ANNEX SUMMING UP BY THE CHAIRMAN

The following remarks by the Chairman were made at the conclusion of the Executive Board's discussion of the World Economic Outlook. They were made on September 4, 2002.

Executive Directors noted that from the second quarter of 2002, economic and financial market developments have been mixed. They pointed to the negative developments on several fronts, including the sharp decline in global equity markets since end-March; the deterioration in financing conditions facing most emerging market borrowers—notably in Latin America; and weaknesses in a number of current and forward-looking indicators for the United States, Europe, and several other regions. These developments were especially disappointing against the backdrop of the strengthening of global economic indicators, including trade and industrial production, seen since end-2001, as well as first quarter growth that exceeded expectations in several regions.

Directors noted that the world economy and the financial markets have shown considerable resilience in the face of multiple recent shocks and that, going forward, several factors should support a steady strengthening in global growth—including the continuing stimulus from earlier macroeconomic easing in many regions, the winding down of inventory corrections, and the recent signs of greater stability returning to global financial markets. Nonetheless, Directors expressed concern that recent developments have raised questions about the strength and sustainability of the recovery, and agreed with the assessment that, overall, the outlook for the remainder of 2002 and for 2003 is likely to be weaker than had been anticipated in the April *World Economic Outlook*.

Directors assessed the risks to the short-term outlook as being predominantly on the downside. In particular, they noted that recent, and possibly further, equity price falls could have a more marked impact on domestic demand than currently expected—especially in the United States, which has led the global recovery to date. Directors noted that recent movements in major exchange rates are appropriate from a medium-term perspective, although in the short term some negative impact on the recovery in Japan and the euro area, which has so far been led by external demand, should not be ruled out. Many Directors also saw the persistently high U.S. current account deficit and the still high U.S. dollar value as posing some risk of an abrupt and disruptive adjustment. Directors were also concerned that tight emerging market financing conditions could further weaken growth prospects and increase vulnerabilities in a number of countries. They also noted the potential for further volatility in oil prices in the event of a deterioration in the security situation in the Middle East.

Against the backdrop of heightened uncertainty about the strength of the recovery, Directors agreed that macroeconomic policies in most industrial countries will need to remain accommodative for longer than had been expected earlier in the year. Should the outlook weaken further, some further easing in monetary policy will likely be needed in the United States and in the euro area, provided inflationary pressures remain subdued in the United States and come down as expected in Europe. Directors noted that among emerging market economies, policy priorities necessarily vary widely. Where there is room for policy maneuver, they felt that the macroeconomic stance should, in general, remain accommodative, but in countries facing external financing difficulties, the restoration of financial market confidence through appropri-

ate policies should be the priority. Looking ahead, Directors concurred that, in most industrial and emerging countries, fiscal restraint and progress with ongoing structural reforms will remain the essential priorities needed to strengthen and broaden the sources of growth over the medium term, to reduce global imbalances, and to improve resilience to future economic shocks.

Major Currency Areas

Turning to the prospects for the major currency areas, Directors agreed that recent indicators still generally point to the continued moderate recovery in the *United States*, supported by the further fall in long-term interest rates, the lower dollar, and the macroeconomic stimulus still in the pipeline. They noted that, nevertheless, important uncertainties to the outlook remain. These uncertainties relate to the extent to which equity market developments and corporate accounting scandals will affect consumption growth and investment recovery, the extent of overcapacity in a number of industries, and the outlook for productivity growth. Against this backdrop, Directors recommended that the Federal Reserve should wait to withdraw monetary stimulus until the recovery is firmly established, and that it consider further easing if incoming data remain weak. While fiscal policy has provided welcome support to activity during the economic slowdown, Directors noted that following its recent deterioration, the medium-term fiscal outlook will need to be strengthened. Many Directors recommended that the U.S. authorities adopt a medium-term budgetary framework directed at attaining budget balance over the business cycle, both to increase domestic saving and to better prepare for the fiscal pressures from population aging. Noting that restoration of confidence will be key to underpinning the recovery, Directors welcomed the U.S. authorities' swift actions to strengthen corporate governance and auditing, and considered that their vigorous implementation and enforcement, as well as their possible further strengthening if needed, will be crucial to ensuring that they have the necessary impact.

