigate the exuberance in asset markets. It might be unrealistic, but nevertheless useful to have the analysis in the area.

Economic conditions in the euro area have improved considerably during the last months. Growth is now widespread while inflation continues relatively subdued despite the strong increase in oil prices. On balance, the situation is clearly more positive and the prospects more brilliant than six months ago. The staff rightly points out a rate of real growth for 2000 close to 3 percent, while they forecast a headline inflation around 1.7 percent, clearly below the 2 percent medium-term target.

As far as the monetary policy to be implemented in the euro area, I think that given the sharp depreciation of the euro and the considerable improvement of economic prospects, the recent 0.25 percent increase by the ECB was warranted. We can argue that maybe they could have waited a little longer since inflationary pressures in the area as a whole are not evident. However, we understand the preemptive strategy adopted by the ECB, especially once the expectations of a rise in interest rates in the U.S. have been confirmed.

Regarding the issue of the need for further advances in the structural field in Europe, we cannot agree more with the staff's view. There is an obvious cap to growth in the inability of supply to respond quickly to strong increases in demand. This being the case, monetary authorities react prematurely to the first signs of price tensions by tightening monetary policy. This constraint shortens the expansionary phase of the cycle and increases the structural unemployment, an accumulation process lived for the last cycles.

There are many things to be done, in particular in the labor market, where the situation is clearly far from optimal. The initiatives taken in the Netherlands, Denmark, and the United Kingdom should be an example to be followed by other countries in the area, where the conditions, although improving, require a major overhaul.

With respect to Japan's subsection in chapter 1, I would have changed the emphasis completely, and instead of calling it "Re-energizing the Japanese Recovery" I would have called it "the Reengineering of the Japanese Economy". I feel we continue to be trapped with trying to solve the problems of the Japanese economy as if they were cyclical, where there is abundant evidence that it is structural. In addition, the short-run oriented aggregate demand policies are deepening the structural problems of Japan, without clear signs that economy activity will increase in a sustainable fashion in the near term. Addressing in a concerted fashion structural problems could be a catalytic factor to jump-start the economy.

With respect to emerging markets, I enjoyed very much the analysis of the staff, and found appropriate the attention paid to the prospects for access to capital markets and to terms of trade behavior. With respect to Latin America, in particular, I coincide with the staff's assessment about the urgency to continue pressuring for further fiscal consolidation, an increase in private savings, further progress in financial system reform and in general in the structural areas of the economy. Slower progress in all these areas in the recent past reflect to adjustment fatigue in the region.

An issue that seems to me it was not addressed in the staff's analysis about Latin America is the wide ranging reforms in pension systems all over the region. This factor certainly will enhance the quantity and quality of savings. A study on this regard by the staff would be welcome. I also would reiterate my petition, now for the third time, of a study by FAD on the convenience to use taxes on financial transactions, a tax that has been widely used in the region and that creates huge distortions in one of the weakest sectors of the economy. Given that the IMF has sanctioned the use of such taxes in at least three countries, I think it is time to set the record straight if they are or are not useful in net terms.

A minor comment is that even though some people might wish for OPEC to brake down, Venezuela still is a member of OPEC, contrary to what the staff mentioned on page 53.

The chapter on asset prices and business cycles is a logic continuation of the work done for last October's edition, when we started discussing the implications of asset prices on monetary policy. In this regard, the present edition provides with a most balanced set of conclusions that should help to deal with the problem of asset bubbles with a broader perspective. I find most valuable the way the staff has presented different methods to estimate the potential overvaluation of assets markets and the implications for policy making. I have, nonetheless, some comments to make.

As regard to the methodology used to assess the potential overvaluation in stock markets, namely the Gordon valuation formula, the use

of a proxy like real GDP growth for the expected growth in real earnings could underestimate the equity risk premia required. In some countries where the stock market is dominated by a small group of multinational companies, whose expected profits depend considerable on external high growth markets, the country's real GDP growth could diverge considerably from the expected growth in stock earnings.

Aside from this possible flaw, I have also a small problem with the estimates for Spain that I would like to clarify. In table 3.1 Spain appears as the country with the smallest implied equity premium reduction, namely virtually zero. However, on page 91, using a different approach, Spain is mentioned among the countries where the stock markets seem to be above what can be warranted by fundamentals. Do you have an explanation for this divergence? If not, I would stay with the results in table 3.1 and avoid any other non-explained reference.

Finally, I would like to make a brief comment about chapter V. I think the analysis made by the staff in this chapter is fair. They clearly point that it is difficult to define a standard set of factors for explaining why slow growth and poverty still remains in many countries, and that these factors should be analyzed country to country. They also recognize that macroeconomic stability, sound institutional arrangements and openness to trade are factors that have been present in the developing countries with sustained and fast economic growth during the last 30 years, while poor education and health, weak rule of law, ineffective governance and wars characterized many of the countries whose real income has decreased in the same period.

In addition, I strongly agree with the remark in the report that "without the strongest commitments on the part of their leaders and elected bodies, supported by society at large, these countries won't be able to grow faster and overcome poverty". The staff is cautious in assuring that the HIPC Initiative is no panacea for all poverty and economic problems in these countries and that their goals can only be achieved with continued hard work by domestic and international participants. Nevertheless, I feel that with this section we continue to inflate expectations about HIPC, when we have to remember that financing is still in the air given the design problem in the Initiative. This would call for a more tamed approach, so as not to exacerbate expectations that would be hard to match.

The Acting Chairman took note of Mr. Carstens' request to undertake studies of pension reform in Latin America, and of the consequences of having a financial transactions tax. However, he cautioned that certain countries might resist suggestions to abolish such taxes, as they were unable to raise revenues by any other means.

Mr. Carstens agreed that the financial transactions tax should not be addressed in the context of the World Economic Outlook. However, the WEO had correctly pointed out that

weak fiscal positions, combined with weak banking systems, provided an additional burden on countries in Latin America. Countries such as Ecuador, Venezuela, Colombia, and Brazil had further weakened their economic situation by introducing a tax on financial transactions, and were arguing that the Fund had sanctioned the use of such a tax. It was therefore important that the Fund state its position on the matter in an open and transparent manner. While it was understandable that the Fund had sanctioned the use of the tax during a period in which the need to close a short-term financing gap had been acute, long-term use of the tax would distort investment patterns.

Mr. Esdar made the following statement:

Let me start by addressing Mr. Carstens' concern about the financing deficit of the enhanced HIPC Initiative. Germany has already made a final commitment to provide its share of the financing.

Coming to the World Economic Outlook, I would like to thank the staff for a well-written and comprehensive set of papers. Let me take this opportunity to thank Mr. Larsen for his contribution to the WEO. I was particularly impressed by the chapter about the world economy in the 20th century, which ought to become mandatory reading for those who plan to protest the Spring and Annual Meetings. The outlook for the global economy has improved further since our last discussion on the subject, and that has been reflected in improved output projections. We share the staff's general assessment, but agree that there are downside risks, including the possibility of a hard landing in the United States, the continued recession in Japan, the stock market bubble, and the rise in oil prices.

We are pleased with the staff's upwardly revised forecast for Germany, which is shared by the authorities. However, although growth has gained a more secure footing due to stronger private demand and exports, I would hesitate to make a final projection for 2001, although it will amount to at least 3 percent of GDP. The reform efforts are paying off, and the authorities remain firmly committed to strengthening growth and fighting unemployment. Large cuts in public expenditure and an impressive income tax reform package have already been adopted. The government has also proposed an additional tax reform, which will be passed by parliament shortly.

The U.S. economy is experiencing its longest economic upswing ever, but the probability that it will come to an end soon is growing. While I do not want to join those who warn about the bursting of the stock market bubble and a subsequent hard landing, one has to wonder whether the situation is sustainable. For a long period of time, overall demand has grown at a faster rate than overall supply without triggering inflation. What are the factors underlying this phenomenon? The large trade deficit is a clear signal that a substantial share of that additional demand has been channeled to foreign markets, in particular to Asia and Latin America. This development has been positive both for those countries, in so far as it has helped strengthen their economic recovery, and for the United States, where it has helped

secure non-inflationary growth. However, the process cannot continue indefinitely: the economic situation in Asia and Latin America has improved, and the absorptive capacity of the region has been reduced as a consequence.

Against this background, it is worth noting that current account imbalances around the world were reduced in 1999, with the only exception of the United States. The WEO refers to the persistence of large external surpluses in Japan and—albeit to a lesser extent—the euro area. However, Japan's surplus decreased from 3.2 percent to 2.6 percent of GDP in 1999, while the external surplus of the euro area decreased from 1 percent to 0.7 percent of GDP. Canada has also registered an improvement in its current account. Accordingly, it is the U.S. current account deficit that constitutes the largest risk.

However, the U.S. current account deficit also reflects cyclical divergences. It is reasonable to expect that some corrections will occur: if the economy slows, the related weakening of the dollar will accelerate the process. The main concern in this respect is the volatility of the U.S. stock market. Although the analysts are resourceful in finding new explanations for the continuous rise of stock market valuations, it is common sense to conclude that economic fundamentals no longer constitute the determining factor.

We share the staff's concern about the share of household wealth placed directly or indirectly in equities, and the high degree of private indebtedness. A large market correction would have a severe impact on overall demand and could trigger a sharp economic slowdown. Against this background, monetary policy has been appropriately balanced. However, I agree with Mr. Carstens, who reminded us that even a slight change in the policy mix might help reduce the risk of such an outcome. I am aware that there is a large surplus in the United States, and that it will not be easy politically to tighten policy further, but it should at least be considered.

I followed the discussion on Japan with much interest. My impression is that the staff is over-emphasizing the demand side. While fiscal stimulus should not be withdrawn at the present stage, structural reforms should be at the heart of any attempt to revive the economy. The Japanese are preparing for the future by saving rather than by reforming their economy. Therefore, the most convincing approach at this stage would be to adopt a comprehensive set of reform measures, as suggested by Mr. Carstens. Psychology is an important factor in this process, and I doubt whether the current emphasis on the demand side will be sufficient to overcome the skepticism that is obviously there.

I agree with Mr. Yoshimura and Mr. Kiekens that incurring further public debt at the current stage might hinder economic growth in the medium term. However, I do not see room for withdrawing fiscal stimulus at this stage, although continued stimulus should be combined with efforts to modernize the economy, including through reforms in the financial sector, the labor market, and the corporate sector.

The sharp increases in stock market valuations are no longer confined to the United States, as pointed out by Mr. Mussa. While the traditional stock market index in Germany (the DAX) has grown only moderately, the NIMAX, which is comparable to NASDAQ, has risen from 4,000 to 9,000 index points, a surge of 125 percent. Volatility has also increased, with swings in stock market prices of up to 5 percent per day.

While I do not believe that monetary policy should seek to influence asset prices, I agree with the staff those prices constitute an indicator to be taken into account when deciding on monetary policy. It is also important to ensure a reasonable and prudent regulatory framework. There is no trade-off between stabilization policy and asset price developments.

Finally, there are some indications that oil prices will ease in the future. This would certainly assist the world economy and would be in the medium-term interest of oil exporting countries.

Ms. Lissakers remarked that it was unlikely that fiscal policy could be tightened further in the United States. A rebalancing of demand and economic growth between the United States and other major industrial countries would accordingly have to be achieved through a vehicle other than fiscal tightening.

Mr. Esdar replied that, while he was aware of the political restrictions, it might be helpful if the Fund were to indicate that tax reductions in the United States would be imprudent.

Ms. Lissakers remarked that the United States had been attracting foreign capital because it had an attractive investment environment. Investors were not simply purchasing government bonds, but were investing in productive capacity. Accordingly, Mr. Carstens's point that the interest rate differential between the United States and Europe constituted the main deciding factor in the destination of capital flows was not totally convincing.

Mr. Wijnholds made the following statement:

This is the last in a series of 30 WEO publications that have been prepared under Flemming Larsen. I would like to pay tribute to the tremendous job he has done in continuously improving the quality of our flagship publication. It clearly has become the global benchmark in its field. I wish him much success in Paris.

This WEO report largely portrays quite a positive assessment of the outlook for the world economy, in contrast to the weak and uncertain outlook a year ago. While I agree that the near term prospects appear positive, I share the staff's assessment that the medium term prospects are subject to considerable uncertainty. In fact, I would tend to be a bit more outspoken and would underline two risks to the global outlook that seem to be increasing rather than decreasing. First, the rise in oil prices may turn out to be more

persistent than currently thought. In particular, the fact that markets consider current oil prices to be unsustainable over the medium term, may provide market participants with little incentives to take the type of action needed to bring about a lowering of prices (e.g., additional oil drilling). In this sense, oil price increases could provide the trigger for a correction along the lines of the hard landing scenario. I take note, however, of Mr. Al Turki's statement that 'oil producers have a vital interest in protecting the global economic outlook.' Second, existing imbalances in the global economy have continued to grow, thereby increasing in my view the probability of a market correction. In this sense, I share the staff's assessment that over the near term, the priority among policy makers should be to contain the size of the underlying imbalances.

All in all, I broadly share the policy strategy advocated by the staff for safeguarding the sustainability of the global recovery. Over the near term, I support a prudent tightening of monetary and fiscal policy in the US, a relatively accommodative, but not loose, monetary stance in the Euro area, combined with an accommodative monetary and fiscal policy in Japan. Although Mr. Yoshimura skillfully drew attention to the limits of such policies. In the case of emerging market countries, in addition to maintaining a prudent macroeconomic policy mix, it is important to accelerate the pace of structural reforms as a means of addressing the root causes of past instability and ensuring the sustainability of the current recovery.

In light of the forward looking focus of this surveillance exercise, it would be interesting to have the staff's views on the policy response that would be appropriate with the hard landing scenario.

Let me merely welcome the latest action of the Federal Reserve in responding to the increasing signs of overheating in the US economy. One does not have to be a prophet to see that more may be needed in coming months.

Generally, I support the staff's analysis of the European economy.

While I am pleased to learn that a nascent recovery seems discernable in Latin American economies, I wonder whether the current staff projections for Latin America are not somewhat too optimistic. Under the baseline scenario, the U.S. economy is expected to slow down in 2001 while interest rates are trending higher. At the same time, the Western Hemisphere, including Brazil, are expected to show a strong expansion in 2001. Could the staff comment about the likelihood of this scenario.

The recovery in countries affected by the financial crisis of a few years ago is heartening. The Korean bounce-back is nothing short of breathtaking. However, the general slow pace of structural reforms in the former crisis

countries, particularly in the banking system, could become a risk factor, especially in countries experiencing renewed major capital inflows.

I found the staff's analysis of recent asset price movements very interesting. In fact, I have taken note of their assessment that there is an element of overvaluation in the Dutch property market, and recently sold my house there. As regards stock markets, it is useful to keep in mind that a large part of the share price gains in recent years has been concentrated in the information technology and communications sector—linked to a belief that companies in this sector are part of a “new economy”. The gains in this sector have occurred around the world, seemingly regardless of differences in economic performance between countries. Focussing on aggregate stock prices might therefore not be all that revealing when it comes to analyzing the implications of recent trends. It would be interesting to know how similar the current upturn in stock prices is (i.e. in terms of sectoral concentration) from previous upturns, and how sectoral differences in stock prices might influence any reduction in prices and associated macroeconomic implications.

As regards the appropriate policy reactions to asset price increases, the difficulty in identifying the likely impact of such increases on other macroeconomic variables (including inflation) makes it very difficult in practice to formulate the appropriate response. Against this background, I have the following points to make:

As the paper notes, the continued volatility in asset prices, despite considerably greater macroeconomic stability, is something of a puzzle. It may be that a sectoral analysis of stock market movements could shed some light on this.

We would probably all agree that monetary policy should be forward looking and remain focussed on consumer price stability. The difficulty is in interpreting the implications of asset price movements for consumer prices. While ‘leaning against the wind’ in case of significant asset price movements is appropriate in theory, in practice it is difficult to know just how far we should lean, and when.

Policy responses will not always be symmetric because the underlying impact of the price movements are not the same. While the pure wealth effects of asset price movements might be symmetric, sharp falls in asset prices can also trigger financial stress and liquidity problems across financial markets. Policy makers have to react to such systemic concerns. The problem is compounded by a tendency for asset price rises to be more gradual than asset price downfalls.

Regarding the policy options suggested in the paper, I would not place a great deal of faith in our ability to use regulations to fine-tune asset price

movements. If we want asset prices to be ultimately based on fundamentals, then we should ensure that regulations do as little as possible to distort portfolio allocation decisions. That generally means fewer, rather than more, regulation. Nevertheless, there may be a need to adjust existing regulations to ensure that they are not contributing to asset price swings. In this light I would like to hear from the staff or Ms. Lissakers, whether tightening margin requirements in the United States would be a useful measure under present circumstances.

Fiscal policy can play a counter-cyclical role, and to that extent forms a part of the solution. Structural reform is also important to both increase the flexibility of the economy in response to shocks, and to encourage asset price decisions to be based on fundamentals.

I was pleased to see that the staff quoted a number of European studies on these matters. In the past such contributions from outside the US and UK, as well as from other international organizations, were often overlooked. I would like to encourage the staff to continue to diversify its sources of information. Finally, let me mention that the Netherlands has recently conducted an in-depth study on mortgage lending. In addition to the factors mentioned by the WEO as likely to be behind the rapid growth in lending and house prices, we also found that demographic factors such as the increasing number of two income households were important. A procyclical relaxation in bank lending criteria was a further factor identified.

Mr. Shaalan remarked that Mr. Wijnholds was overstating the risks of the recent increase in oil prices to the world economy. The increase in prices had occurred from an unusually low level. Furthermore, the price increase was insignificant when viewed over a longer period of time. As the staff had pointed out, oil prices were probably close to their long-term equilibrium level at present. Accordingly, risks to the world economy were more likely to arise out of disincentives to increase oil supplies due to the current volatility of prices: if there were no volatility and prices were expected to remain high, there would be an important incentive to increase supplies. In that respect, the oil-producing countries had repeatedly stated that they were committed to reaching an agreement to stabilize the price of oil internationally, which was both in the interest of producers and consumers.

Ms. Lissakers replied that whenever oil prices had been at a high level for a sustained period of time, the result had been a substantial increase in drilling and exploration and an increase in reserves, particularly outside OPEC. The current price constituted a spike, which had been caused by a sharp rise in global demand. However, many OPEC members had access to ample reserves. History had shown price moderation on the upside to be an effective means of ensuring price moderation on the downside, a consideration that ought to be taken into account by OPEC policy makers.

The Federal Reserve had in the past been skeptical of proposals to increase margin requirements, Ms. Lissakers noted. However, given the sharp increase in margin debt relative to income, the proposal might be worth reconsidering.

Mr. Milleron made the following statement:

I have some reactions or comments, maybe if the order is not perfect.

First, I was very interested in seeing that today Mr. Mussa emphasized the issue of volatility. I think that it is something important and significant, and that we should pay more attention to it. May I just make one or two comments on the way it is presented.

The graph which just compared the first quarters of each year may be misleading, because it might be very interesting, for instance, to compare today's volatility with the top level of volatility, for instance, for NASDAQ, or that which took place between August and October of 1998, and to see if we are far from this level. I think we should have a look at the whole graph. That is important. It might be interesting to have a look at volatility in the various places in Asia. I do not think, as far as I can see, that the situation may be different in various places. Please, provide us with more from that point of view; it would be very helpful.

Concerning the questions of inflation, oil price and the relationship with the oil price, we can discuss them on the basis of the assumption. I am not sure that what you propose is fully consistent with what we have seen since the beginning of the year 2000; maybe you are a little too optimistic. My assumption would be that on the link between price level and oil price, we know rather well; I follow you, and your assessment is certainly the right one. There is one issue on which perhaps you could elaborate a little more, especially for Europe. The relationship with the euro level is not uncharted waters, but I would say there is probably less variance in the observations through time, so maybe the diagnosis we have from this point of view is more fragile. Would you please tell us where we are, what the lags, are, for instance, and such issues? I would like to have an updating on the various econometric studies that are available from that point of view.

On growth itself, it is very impressive to see the revisions. For the year 1999, in one year, there is an upward revision of 1 percentage point, which is a very significant one. It seems to me that for the fair presentation of the report, it would be good to have two or three ex post tables showing the changes for each year. You only compared, as far as I could see, to the previous exercise. If we could have a longer view, this could be interesting and probably could show very significant revisions.

The question is probably: are there places in the world today in which the growth prospects are not so good? I do not see so many. But it means in terms of synergy that there might be a strong message to push forward.

For Europe, I agree with the orders of magnitude. There is a point on which perhaps you would like to comment. For 2001, you describe a homogeneous situation in Europe, which means that France would slow down, Germany would experience strong acceleration. Is this really the story you want to present? I understand that there might be some special circumstances due to the quarterly profiles or similar aspects, but it could probably be important to explain a little more, if such were the case. Saying this, I do not pretend that there will be an acceleration in France in 2001. I just do not know.