Directors were encouraged by recent indicators in *Japan*, suggesting that activity is stabilizing. They were concerned, however, that economic signals still remain mixed. With the outlook for domestic demand remaining weak, the modest rebound projected for the rest of 2002 and for 2003 is subject to downside risks, particularly if, in an uncertain external environment, the global recovery turns out to be weaker than expected or if the yen appreciates further. Directors agreed that strong implementation of structural reforms to improve the financial health and profitability of the banking sector, accelerate corporate restructuring, and increase investment opportunities remain key to strengthen Japan's growth prospects durably. To support activity in the short term, most Directors recommended a more aggressive monetary stimulus, combined with a public commitment to end deflation in the near future. In view of the high level of public debt, Directors agreed that the focus of fiscal policy will need to turn toward gradual consolidation. They suggested that in the context of an acceleration in structural reforms, the authorities should consider maintaining a neutral fiscal stance in the short run to mitigate any initial negative impact on growth of the reforms.

Directors noted that recovery is not yet well established in the *euro area*, with domestic demand still weak—especially in Germany and Italy—and the resilience of export-led growth possibly at risk should the global recovery falter. Several factors should, however, support a steady—albeit moderate—pickup in activity in late 2002 and in 2003, including growth in household and corporate earnings, lower inflation—partly as a result of a stronger euro—and improvements in labor market performance over recent years. Given the hesitant recovery, and with risks to price stability having become more balanced, Directors concurred that monetary policy should remain on hold for the time being, and that the ECB should stand ready to consider interest rate cuts if activity weakens and inflation declines as expected. With budgetary

positions in several countries having become more difficult, most Directors saw little room for maneuver on the fiscal front. Directors generally were of the view that in most euro-area countries, a further strengthening of fiscal positions over the medium term will still be needed to prepare for the effects of population aging and to provide scope for reductions in high tax burdens. In addition, building on the significant progress achieved in recent years, Europe should press ahead with the sustained implementation of structural reforms, especially in its labor and product markets, as these will boost productivity and growth potential. Some Directors encouraged deeper analysis of the impact of the structural reforms in Europe on potential output.

Directors welcomed the staff's analysis of external imbalances in the industrial countries during the 1990s as providing a useful framework for discussing policy responses in a multilateral setting. They noted that the significant expansion in current account imbalances among deficit countries reflects faster growth combined with buoyant expectations about future economic prospects associated with the IT revolution, which has supported real demand and fostered autonomous capital inflows. Directors agreed that existing current account imbalances are unlikely to be viable over the medium term, and that an adjustment will be needed over the coming years, with its speed likely to reflect in part underlying differences in growth prospects across countries. To enhance prospects for a smooth rotation of demand from countries in deficit to those in surplus, Directors reiterated the importance of fiscal consolidation in deficit countries, which should be combined with accelerated structural reforms in surplus countries designed to make these economies more flexible, and enhance their medium-term growth potential and demand.

Emerging Markets

Directors noted that developments and prospects among *emerging markets* are being shaped by the hesitant recovery in industrialized economies, adverse developments—including heightened risk aversion—in international financial markets, and significant economic and political uncertainties in some major economies with large external financing requirements. In particular, Directors expressed concern about the sharp deterioration of economic conditions in *Latin America,* although some countries continue to resist the region's difficulties reasonably well. They noted that this deterioration partly reflects the turmoil in Argentina and its spillover effects on some neighboring countries, notably Uruguay. The difficulties being faced by a number of Latin American economies are, however, also largely the result of interactions between domestic political uncertainties and underlying economic vulnerabilities, particularly high debt levels, large external financing requirements, and—in some countries—fragile banking systems. To reduce these vulnerabilities, Directors urged these countries to make further determined efforts to achieve sustainable improvements in fiscal positions, maintain firm monetary policies, and push ahead with wide-ranging structural reforms—including measures to strengthen banking systems and liberalize external trade.

In contrast to most other regions, activity in *emerging markets in Asia* has picked up markedly, led by strong growth in China and India and improvements among countries most oriented to the information technology sector. To reduce remaining vulnerabilities, Directors agreed that in general policy priorities across the region will need to include creating the conditions for a sustainable strengthening of domestic demand and improving the region's resilience to shocks, including through further bank and corporate restructuring, strengthening medium-term fiscal sustainability, and ensuring appropriate flexibility in exchange rate regimes. Noting the increasing contribution of intra-Asian trade to regional stability and growth, Directors also highlighted the importance of ensuring that the Asian economies remain sufficiently flexible and dynamic to take advantage of prospective

changes in intraregional trade opportunities—including as a result of China's rapid growth and entry into the World Trade Organization.

Growth among most of the *European Union accession candidates in central and eastern Europe* has been relatively well sustained, aided by strong domestic demand and export growth. Although the high current account deficits in many of these countries have been readily financed, especially through direct investment, Directors suggested continued vigilance to ensure that these investment inflows are sustained. Fiscal restraint, together with structural reforms, will help underpin market confidence and support economic adjustment. Noting the recent increases in economic and political uncertainties in *Turkey*, Directors urged the authorities to maintain their commitment to macroeconomic stability and structural reforms, including improvements in bank supervision and public financial management.

Directors noted that growth in the *CIS*—especially *Russia and other countries relatively advanced with economic reforms*—has remained reasonably strong, mainly on account of robust domestic demand. The key medium-term challenge remaining for the region is to accelerate the reform process, especially among the less advanced reformers whose growth performance continues to be hampered by macroeconomic instability, lack of corporate restructuring, and an unfavorable investment climate. Directors looked forward to improved prospects for the lowest-income CIS countries, with technical and financial assistance provided under the CIS-7 Initiative supporting their reform efforts.

Directors noted that growth in *Africa* has weakened in 2002 as a result of commodity price developments, the severe drought in southern Africa, and the remaining conflicts in some countries. The expected strengthening of external demand and improvement in commodity prices are, however, expected to support a pickup in growth in 2003. Welcoming the substantial progress that many African economies have made since the mid-1990s toward macroeconomic stability, Directors agreed that the pressing need now is to improve the overall environment for investment and growth—particularly by strengthening the economic infrastructure and the main market institutions, as well as the quality of governance. In this context, Directors looked forward to the sustained implementation, with appropriate external support, of the New Partnership for African Development (NEPAD), which embraces these key priorities. They also noted the positive contribution of the HIPC Initiative in reinforcing growth prospects and development efforts in the region.

Directors noted that, following the recent slowdown, growth in the *Middle East* is expected to pick up in the near term, assuming the global recovery gains momentum, oil prices remain firm, and the regional security situation improves. In several countries, sustaining stronger and broader-based growth will also importantly require strengthening the fiscal situation and accelerating structural reforms, especially as regards trade and price liberalization.

Agricultural Policies

Directors welcomed the essay on agricultural policies as an important contribution to the increasing body of Fund analysis demonstrating the benefits of trade liberalization for both industrial and developing countries. They noted that the extremely high level of support provided to farmers in industrial countries affects developing countries in various ways—including by depressing the world prices of commodities of interest to poor farmers and by increasing world price variability. Directors strongly encouraged industrial countries to use the opportunity provided by the Doha round of multilateral trade negotiations to reduce agricultural support and/or shift to less distorting forms of support—moves that would bring aggregate gains by increasing efficiency and real incomes in both industrial and developing countries. Directors also saw a need for food-importing poor countries to receive appropriately targeted assistance to mitigate the effects of higher food prices resulting from liberalization.

Capital Structure and Corporate Performance

Directors welcomed the essay on capital structure and corporate performance with its focus on differences in corporate structures and financial vulnerabilities across emerging market countries. Directors underscored the importance of close monitoring of the health of the corporate sector and of strengthening financial sector supervision, in particular to take account of the significant increase in corporate leverage that normally occurs as countries move from low to moderate levels of financial development. They generally agreed with the main thrust of the staff's findings that greater openness to foreign investment tends to reduce leverage and reliance on short-term debt, thus helping strengthen corporate performance—but cautioned that care should be taken to avoid currency mismatches in balance sheets.

Trade and Financial Integration

Directors welcomed the analysis of trade and financial integration. They noted the observed complementarity of trade integration and financial integration, both over time and across countries, with policy liberalization being the driving force of the integration process in the current episode of globalization. Despite the overall historical trend toward progressive liberalization, today's trade and capital account restrictions across the world continue to restrain global trade flows. Full liberalization around the globe will surely increase international trade flows significantly. Directors also agreed that trade and financial integration tend to reinforce each other. Increased trade integration is naturally accompanied by rising international financial flows, which in turn fosters financial integration. At the same time, increased financial integration fosters trade integration, as financial frictions partly explain the segmentation of global goods markets. Based on this analysis, Directors were of the view that balanced trade and financial integration is essential, since recent experience reemphasizes that an uneven pattern of integration can pose risks to macroeconomic stability. Directors also discussed, and many endorsed, the finding that—along with macroeconomic stability and domestic financial and institutional development—international financial openness reduces output volatility. A number of Directors, however, stressed that financial openness could be risky, especially if the domestic financial sector is insufficiently robust. They also noted that, while greater openness to FDI and portfolio flows is associated with lower output volatility, higher external debt ratios lead to higher output volatility in both financially open and closed economies.