Looking at the graphs that are herewith presented, the question comes for East Asian countries. In terms of steps, you present both, but finally what was the downward step, what was the cost of the crisis: is it 20 percent, 15 percent, 25 percent? If we could have a rough estimate, that is something we should keep in mind.

I was interested in the discussion that took place on exchange rate policy in Asia, and especially in East Asia. The increase, the amount of the increase in reserves is very significant.

I am always impressed when Mr. Mussa presents the graph on comparing real effective exchange rates. Everything happens as if there were a kind of band. Immediately you have in mind the kind of implicit intervention behind it, and I share the view that was expressed that in the management of the float: Asian countries should probably refrain from following too strict exchange rate rules, whether they are publicly or nonpublicly announced. But I was reassured by the data that was provided to us by Mrs. Hetrakul.

On Latin America, I am impressed by the amount of capital flows we are talking about, especially for the four major countries: something like \$160 billion. We have to keep this in mind. Certainly behind it there is a question of increasing the domestic saving efforts in the concerned countries, but I will not develop this, because it was taken up in the previous discussion.

Finally, let me congratulate Mr. Larsen for fixing so well the world economy. The last WEO exercise for him leaves us with a wonderful outlook, and as a member of the host country, I wish him all the very best.

Mr. Pickford made the following statement:

I would also like to thank Mr. Larsen for his contribution, and wish him well. More generally on the WEO, it seems to me particularly well focused. It concentrates

on timely policy issues, and has a greater ratio of analysis to description than has been the case in the past.

With respect to the first chapter, I want to comment mainly on the United States. While I do not want to administer on equity markets, I take note of the fact that the report is once again forecasting strong growth, but that the staff expects the economy to slow soon. One uncertainty in the scenario is related to the estimation of trend growth in the United States.

I agree with the staff that the current account deficit can be easily financed, at least for the foreseeable future, but I wonder to what extent the deficit is structural. How much improvement should we expect as the economy slows down?

Mr. Mussa points out that the current account deficit is to some extent the counterpart of inflationary pressure within the United States. Another concern is that at some point that pressure will begin to be realized. I am also concerned that the structural component of the current account deficit may be larger than currently estimated by the staff.

In the chapter on emerging market economies, the analysis appears sound, but I am disappointed by the lack of data on countries' external balance sheets—the chapter ought at least to have included vulnerability indicators. One of the issues that the staff raises for discussion is whether improvement in domestic savings coming primarily from fiscal consolidation would be sufficient to reduce external vulnerabilities. That clearly will help, but it is still important to assess other vulnerabilities, such as countries' exposure to external shocks, such as changes in commodity prices. One reason why Mexico has seen substantial improvement and has been able to have its credit rating upgraded is that it has been successful in diversifying away from dependence upon oil.

The third chapter on asset prices and the business cycle also constitutes sound work. The staff has correctly highlighted caveats about asset pricing models. Another point is that financial sector supervision and regulation can be important in terms of helping to avoid asset price booms and busts. The merits of bank provisioning against possible losses are also emphasized. In this respect, it might be useful to look in some detail at the experience with activist regulatory policies.

Finally, on debt relief and poverty, Mr. Carstens unduly criticizes the staff for exaggerating the impact of debt relief. It is clear from the chapter that the staff does not regard the HIPC Initiative as a panacea for poverty and economic problems. The chapter stresses the need to overcome other impediments to growth, such as bad governance, a lack of institutions, and war. The answers are to be found not only in debt relief, but also in effective aid programs, and—looking further into the future—in access to private capital markets. However, debt relief is an important component: there is abundant evidence showing that an excessive and unsustainable debt burden is an impediment to growth.

One final point in that regard: I wonder whether the WEO forecast has taken enough account of the impact of the HIV-AIDS epidemic in Africa, and increasingly in Asia, and its devastating human and economic impact.

Mr. Carstens remarked that his main concern about the HIPC Initiative was the lack of financing commitments at the current stage. The Fund might set itself up for criticism if it did not succeed in raising sufficient funds to finance the Initiative. Accordingly, it was important not to create false expectations.

Mr. Pickford agreed with Mr. Carstens and noted that he was particularly concerned about the ability of regional development banks to deliver their share of the financing for the HIPC Initiative.

Ms. Lissakers remarked that it was important to promote the HIPC Initiative as an essential element of world growth and development. However, it was worrying to have countries reach the completion point without satisfactory financing assurances in place.

Mr. Kelkar made the following statement:

We wish to compliment the staff for a lucid, well-balanced and informative set of papers, which in keeping with the tradition of the WEO, present a rich fare on major economic developments and their implications for the future evolution of the world economy. We are pleased with the choice of the four main themes for this year. Since this is the first WEO document for the new millennium, we welcome the inclusion of a detailed chapter on the most striking aspects of economic developments in the 20th century.

Global economic and financial conditions have improved significantly in the course of 1999. It is heartening to note that growth projections have been revised upwards for 1999 and 2000 in respect of world output as well as for most country groups—the only exceptions within the developing countries being Africa, Middle East and Europe (for 1999). In fact, the extent of upward revision is especially significant in respect of ASEAN-4 and for the transition economies. It is also comforting to note that growth projections for Brazil and Russia have been revised upwards quite substantially.

There are several features of the current scenario which are gratifying. These include: continuation of impressive economic expansion in the USA which is now the longest on record; improved outlook for Europe; a strong V-shaped recovery in the emerging market economies in Asia; and the beginning of recovery in Latin America and in the transition economies from the Brazilian and Russian crises.

Notwithstanding these favorable developments, there are a number of risks and uncertainties which continue to cause serious concerns. These include: The unbalanced pattern of growth among major industrial

countries—especially the United States, the euro area and Japan, and corresponding payment imbalances marked by exceptionally large and growing current account deficit in the United States and persistently large external surpluses in Japan, and to an extent in the euro area, are increasingly being perceived to be unsustainable.

These are significant misalignments among the key currencies reflecting inconsistencies between medium-term imperatives and short-term realities. The prospects for depreciation of the U.S. dollar remain uncertain in view of the recent interest rate hikes. On the other hand, the recent weakening of the Euro is not warranted given the strengthened recovery of economic activity in the euro area whereas the prospects for the appreciation of the Japanese yen are not bright given the weak cyclical position in Japan. The possibility of a sudden change in market sentiment followed by potentially disruptive realignments of exchange rates poses a major downside risk to the prospects for global recovery.

The very high stock market valuation around the world—especially in the United States and the asset price inflation in general, represent another area of vulnerability for the financial systems that could have severe systemic ramifications.

Oil prices continue to increase rapidly—doubling since early 1999, while the corresponding recovery in non-fuel commodity prices is generally sluggish. This has meant a major terms of trade shock, especially for major oil importing developing economies with serious implications for their external sector, growth prospects as well as outlook for inflation. If oil prices continue to rise, the generally benign effects on global activity so far could become alarming.

The net private capital flows to the emerging market economies still continue to be low compared with the high levels witnessed prior to 1996.

Furthermore, resumption of capital flows on a scale recorded in the first half of 1990s does not seem to be in sight. Thus, while the net private capital inflows in 1999 were modestly higher than the low level of 1998, Table 2.2 shows that in 2000, the flows are projected to be even lower than in 1998. Moreover, the terms and conditions of primary market access for emerging market borrowers have remained generally less favorable than prior to the Russian crisis.

The WEO has repeated an observation from the last WEO that “the global downturn in the wake of the crises in Asia and other emerging market countries since 1997 now appears to have been relatively mild and brief” (p.1, Figure 1.1). While it is true that global growth bottomed out at 2.5 per cent in 1998, at which level, it was higher than the corresponding growth rates during

the earlier three slowdowns in the last three decades, it is important to note that the overall world output growth was heavily influenced by the unusually strong expansion in the United States. In fact, the quality of growth, as proxied by say, distribution of growth rates across countries was probably far worse in the recent slowdown than during the earlier ones. Illustratively, as can be seen from Table 1.1 (p. 2), the combined decline in output was as high as 9.5 per cent for the ASEAN-4 in 1998, while output in Russia and Japan declined by 4.5 per cent and 2.5 per cent respectively, all of which have been unprecedented. Several Fund documents have also pointed out the formidable social costs involved in the Asian financial crisis. Against that background, the assessment in the WEO is not only insensitive but also reflecting complacency that we can do without.

Chapter II, inter alia, provides a useful analysis of commodity market developments, especially the sharp increase in oil prices since the first half of 1999 reaching a nine-year high in February, 2000.

This important development is likely to have different consequences for different groups of countries. The WEO has assumed the average price level of \$21.40 per barrel in 2000 compared with \$18.25 per barrel in 1999. Footnote 2 (p. 4) however reveals that oil prices have further increased by over 25 per cent above the assumed average prices. This clearly suggests that the average price for 2000 could be easily higher than the average price for 1999 by \$5 per barrel or even more. According to the staff calculations (p. 55), the direct (first round) effect of a \$5 per barrel rise in oil price on oil exports and imports would be around \$60 billion. Reflecting the reduced dependence of main industrial countries on oil however, the resultant deterioration in their current account would be confined to \$10 billion. In other words, the main brunt of the steep oil price rise would have to be faced by oil-importing developing countries.

Most oil importing developing countries may thus experience current account shocks. This, coupled with the projected decline in net private capital flows from \$64.4 billion in 1999 to \$57.5 billion in 2000 implies serious difficulties for many of them. The Middle East which is projected to benefit from the oil price rise by about \$30 billion is, unlike the earlier oil price shocks, not expected to emerge as a major net exporters of capital. Besides the constrained availability of capital inflows, the cost of such capital may also be higher given the recent interest rate hikes. Under the circumstances, oil-importing countries may have to compress non-oil imports at least to an extent, which would have adverse implications for their growth prospects.

Chapter III presents an interesting overview of the complex inter-relationship between asset prices, output growth, and inflation, and the challenges they pose to the broader task of macroeconomic stabilization.

The current high P/E ratio in the United States could be justified only if the future average growth rate of the US economy is considerably higher than its present level (which is already believed to be above its potential) propelled by the "new economy" impulses. Such a growth outturn for a prolonged period seems extremely unlikely and, therefore, the US stocks appear overvalued. One could also interpret perceived overvaluation of the US stocks as a "rational bubble" - that grows in size by the action of "noise traders" but sustained and allowed to grow further by "informed traders". If one takes into consideration the observed behavior of output gaps and stock returns over different phases of business cycles in the past, rising equity prices in the euro zone may be justified as predictor of faster economic recovery and a prolonged period of prosperity that may accompany the upswing phase of the business cycle. In the case of the United States, however, the U.S. GDP growth is projected in the WEO to decelerate from above 4 percent in the recent past to about 3 percent in 2001, indicating that any further increase in U.S. stock prices can possibly be interpreted as a financial bubble.

Asset price bubbles entail significant risks in the form of higher inflation when the bubble grows in size and in the form of financial instability and lost output when the bubble bursts. Monetary and fiscal authorities, therefore, should closely watch the asset market developments. The positive wealth effect resulting from bull runs could impart a first round risk to inflation—through demand exceeding supply. If the bull run is prolonged, a second round pressure on prices may result from subsequent upward wage revisions. When domestic supply fails to respond to the rising demand, it may also result in high current account deficits (as is being the case with the US with a record CAD/GDP ratio of 3.6 per cent in 1999). If the monetary conditions are not tightened appropriately, the bubble may grow unchecked. The general easy monetary policy stance of the advanced economies in the post-Asian crisis period might have contributed in allowing the bubble to grow. Once the bubble is allowed to grow unchecked for some time, it may be difficult to check it later. This is amply demonstrated by the failure of the recent monetary tightening measures of the Fed and the ECB in arresting the rising stock prices. Adequate signals from the Fed indicating misalignment of stock prices in relation to the fundamentals, including even a reference to the stock performance as "irrational exuberance", did not work. The focus of the monetary authority, therefore, should continue to be on inflation and risks to inflation from booming asset prices. Threat to financial instability resulting from sudden collapse should be avoided by soft landing measures which include: (a) monetary tightening to raise the discount rate; this may not be possible if stock prices rise amidst recessionary conditions in the economy, (b) limiting the exposure of banking sector to stock and real estate markets; during a sudden crash the value of collateral may decline significantly and, therefore, lending against such collateral should be subjected to high margins, (c) appropriate hedging of individual and corporate risks, as a sudden collapse may erode the net worth of individuals and corporates and thereby may

increase bank's NPA's. (d) a tax structure that progressively increases the burden on profits from asset transactions, particularly for returns in excess of what could be justified by fundamentals. (e) significant fiscal consolidation during stock market booms so that during a sudden crash in output could be stabilized through anti-cyclical fiscal expansion.

We are in a broad agreement with the staff analysis of income growth and poverty reduction provided in Chapter IV.

The WEO records that the relationship between growth and income inequality is theoretically ambiguous : while given the differences in propensities to save across income groups, a more unequal distribution may raise the saving rate and facilitate an increase in the rate of growth, a highly skewed income distribution may also deprive low-income groups of the means/opportunities to acquire necessary skills and thus result in a potential loss of human capital, thereby adversely affecting income growth. Moreover, income inequality can be a source of social unrest and political instability, thus impeding saving, investment and growth.

We agree that income redistribution can supplement but not supplant efforts to raise economic growth.

Chapter V represents a useful departure from the set pattern of the WEO in providing a survey of striking developments and policy lessons from the experiences in the 20th century.

Our chair feels however, that several major developments have not found their due place in the survey. These include, to name a few, the rise of Asia, the emergence of transnational companies, the importance of raising agricultural productivity, role of social capital, the need to enhance and implement the ODA target and issues relating to public health. It would have also been useful if the role of the multilateral institutions like the IMF and the World Bank was placed in a broader historical context.

Finally, we welcome the inclusion of a box (Box 4.2), on India's economic performance in the pre and post reform period, besides the coverage in the text (p. 26). There are however some factual inaccuracies that we would like to highlight and make some other observations :

(i) Over the past few years, India's growth has consistently been under-estimated by WEO. 1999 was not an exception. The staff reports growth of 6.8 per cent—compared with October 1999 WEO estimate of 5.7 per cent and May 1999 WEO projection of 5.2 per cent. For 2000, the consensus forecast exceeds that of the staff by ½ per cent and for 2001, by 1 per cent (EBD/00/22, Table 3).

(ii) It is noteworthy that high growth performance of India in 1999 was accompanied by a sharp fall in inflation despite higher oil prices.

(iii) The combined deficit of the center and states may be little over 9 per cent of GDP in 1999-2000, but is unlikely to exceed 10 per cent of GDP as indicated in the WEO.

(iv) The assessment that India's large fiscal imbalances have pushed public debt up to 80 per cent of GDP is exaggerated. In our view, the public debt may not exceed 70 per cent.

(v) The assessment regarding the alleged deterioration in industrial sector productivity is not supported by facts.

(vi) The WEO recognizes elsewhere that India is one of the fastest growing economies in the world. Yet, the emphasis is placed more on her policy inadequacies rather than achievements.

Mr. Wei made the following statement:

We generally concur with the staff's views on the analysis of the world economy which has improved significantly during the past year and the overall outlook is increasingly promising for 2000. The latest statistics indicate that global economic conditions have improved substantially in 1999. Over the past year, most of the Asian crisis countries posted V-shaped economic recovery. The crisis affected Latin American countries also successfully came out of their difficulties and demonstrated strong signs of recovery. The economy of the United States continued to grow strongly, while the recovery in the euro area gained momentum from the latter part of 1999. Russia registered substantially better than the anticipated macroeconomic performance for 1999, while Japan, although a mixed picture, has signaled out positive signs of recovery in the beginning months of 2000.

However, there have been signs of uncertainty affecting the stability and sustainability of the world economy, including, for example, increasing concern if the U.S. economy fails to secure a soft landing which will have a huge impact on the sustainability of the world economy.

We agree with the view that the outlook for the global economy very much rests on the future developments of the major industrial economies. Can the U.S. land softly without negative shocks? Can Japan manage to sustain its early recovery, and can the euro area continue to maintain growth momentum? Meanwhile, the outlook also rests on the East Asia crisis-hit emerging economies and whether they can continue to recover strongly whilst preempting the risk of overheating and whether the Latin America countries can sustain the trend of the strong recovery. In the meantime, it is equally

important to see continued growth in the Middle East and Africa as well as in the transitional economies.

My authorities believe that it is critical for the sustainability of the world economy that the industrial countries maintain stable exchange rates among themselves, thus facilitating capital flows to developing countries, and further opening up their markets so that the developing countries have a better chance to catch up.

As for the U.S. economy, it is well noted that the Federal Reserve has raised official interest rates consecutively in the recent past, which I believe is necessary in preventing the economy from overheating. However, I share Mrs. Hettrakul's view that we would favor a gradual rate increase by the Federal Reserve rather than adopting a more aggressive stance, which could trigger a worse-than-expected plunge in asset prices. Given the high asset price valuation, strong domestic consumer growth(which has continued to strip the GDP growth(the persistent low level of private savings, and signs of general price increases, it seems unlikely that the U.S. economy will continue to grow without any risks. As pointed out by many others, it is of utmost importance for the U.S. authorities to strike a balance between on the one hand, cooling down the economy, and on the other hand, sustaining its growth at an appropriate rate. Having said that, it has been clearly recognized that the spillover effects of the industrial countries' policies to developing countries has become more intensified over the past two decades during the process of globalization. Given the important role of the U.S. economy in the world economy, a gradual approach by the Federal Reserve in dealing with the overheating issue would be more desirable not only to the United States itself but also to the rest of the world.

It is encouraging to learn from Mr. Yoshimura's preliminary statement that economic activity in Japan has been showing a modest recovery this year and his authorities are expecting 1 percent growth of GDP for FY2000. Nevertheless, compared with other major industrial countries the Japanese economic performance in recent years has been less than satisfactory and the outlook for 2000 is still tentative. In my view, the authorities are encouraged to further promote domestic demand so as to achieve a steady recovery. On the fiscal policy front, the authorities are recommended to continue the current stimulus program in the short term, and be prepared to continue with such a policy until full recovery is established. Meanwhile, the medium-term fiscal sustainability clearly warrants close monitoring given that gross public debt is estimated to exceed 120 percent of GDP as of March 2000. On the monetary policy front, we agree with the authorities that the Bank of Japan should maintain the zero interest rate policy, which is concordant with fiscal policy, to support the economic recovery. On exchange rate policy, it is vitally important for Japan to maintain a stable exchange rate against other major currencies. In this regard, I agree with Mr. Yoshimura that excessive

appreciation of the Japanese yen would be detrimental to the Japanese recovery. In addition I could add that it will also be a burden to many Asian countries for their yen debt. Given the important impact of a prompt recovery of the Japanese economy to the sustainable growth of the world economy, the authorities are encouraged to take broad-based measures to revitalize its financial and banking sector. Moreover, continued efforts are needed to promote land and agricultural reforms.

In 1999, the European economy recovered much better than anticipated due primarily to appropriate macroeconomic policies and strong external demand aided by the robust recovery in most emerging markets. It is forecast that such momentum will continue in 2000. Recently, high energy prices have driven up headline inflation somewhat. However the inflation pressures have remained subdued because output potential still exists in the euro area. Given the continuing differences in cyclical conditions between the euro area and the United States, the European Central Bank (ECB) should adopt a balanced approach, namely continue to give emphasis to maintaining price stability while trying to avoid holding back the recovery. We are of the same view that the authorities should make further efforts in removing all the obstacles and barriers which are not in favor of encouraging employment. On exchange rate policy, I note that recently the euro has significantly depreciated against the U.S. dollar, which many people believe is not in line with economic fundamentals in the euro area. It is hoped that along with the recovery, the euro exchange rate will eventually reflect its fundamentals and prospects.

Last year, most of the East Asia crisis-hit countries recovered significantly (even much better than anticipated) (with Korea as the most outstanding performer. These countries are bound for continued and steady growth in 2000. I believe there are two driving forces behind the successful recovery in Asia (an appropriate national macro policy response toward the crisis and the substantial financial assistance from the international community. However, the authorities should not be complacent. They are encouraged to persevere with their appropriate macroeconomic policies in supporting the sustainable economic recovery. Thailand and Korea are to be commended for their impressive progress in banking and corporate sector reforms. Other countries are encouraged to move expeditiously in the same direction to ensure a full and complete recovery.

Russia posted a better economic recovery in 1999 than had been expected. GDP growth was above 3 percent. As indicated in Mr. Lushin's preliminary statement, there was also much progress in the performance of the fiscal and external accounts and on inflation. However, much remains to be done to strengthen market confidence and secure a sustainable recovery for the future. I concur with the authorities' views that continued efforts are needed in streamlining the tax and administration system, to further improve

fiscal consideration as well as in putting the financial and banking sector on a firmer footing. The strong recovery in oil prices providing great opportunity for the authorities to accelerate institutional, legal, and structural reforms.

It is sad indeed to realize that the world is entering the 21st century with the greatest divergence ever recorded between rich and poor. Among the many causes behind this phenomenon, the persistent deterioration in the terms of trade for the developing countries, insufficient development resources, and heavy external debt burdens are the most important contributors.

Therefore, the developed countries are urged to further open up their markets, improve the terms of trade for the developing countries, and increase official development assistance to them.

Poverty reduction rates high on my authorities' agenda, and they believe that improving the quality of living standard and alleviating poverty are the most important assignments for the government. They believe that balanced social development and sustainable economic growth are one of the best ways to uplift living standards and address the problem of poverty. Therefore, my authorities have earmarked a large quantity of funds to poor rural areas for infrastructure developments, including education and health care. My authorities have put various tax incentive schemes in place to attract both domestic and foreign capital flows to well-targeted poor areas. They have vigorously promoted economic cooperation between the developed and the less developed areas within China. As a result, poor areas have caught up, living standards have been raised enormously, and the poor population has been greatly reduced over the past decade. The recently announced Great Western Development Project is just one of the projects actively championed by the authorities aimed clearly at achieving geographically balanced economic growth and poverty reduction in China. In urban areas, my authorities have established social welfare benefits and safety nets to address city poverty, particularly for laid off employees. Over past decades, the Chinese economy has grown at a stable and fast pace, with an impressive rise in living standards and a continuous reduction in poverty. However, it is well understood that China is still a developing country and much needs to be done to eliminate poverty. Therefore, there is no room, and no time, for complacency. My authorities are strongly committed to renewed efforts to fight against poverty.

I have a concern regarding the issues facing the emerging markets, namely, declining private capital flows to emerging markets.

Net private capital flows to emerging markets in 1999 rose modestly to \$64.5 billion from a decade low of \$60 billion in 1998. Net flows are projected to decline somewhat again in 2000, but to pick up considerably next year. This is not such an encouraging picture for recovery in the emerging

market economies in the short run. Therefore, the industrial countries are again urged to create a favorable international environment through policy coordination so that private capital flow to the emerging market economies could be increased. As far as the emerging markets are concerned, renewed efforts are much needed in improving the investment climate to better attract foreign direct investment, which may offset the possible decline in other capital flows.

The staff has done an excellent job exploring the possible correlation between asset prices and the business cycle. In understanding the rationale behind high asset valuations, particularly high stock valuations, the following factors should be given sufficient attention.

Globalization created better access to foreign markets, in which the corporate sector has benefited significantly from expanded cross-border markets; Deregulation and the liberalization of capital flows as well as financial innovation have provided more avenues for investors to diversify and, thus, reduce the risks; New technologies in computing, telecommunications, and transportation have improved the decision-making quality and reduced transaction costs by providing better and faster information; Success in curbing inflation in most countries kept the outlook benign for further inflation expectations, which, arguably, has brought the risk premium on stocks down over the past decade. Finally, mergers, acquisitions, and other forms of corporate reorganization played a large role in improving corporate profitability in many ways, including savings on synergies.

However, as I mentioned earlier, the growth rate of stock market valuations has exceeded GDP growth and corporate profits in most industrial countries recently by a wide margin.

Therefore, it is necessary to adjust asset prices, in particular equity prices in line with the economic realities and corporate profitability. Needless to say it is hoped that in the process of squeezing or reducing stock market bubbles, the negative impact on the sustainability of the world economy should be minimized.

In 1999, the Chinese economy China continued to grow vigorously and registered an impressive GDP growth rate of 7.1 percent.

For 2000, my authorities will continue with a fiscal stimulus stance, including floating RMB100 billion (equivalent to US\$12.1 billion) long-term government bonds. The proceeds will be used to finance the following projects and /or programs, including: key infrastructure projects; science, technology, and educational programs; environmental protection and ecological improvement projects; corporate sector technological innovation

projects. Geographically, priority will be given to the hinterland in the less developed mid and western areas.

My authorities believe that the increased budget deficit and government debt have been well justified and warranted by the legitimate needs of on going reforms, economic development, and social stability. In 2000, for the first time in recent history, interest payments for government debt will be listed under budgetary expenditures, which may increase the budgetary deficit in numbers compared with those produced under the previous approach to budgeting. However, the current budget deficit and new government debt are controlled and maintained at last year's level, which my authorities strongly believe to be prudent and sustainable. My authorities further believe that the government debt servicing capacity for the medium and long term will be guaranteed as long as an adequate growth rate is maintained and macroeconomic efficiency continuously improved.

For 2000, the central bank is committed to further tap its monetary policy by policy targets listed below: proactively adjust money supply to ensure that annual growth rate of broad money will not be less than that for 1999; set up directives on credit policy in a timely manner to send signals to investors, including banks; further strengthen supervision on banks, improve corporate sector management and push economic restructuring forward; encourage more direct financing to nurture capital markets; deepen reforms of the central bank system; accelerate banking and financial sector reform to lay better ground for the full play of monetary policy. Furthermore, further deregulation on interest rates of commercial bank loans will be introduced this year, and interest rates will gradually be liberalized.

My authorities wish to emphasize once again that the only acceptable nomenclature for Taiwan is Taiwan Province of China and the incorrect nomenclature on page 23 of the WEO should be corrected. I hope that the staff can be reminded of the point so that such errors will not be repeated in the future.

Adjustments have taken place swiftly and smoothly in Hong Kong SAR, leading to an early recovery. The recession, though very short, is over and activity is gathering momentum. The linked exchange rate system has served Hong Kong SAR well as an anchor in helping itself weathering the crisis. Looking forward, the Hong Kong SAR economy is going to grow faster in 2000. China's prospective accession to the WTO will create more opportunities than challenges for Hong Kong SAR since Hong Kong SAR will benefit from the process, and is well placed to assist in the ongoing restructuring of the Mainland's financial and corporate sectors.

China resumed its exercise of sovereignty over Macao on December 20, 1998. Since then, with strong support from the Mainland, the Macao SAR economy has been growing smoothly and rapidly.

The Executive Board recessed at 1:07 and reconvened at 2:30 p.m.

Ms. Jul remarked that there was a discrepancy in Table 24 regarding Chile's external debt. The discrepancy, which lowered the official debt figure by 4-6 percent of GDP, might stem from the exclusion of short-term credit, including trade credit. Page 63 referred to the fact that Chile, Colombia, and Mexico were planning to introduce inflation targeting. However, Chile had had such a framework in place for some time, and had recently adopted an inflation range. However, it was true that the inflation targeting framework remained tentative.

The Observer from the European Central Bank made the following statement:

Once again, I would like to commend the IMF staff for preparing a very high quality and thought-provoking WEO document.

I would first like to comment on the prospects and policy challenges identified in Chapter I before turning to discuss Chapter III, which contains such an insightful discussion of asset price developments, their relationship with the business cycle, and their policy implications.

Overall, the ECB agrees with the WEO baseline scenario and its assessment of risks to global growth, however, it does have some reservations on the specific monetary policy recommendations contained in the WEO.

The global outlook continues to improve as the US and emerging market countries of Asia have seen much stronger growth than expected earlier. As evidence of a strong rebound in the global economy has become more apparent over the past months, overall risks to growth have gradually shifted to the upside. As before, downside risks to growth remain mainly related to the following three potentially interrelated factors:

Large current account imbalances, especially in the US and Japan; apparent deviations of the three key currencies from their medium term levels, notably the weakness of the euro vis-à-vis the US dollar and the yen; high stock market valuation in a number of markets, in particular in the US.

At present, in the ECB's view these risks seem to be more than offset by the persistence of favourable economic indicators. Nevertheless, it still holds true that an orderly reversal of existing imbalances and better balanced regional growth patterns are essential to ensure sustained global economic growth.

The current WEO documents suggest that what has been cyclically appropriate in recent years (in particular, the strength of the US economy and of the dollar) has resulted in developments which may not be sustainable in the medium term (in particular, the large and growing US current account deficit). Indeed, since these imbalances have been mainly caused by unbalanced growth patterns over the last years, the Fund recommends a concerted strategy to rebalance growth trends among the three main economic areas, in particular by pushing demand growth in the euro area (and Japan) above potential for some years (and vice versa for the US). As regards monetary policy, the staff's specific policy recommendations reflect this overall strategy: pre-emptive further tightening by the Fed and no premature or aggressive tightening by the ECB and Bank of Japan.

Although a number of elements in this analysis are justified, the ECB has difficulties with the notion that monetary policies should play an active role in trying to fine-tune the world wide composition of growth in this way. The ECB's monetary policy focuses on its primary objective of maintaining price stability in the euro area. This is in the ECB's view its best and certainly a very significant contribution to a sustainable euro area growth and as such may certainly help re-balance global growth trends in the medium term. Focusing on demand management directly may, however, have undesirable consequences. Indeed, holding interest rates artificially low in the euro area would not foster world demand and sustainable growth beyond the levels projected in the baseline scenario. Rather, such a policy, in the ECB's view, could sow the seeds of new imbalances and thus be counterproductive.

Indeed, using monetary policy in this way would be inconsistent with two other assertions of the WEO. First, further monetary stimulus could not by itself spark additional sustainable growth in the presence of structural rigidities which still prevail in the euro area. As the staff rightly points out, structural reforms in this area remain central to enhancing medium term growth and employment prospects. Second, the staff in the WEO argues that ample liquidity supply may contribute to the building-up of highly leveraged positions and attendant unsustainable increases in asset prices. In this context, the staff is of the view that "policy should...respond to an apparently build-up of asset prices which- even when not immediately accompanied by inflation pressures -carries a high risk of crashing an, spilling over into macroeconomy to produce substantial out and employment losses." (p. 114). Indeed, given that equity prices have been rising in the euro area roughly as much as in the United States, while property prices in some areas have increased even more than in the United States, it is unclear why the Fund's policy advice for the two areas in this regard should be so very different. Against this background, and also more generally, the ECB's view is that in the long run, balanced and sustainable growth is best served if each economic area ensures that its own policies are sustainable and stability-oriented. Therefore, I would like to discuss in this context in some more detail growth and inflation outlook for

the euro area and highlight the slight differences which at the moment seem to exist between the Fund's and the ECB's assessments.

The Fund's assessment of the improved growth prospects for the euro area is broadly in line with the ECB's own views. The recent upturn in euro area activity is expected to continue in 2000 and 2001.

However, there are clear differences between the Fund and the ECB as regards the assessment of risks to price stability in the euro area. In particular, the WEO seems to attach very much importance to the estimate for the euro area output gap (1.25 percent in 2000), which would suggest the existence of significant spare capacity in the euro area. However, I would like to emphasise that the ECB is of the view that such estimates, though useful as an additional indicator, are subject to large uncertainties and errors and therefore have to be treated with great caution in the context of other available information. Perhaps as a result of the importance given to such an estimate but also as a result of exchange rate and oil price assumptions which look quite optimistic given the recent developments in these variables, the WEO outlook forecasts a rate of consumer price increase of only 1.7 percent in 2000 and 1.5 percent in 2001.

Indeed, as was the case with the recent staff report on Monetary and Exchange Rate Policies of the Euro Area, the WEO seems to take a rather benign view on the inflation outlook in the euro area. It stresses that the euro area has room to maintain a relatively easy monetary policy until the recovery is on a sufficiently strong footing (p. 7) and that it is currently important for the ECB to avoid holding back the ongoing recovery through a rapid tightening of monetary policy (p. 16). In contrast, the ECB's view is that an approach which rejects pre-emptive monetary policy in this way, is likely to result in an inflationary bias. A careful examination of information provided by both pillars of the ECB's forward looking monetary policy strategy suggested that in early 2000 the balance of risks to price stability have been on the upside.

The first pillar indicates that there is a generous provision of liquidity in the euro area, which points to upside risks to price stability. The three-month average of the annual growth rate of M3 remained above the reference value of 4½ percent throughout 1999 and early 2000. At the same time, the growth of credit to the private sector continued to grow at strong annual rates close to 10 percent.

As regards the second pillar, upside risks to price stability derive from the possibly longer lasting effects on consumer price inflation of the strong rise in oil prices and the decline of the exchange rate of the euro in the past, in the context of a strong cyclical upswing.

As expected, consumer price inflation saw a further increases in January and February, with annual HICP inflation reaching 1.9 and 2.0% respectively after 1.7 percent in December 1999. The higher inflation rates in January and February are largely accounted for by the ongoing increase in oil prices and its effect on energy prices in the HICP, reinforced by base effects from declining oil prices at the turn of the year 1998/99. (Excluding energy and seasonal food, current price have remained moderate—the rate of increase in the HICP excluding energy and seasonal food was 1.1 percent in January and 1.2 percent in February.) Nevertheless, the slight acceleration in prices for non-energy industrial goods may represent a first sign that oil prices have started to impact on consumer price inflation via producer prices which increased rapidly at around 5 percent annual rate. Oil prices increased further in February and early March and will thereby continue to place possibly more prolonged upward pressure on consumer prices in the next few months.

Also survey data points to a very positive economic climate in early 2000, with industrial confidence increasing further in February 2000 and consumer confidence remaining at a very high level. The latest forecasts point to real GDP growth in the euro area of slightly above 3 percent in 2000 and 2001. Indeed, economic conditions and prospects for the euro area appear to be better at present than at any time in the past decade.

To address the risks for the outlook for price stability in a timely and pre-emptive manner, the ECB raised interest rates on 3 February and 16 March 2000 in each case by 25 basis points. We are of the view that by ensuring a non-inflationary environment, these policy moves will contribute to ensuring sustainable economic growth in the euro area. In this context, I would like to point out that in the WEO documents the staff assumes a level of the 3-month interest rate in the euro area of 4.0 percent in 2000 and 4.9 percent in 2001, implicitly assuming that an increase of ECB interest rates from the current level is needed to maintain price stability as forecast in the IMF staff paper.

We agree with the staff that the present level of the euro/dollar exchange rate does not reflect the medium-term level that could be justified by economic fundamentals. Furthermore, the past movements of the exchange rate of the euro have increasingly become a cause of concern for price stability through their effect on import prices and producer prices. (On 14 March 2000, the euro nominal effective exchange rate was 2.0 percent below the average for February 2000 and 12.5 percent below the level recorded for the first quarter of 1999.) The ECB is of the view that throughout 1999 exchange rate developments among the three major currencies reflected mainly changes in actual and expected cyclical positions. However, recent developments do not reflect the underlying strength of the euro area economy given the further evidence of robust economic growth and much improved area-wide confidence. In view of the acceleration of growth and given that the

euro is firmly based on internal price stability, the euro has a clear potential to appreciate. The expected narrowing of growth differentials between the euro area and the United States as well as the growing U.S. current account deficits in combination with the low savings of U.S. households are also factors likely to support a correction of the euro exchange rate vis-à-vis the dollar over the medium term. Nevertheless, the exchange rate of the euro at present is indeed a cause of concern and requires increased vigilance, given the magnitude and duration of the depreciation since beginning 1999.

The WEO (pages 15-17) places a strong emphasis on existing divergences among the big euro area Member States and between the larger economies and the periphery. In the ECB's view (as shared by a recent assessment of the European Commission), however, it is quite encouraging to see that there has already been some synchronisation of euro area Member States' business cycles. Given the differences in terms of living standards and productivity levels, taking into account the still relatively low level of labour mobility, and noting that fiscal policy remains predominantly a national responsibility, the relatively high level of cyclical convergence may be seen as significant. Moreover, recent divergences in the euro area are by no means exceptional compared with previous historical experience or, more importantly, compared with regional divergences in other economic areas such as the US. In addition—according to both the IMF and other forecasts—growth divergences among the main euro area economies are expected to decline further over the forecast horizon.

Regarding inflation differentials, the recent increase in euro area divergences is primarily driven by one country (Ireland). While this certainly reflects cyclical factors, in the case of Ireland there may be strong structural reasons for some divergence associated with economic convergence or “catch up”. Moreover excluding Ireland, inflation divergence in the euro area remains relatively moderate and is expected to continue so.

Chapter III of the report offers a thorough, insightful and wide-ranging discussion of asset price developments (equities and property prices), their relationship with the business cycle and their policy implications. The concerns raised in the WEO about the implications of strong increases in asset prices are partly shared by the ECB and many of the policy recommendations given in the WEO are very much in line with the ECB's conduct of monetary policy, to the extent that they strictly focus on price stability in the euro area.

However, in some instances policy prescriptions appear to be rather strong given the limited knowledge of the phenomenon and of its consequences, especially with regards to the euro area. As I have already stressed, taking into account the uncertainties related to the estimates of the possible effects, it is unclear why policy prescriptions for the US and the euro area in this regard should be as contrasted as the IMF staff seems to

recommend. In any case, the argument that the ongoing "recovery" in the euro area is still at an early stage is not fully consistent with the stated principle of the need for a pre-emptive and timely action.

I would emphasise that even if the recent strong increases in stock market prices were to reflect changes in fundamentals (for example, anticipating the advent of the "new economy" for the euro area) they could still have the consequence of pushing aggregate demand ahead of supply. In this respect, one gets an impression that too much emphasis is given to monetary policy actions as opposed to structural or regulatory policies.

I would like to conclude by pointing out that the ECB's two-pillar approach provides an appropriate framework to take into account the effects of asset price changes. The first pillar, assigning a prominent role for money, implies that aggregated balance sheets of banks and other Monetary Financial Institutions have to be carefully analysed for their information regarding future price developments. Moreover, it assesses the danger of credit-financed asset price bubbles. The second pillar, on the other hand, takes into account the possible indirect effects of asset prices on future inflation mainly via wealth and confidence effects and analyses the information regarding financial markets expectations contained in asset prices.

This approach ensures that the implications of asset prices developments in the euro area are taken into account in full so that their consideration is not limited to the weight they have in the euro area HICP or M3, as claimed in the WEO.

The Deputy Director of the Research Department stated that an easing of monetary conditions around the world had been the appropriate response to the crises in Asia, Russia, and Brazil, and to the Y2K concerns. As a consequence of those timely monetary policy responses, global economic recovery had been faster and more broad-based than had originally been expected. Accordingly, world financial conditions were now being tightened once again, especially in those economies where there was a real danger of overheating. Until recently, economies in danger of overheating had been restrained by weaknesses experienced elsewhere in the world economy. Such weaknesses had helped contain inflation through exchange rate movements and by moderating increases in commodity prices. As those temporary influences abated, price pressures were likely to emerge during the period ahead.

While the staff was recommending a more significant policy tightening in countries such as the United States, where pressures on resources were great, concerns about the robustness of the economic upswing remained in other economies around the world, including part of the euro area, the Deputy Director continued. The staff agreed with Messrs. Carstens and Esdar that a tightening of fiscal policy would constitute an appropriate response in countries that were in danger of overheating—including the United States and some countries in the euro area. However, such a tightening would probably not be politically feasible.

The staff had not recommended the active use of regulatory policies for countercyclical purposes, the Deputy Director remarked. Such policies were not sufficiently precise, and their economic impact was difficult to predict. However, it was also true that a significant increase in margin borrowing had occurred in recent months that might justify an adjustment of current regulatory policies. Such adjustments might help prevent an excessively procyclical behavior by banks, for instance in financing real estate purchases.

The staff's projections pointed toward a significant widening of the global current account deficit, the Deputy Director said. In the short run, that might result in stronger export growth—and higher surpluses—for many countries, including Japan, some countries in the euro area, and many Asian countries. Such surpluses would constitute the counterpart to the large—and growing—external deficit of the United States. Over the medium term, the widening imbalances might make it increasingly difficult for countries with large external deficits to finance those deficits. Such scenarios had reinforced the staff's concern about the sustainability of the U.S. external deficit.

However, it should also be noted that global current account projections often were inconsistent, the Deputy Director added. The problem with such projections was to determine how to allocate the large current account discrepancy: should it be allocated in the form of a weaker forecast for the United States, including a lower current account deficit; in the form of lower financing flows to emerging market countries; or in the form of higher surpluses in Europe, Japan or the Asian crisis countries? In order to address those data problems, it had been proposed that the WEO current account projections be constrained through the use of a fixed figure for the global current account discrepancy. Such an approach would have the advantage of resolving the problem of how to allocate the discrepancy and would enable the staff to reach a consensus with respect to the projections, even if that would entail a deviation from the current baseline projection.

Mr. Lushin wondered why the global current account discrepancy for 1999 had expanded as well, given that it was based on historical statistical data, rather than on projections, as was the case for the 2000 current account discrepancy.

The Deputy Director of the Research Department replied that, while it was correct that the data for 1999 pointed to a significant widening of the current account discrepancy, it was likely that data revisions would eventually reduce the figure once again. The trend of recent years was toward a reduction of the discrepancy. Accordingly, the outcome for 1999 should not be viewed as an indication that the global discrepancy problem had worsened. For 2000, a key problem was that the staff's projections suffered from export pessimism. U.S. import growth remained considerable, and there were therefore large export opportunities for other countries that might contribute to stimulating growth worldwide. At some point, the staff's projections might therefore need to be revised in order to take that factor into account.

The staff representative from the Research Department stated that Mr. Kelkar had made the observation that enhanced political security, associated with the end of the Cold War, might have lowered the risk premium for investors. Other factors that had contributed

to lowering the risk premium included the wider availability of mutual funds in the United States and elsewhere, which had increased portfolio diversification, the falling cost of transactions associated with new technology, and the demographic bulge associated with the baby boom. However, the actual size of that reduction was difficult to quantify. Furthermore, research had also suggested that risk premiums were linked in a fairly predictable manner to economic cycles. Finally, changes in risk premiums could not by themselves explain the recent bifurcation of stock markets into new and old economy stocks, and the accompanying large divergences across sectors and markets.

The Economic Counsellor stated that low interest rates and persistent public expenditure packages might have contributed to delaying structural reform in Japan, as had been suggested by Mr. Yoshimura. Low interest rates had made it easier for banks to maintain non-performing loans on their balance sheets, and for firms to delay restructuring by borrowing funds to finance their losses. Public investment spending might also have had the effect of keeping fundamentally insolvent construction firms afloat in the short run. For those reasons, the staff favored a more aggressive approach to re-launching the economy. The authorities must also seek to remain particularly vigilant vis-à-vis banks with nonperforming loans. Recent progress had been made in that respect by the large banks, which had written off at least some of their loan portfolio. However, there had been less progress among smaller regional institutions and credit unions, and non-performing loans therefore remained a key area where action was needed. Impetus for such action would come only from the pressure of positive interest rates.

A further appreciation of the yen would not be helpful to economic recovery, the Economic Counsellor remarked, as it would mainly serve to undermine external competitiveness and spark a sell-off in the stock market. Mr. Kelkar had suggested that it would contribute to shifting relative prices and put pressure on the traded goods sector, where structural problems remained severe. However, the traded goods sector was relatively efficient at the current stage, as it had made rapid progress toward restructuring. Accordingly, a further appreciation of the yen would affect economic growth negatively, and ought therefore to be resisted.

Setting an inflation target would not by itself ensure that it was met, the Economic Counsellor said. Central banks normally had the option of either increasing or reducing short-term interest rates to reach a particular inflation target. In the case of Japan, however, the setting of monetary policy was more complicated: short-term interest rates were being maintained at zero percent for fear of deflation. The question was whether it would be possible to reverse the trend toward deflation by introducing inflation targeting. The staff's view was that the Bank of Japan must operate a broader range of assets apart from short-term credit market instruments to influence price developments. It ought therefore to purchase other instruments, including government and corporate debt. It could even intervene in the real estate market, even though that might require a legal revision to the central bank charter. The purchase of such assets would lead to price increases, thereby adding stimulus to the economy. The central bank also had the option of intervening in the foreign exchange markets. In sum, the staff recommended testing the limits of other policy instruments in a situation where monetary policy had been pushed to the limit. By influencing long-term bond

yields and the foreign exchange rate, it might be possible to generate moderate price inflation. Although an announcement to the effect that deflation would not be tolerated might be positive at the current stage, the staff would not recommend announcing an inflation target in the current circumstances.

The concern that a failure to meet an announced inflation target would reduce the credibility of the Bank of Japan did not carry much validity, the Economic Counsellor continued. Vice versa, there was little reason to fear a sudden surge in inflation. Rather than using fiscal policy as a means to stimulate the economy—thereby creating debt that would ultimately have to be serviced at positive interest rates—expanding liquidity was an operation that could easily be reversed. The central bank had, for instance, injected a large amount of additional liquidity to address concerns about Y2K, and had withdrawn it again without disturbing the economy. The Bank of Japan accordingly had the necessary capability of to control liquidity as required.

In Japan, macroeconomic policy had lost its usual ability to influence the economy, the Economic Counsellor remarked. Fiscal policy, and especially monetary policy, operated in part by influencing consumer expectations in a favorable direction. Accordingly, when successive policy initiatives failed to deliver the promised results, as had been the case in Japan, they lost their credibility and, hence, their capacity to influence expectations. Japanese consumers had become concerned that taxes would increase in response to the higher level of public spending of recent years. In that respect, however, it should be noted that consumer spending had undergone a progressive decline throughout the 1990s, measured as a ratio of household spending. There was accordingly no evidence of a sudden decline in consumer spending had occurred when the government had announced new stimulus packages, and fiscal policy might therefore still have some effect in the short run.

Important structural problems remained in Japan, some of which dated back to the collapse of the asset price bubble in the early 1990s, the Economic Counsellor noted. Other problems, such as the persistence of non-performing loans in the banking sector, resulted from Japan's poor macroeconomic performance throughout the 1990s, although some of those loans dated back to the period of unwise lending in the late 1980s.

At the end of the 1980s, the bubble in equity, real estate and investment had come to end with the tightening of monetary policy, leading to an inevitable collapse of the economy, the Economic Counsellor continued. The result was a prolonged period of recession, followed by a period of weak growth in the first half of the 1990s, which, according to the staff, was an inevitable macroeconomic consequence of the collapse of the bubble. While both monetary and fiscal policy were eased in the first half of the 1990s, they failed to restore economic growth. However, the adoption of expansionary monetary and fiscal policies had undoubtedly helped cushion what would otherwise have been an even deeper and more prolonged downturn at the beginning of the decade.

It should also be recalled that the yen had appreciated strongly during that same period, reaching a high of ¥79.5 against the dollar in April 1995, the Economic Counsellor related. The steep currency appreciation had prevented economic recovery in the traded

goods sector. In response to those developments, the authorities had adopted a large fiscal stimulus package and had reduced short-term interest rates to 0.5 percent—the lowest level ever in the history in Japan, and perhaps in any industrial country. The economy had responded to the monetary and fiscal stimulus by growing by 5 percent of GDP in real terms in 1996. There was accordingly no doubt that those policy actions had produced the intended result by inducing a recovery from recession.

In the period from mid-1996 through early 1997, the Japanese government had, however, decided to introduce a fiscal contraction in the order of 3 percent of GDP consisting of a consumption tax increase, the removal of certain income tax rebates, a reduction of public investment spending, and an increase in pension contribution rates, the Economic Counsellor said. From the time when the consumption tax increase had come into effect in April 1997, the economy had begun to contract sharply. Just as it had begun to recover from that blow, the Asian crisis had reduced exports and had seriously impaired the financial condition of a number of Japanese firms, thereby worsening the condition of the banking sector, and sparking a banking crisis in November of that year.

Following the Asian crisis, the yen had weakened for sometime to ¥147 against the dollar, only to appreciate once again during the second half of 1998 to ¥120, the Economic Counsellor related. In 1999, the yen had almost reached ¥100 to the dollar, which once again held back economic recovery. It was therefore not surprising, in light of the series of negative shocks—including the collapse of the asset price bubble at the beginning of the decade, the subsequent fiscal tightening, the Asian crisis, the banking sector crisis, and the appreciation of the yen—that the Japanese economy had not performed well during 1998-1999. In conclusion, it was not entirely correct to attribute the problems of the Japanese economy to largely structural factors—cyclical factors had played an important role as well.

In light of those considerations, consumer confidence probably needed more time to recover from the experience of the previous decade, the Economic Counsellor concluded. In the meantime, the staff believed it was important to maintain expansionary monetary and fiscal policies in order to put the economy on the path of recovery. The risks related to continued monetary and fiscal stimulus were relatively minor compared with the risks of withdrawing stimulus at that important point in time.

Mr. Toyama stated that, while he was in broad agreement with the staff's analysis of the Japanese economy in the 1990s, he did not think that it would be possible to further ease monetary policy. Several measures had been suggested by the staff to that effect, including the purchase of Japanese government bonds. However, that might lead to an increase—rather than a decline—of long-term interest rates, which would have a negative impact on the economy. The staff had also suggested that the Bank of Japan purchase other instruments, such as real estate and corporate debt. However, that might impact negatively on the quality of the central bank's balance sheet. While the Bank of Japan would not be allowed to default, its assets could deteriorate to a point that would lead to a generalized loss of confidence, not only in the bank itself, but in the economy as a whole. That was why the Bank of Japan had limited the scope of its interventions to short-term financial debt.

The staff had also suggested that the Bank of Japan intervene in the foreign exchange rate markets, Mr. Toyama continued. In Japan, however, there was a division of labor between the ministry of finance and the central bank: while the Bank of Japan could purchase foreign exchange assets for the purpose of monetary policy, interventions in the foreign exchange markets usually were carried out by the ministry of finance. The staff's proposal might therefore mislead the markets into believing that the Bank of Japan had begun to intervene in the foreign exchange markets independently of the ministry of finance.

The Japanese authorities were of the view that the economy had begun to recover in 1999, and that it was on the path of recovery, Mr. Toyama concluded. Therefore, there was no need for the Bank of Japan to undertake unorthodox actions at the current stage.

Mr. Carstens remarked that poor economic management could transform cyclical problems into structural problems, which was probably what had happened in Japan. Traditional demand policies had lost their efficacy, and it had therefore become necessary to press ahead with structural reforms. The staff had over-emphasized the effect of aggregate demand measures in the WEO.

Mr. Esdar remarked that macroeconomic policies had been used either actively or passively to postpone necessary structural adjustment. Structural reform might accordingly help boost confidence in the economy.

Mr. Sobel stated that the U.S. authorities had emphasized the importance of creating demand-led growth in Japan for some time now, and had opposed the tightening of fiscal policy that had been implemented in 1997. However, it was important not to underestimate the importance of financial system deregulation and other structural reforms. It remained unclear at the present stage whether the Japanese economy was regaining momentum or not.

The Economic Counsellor noted that he remained more optimistic about Japan's economic prospects than the rest of the staff. However, macroeconomic policy might be losing its efficacy, and another failure could have very damaging consequences. The staff had consistently emphasized that structural reform was essential to strengthen long-term growth performance. Some elements of structural reform might even help stimulate the demand side of the economy. The ratio of consumption to personal income had undergone a continuous decline in Japan throughout the 1990s from 82 percent in 1990 to 76 percent in 1999. While the decline was related to the collapse of the asset price bubble, it also reflected a loss of confidence on the part of consumers about their economic future, which was related to the poor overall performance of the Japanese economy. That loss of confidence was not credibly related to the absence of structural reform. While structural reform was essential in many respects, it would not by itself trigger a return of confidence. That would only happen when the Japanese economy improved its performance on a more sustained basis. Some structural reforms, which might have a negative impact on macroeconomic performance in the short term, ought therefore to be implemented with caution, and possibly delayed. Other structural reforms ought, however, be implemented at once, including reforming the banking system, particularly the regional and smaller institutions, where bad loans had not yet been credibly and forcefully addressed.

The Acting Chairman thanked Mr. Larsen for his contribution to making the *World Economic Outlook* the flagship of the Fund's publications, but also of the official sector's publications on the world economy.

2. INVOLVING THE PRIVATE SECTOR IN RESOLVING FINANCIAL CRISES – SUMMING UP

The Executive Directors considered a staff paper on involving the private sector in resolving financial crises—experience and principles, together with a staff report on a meeting with market participants on private sector involvement (EBS/00/42, 3/7/00; and Sup. 1, 3/17/00).

The Acting Chairman made the following summing up:

Executive Directors continued from their earlier discussions on involving the private sector in the resolution of financial crises and in assisting member countries to return to balance of payments viability. They reviewed the Fund's recent experience with countries for which private sector involvement had been an issue, and discussed a proposed framework which, building on this experience, could help guide decisions on issues associated with private sector involvement. They considered that the staff paper made a useful contribution in clarifying the issues involved.

Prevention

Directors reiterated that prevention remains the first line of defense against financial crises. Recent experience confirms that consistent macroeconomic and exchange rate policies, debt management, and prudential supervision of financial systems are all critical elements of a policy framework designed to manage vulnerabilities and thereby reduce the frequency and mitigate the severity of crises. At the same time, policies designed to improve the environment for private sector decision-making can also be expected to contribute to reducing buildups of vulnerability. Improvements in the transparency of both the public and private sectors, as well as efforts to promote the adoption of and adherence to standards, should facilitate risk management on the part of investors. Directors also noted the importance attached by private market participants to regular contacts between the authorities and market participants, as a means of ensuring regular provision of information on economic developments and policies, and maintaining lines of communication both in good times and when possible difficulties in the member's economic situation begin to emerge.

Recent Experience

Directors noted that two recent cases of efforts to secure private sector involvement through the restructuring of international sovereign bonds had

been encouraging. In these cases, debt exchanges had been arranged successfully, and disruptive litigation had not been a problem. They noted that while it is premature to assess whether litigation might ultimately become an issue, it appears that in recent cases the risks were not as great as previously thought. Directors stressed that successful debt exchanges involved the recognition by creditors of the limited debt-servicing capacity of the debtors involved, and of the unpalatability of alternative outcomes. Directors also noted that the precise form of the recent debt restructurings depended on the structure of the payments falling due as well as the particular country circumstances, and did not necessarily involve comparable treatment of all debt or maturities.

Involving the Private Sector in Crisis Resolution

Directors reviewed the experience to date in a number of cases of crisis resolution which had involved the private sector. They saw merit in continuing to work toward an operational framework for securing private sector involvement, building on the principles and framework articulated by the G-7 Finance Ministers in their report to the Köln Economic Summit, which would be a first step in responding to the request made by the Interim Committee in September 1999.

Directors noted that flexibility would be required in handling individual cases; the form of continued private sector involvement would depend on the case, as would the methods used to ensure it. Directors agreed that the financing of the adjustment program of a member coping with a financial crisis would normally be based on the expectation that private sector exposure to the country would either be maintained above some level, or begin to be rebuilt soon after the emergence of a crisis. In some cases, reliance would be placed primarily on the Fund's traditional catalytic role, with the strength of the Fund-supported adjustment program enhancing market confidence and therefore expected to lead to the restoration of spontaneous private capital inflows. In cases where greater assurance was needed, the catalytic role of the Fund would have to be supplemented by measures to improve coordination among creditors.

Directors noted that assessing the appropriate means of securing private sector involvement in individual cases raises complex issues, and will require considerable judgment. Directors considered that a range of issues would have a bearing on the approach to private sector involvement in individual cases, including the size of the financing requirements, both during the program period and over the medium term; the prospects for a spontaneous return to capital market access; the availability of tools for securing appropriate private sector involvement; and the desirability of minimizing possible spillover effects on other countries. Directors recognized

that reaching these judgments would require addressing complicated analytical issues.

Directors agreed that the basic principles underlying the Fund's approach toward private sector involvement should be to allow the Fund to support effective balance of payments adjustment programs leading to sustained growth and medium-term viability, while providing adequate safeguards to maintain the revolving character of Fund resources. These principles, in turn, require that programs with member countries be fully financed. In addition, it is important that the availability of official financing, insofar as possible, not create moral hazard by providing incentives for inappropriate lending or borrowing. Directors stressed that, in making operational a framework for private sector involvement:

- contracts should be honored to the extent possible;
- members should seek cooperative solutions to emerging debt difficulties;
- no one category of private creditor should be regarded as inherently privileged relative to others; and
- the approach taken in individual cases should reflect a member's specific circumstances, including the composition of outstanding debt instruments, and should be based on a substantive analysis of the member's medium-term balance of payments prospects and debt sustainability.

Directors considered that the framework of propositions suggested by the staff for private sector involvement, in conjunction with the principles listed in the preceding paragraph, constituted a useful start, but pointed to several problems in making it operational, including the difficulty of the underlying analytical judgments. Under the proposed framework, private sector involvement would be ensured primarily through reliance on the Fund's traditional catalytic role:

- if the member's financing requirements are moderate, or
- if the financing requirements are large, but the member has good prospects of rapidly regaining market access on appropriate terms.
- More concerted forms of private sector involvement would be required;

- if the financing requirement is large and the member has poor prospects of regaining market access in the near future, or
- if the member has a debt burden that appears unsustainable in the medium term.

Directors called upon the staff to continue work on the analytic underpinnings and operational issues involved in making the framework operational.

The Fund's approach toward a given case requires a decision on how much financing the official sector is willing to make available in support of a strong adjustment program. Most Directors noted that the availability of Fund financing beyond that provided through the regular access policy was quite limited, and that while the Supplemental Reserve Facility is available under specified circumstances, care should be taken to avoid creating the impression that the Fund, or the official sector as a whole, would fill all financing gaps. At the same time, the difficulty of determining ex ante the precise distribution between official and private sector financing was noted. Some Directors considered that there should be the presumption that private sector involvement will be secured, should the Fund's financing in relation to the member's quota exceed some limit. Other Directors, however, considered that the size of the financing requirement was only one factor in deciding on concerted involvement and placed more stress on the need for a strong program that would ensure the rapid restoration of market confidence and limit the risk to official resources.

In cases in which reliance is placed primarily on the Fund's catalytic role, Directors noted that if the assumptions about the return to market access prove to be wrong, possibly because the Fund's catalytic role was slow to bring desired results, the risks to the program's financing and the Fund's resources would grow, unless there was a switch to more concerted forms of private sector involvement. To justify the strategy of relying on the Fund's catalytic role, it is crucial that the authorities' program be directed toward rebuilding market confidence, and the removal of any factors that inhibit the right sort of capital inflows, and that the authorities be fully committed to its sustained implementation. Some Directors considered that a reduction of official financing might be needed in certain cases to ensure an appropriate balance in the contribution of the private and the official sectors.

Directors also agreed that when a member had an unsustainable debt burden, private sector involvement in a broad restructuring or reduction of that burden would be required. They recognized, however, that the determination of whether a debt burden was unsustainable was inevitably a judgmental exercise, and it could take time for the member and its creditors to reach agreement on the extent of the problem and its solution. In such cases, the

Fund would be prepared to lend into arrears to private creditors under its established policy, in support of a strong adjustment program and provided the member was negotiating with its creditors in good faith.

Where private sector involvement was required, Directors agreed that its precise form would have to be decided on a case-by-case basis. Some Directors considered that the approach to be taken in individual cases should seek to avoid prohibitive increases in the future cost of financing for the country concerned. Directors took note of the staff's views that, in general, efforts would be concentrated on the debt payments associated with the immediate financing problem, and would thus not necessarily be comprehensive across all classes of private instruments. However, experience suggested that comprehensiveness within an asset class can often contribute to a successful outcome. Directors also considered it particularly important that no one category of private creditor be regarded as inherently privileged.

Directors recognized that only limited progress had been made in lifting institutional constraints to debt restructuring. They encouraged the establishment of creditor committees as needed and on an ad hoc basis. Directors also saw merit in incorporating collective action clauses in international sovereign bond contracts. They welcomed efforts on the part of the United Kingdom in this regard and the recent clarification of the legal status of such clauses by the German government. Directors considered that temporary and voluntary market-based standstill arrangements could be desirable in some circumstances to minimize the risk of disruptive litigation. Some Directors considered that the staff should continue to explore issues related to a modification of Article VIII, Section 2(b).

Directors confirmed that there is a role for the Fund staff in informing creditors of the status of negotiations with the Fund and the member's economic situation, including its adjustment program and payments capacity, provided that that was acceptable to the member concerned. Nevertheless, it was important to maintain the principle that the Fund is not a party to the negotiations between a member and its creditors.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/30 (3/21/00) and EBM/00/31 (3/22/00).

3. ELECTRONIC TRANSMISSION OF ENCRYPTED BOARD DOCUMENTS TO MEMBER COUNTRIES AND ELIGIBLE INTERNATIONAL ORGANIZATIONS

The Executive Board approves the Executive Board's proposal to offer the service of electronic transfer of certain encrypted Board documents to member

countries and to eligible international organizations under the Fund's policies on transmittal of documents to other institutions as set forth in EBD/00/29 (3/14/00).

Decision No. 12162-(00/31), adopted
March 21, 2000

**4. RELEASE OF INFORMATION—REVIEW OF FUND'S DATA
STANDARDS INITIATIVES**

The Executive Board approves the release of the staff paper on the third review of the Fund's data standards initiatives to other organizations as set out in SM/00/55 (3/15/00).

Adopted March 20, 2000

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBAM/00/39 (3/20/00) is approved.

APPROVAL: December 11, 2000

SHAIENDRA J. ANJARIA
Secretary