

WORLD ECONOMIC OUTLOOK
April 2004

Advancing Structural Reforms



©2004 International Monetary Fund

Production: IMF Graphics Section
Cover and Design: Luisa Menjivar-Macdonald
Figures: Theodore F. Peters, Jr.
Typesetting: Choon Lee

World economic outlook (International Monetary Fund)

World economic outlook: a survey by the staff of the International Monetary Fund.—1980— Washington, D.C.: The Fund, 1980—

v.; 28 cm.—(1981–84: Occasional paper/International Monetary Fund ISSN 0251-6365)

Annual.

Has occasional updates, 1984—

ISSN 0258-7440 = World economic and financial surveys

ISSN 0256-6877 = World economic outlook (Washington)

I. Economic history—1971—Periodicals. I. International Monetary Fund. II. Series: Occasional paper (International Monetary Fund)

HC10.W7979 84-640155

338.5'443'09048—dc19

AACR 2 MARC-S

Library of Congress 8507

Published biannually.
ISBN 1-58906-337-6

Price: US\$49.00
(US\$46.00 to full-time faculty members and
students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel.: (202) 623-7430 Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: <http://www.imf.org>



recycled paper

CONTENTS

Assumptions and Conventions	viii
Preface	x
Foreword	xi
Chapter I. Economic Prospects and Policy Issues	1
North America: Growth in the United States Surges; In Canada It Slows	22
Euro Area: Subdued Recovery, With Domestic Demand Still Uneven	24
Japan: Is a Sustained Recovery Finally Under Way?	27
Latin America: Is There a Tension Between Tackling Social Issues and Reducing High Public Debt?	29
Emerging Asia: With Recovery Taking Hold, Scope for Greater Exchange Rate Flexibility	33
EU Accession Countries: External Imbalances Need to Be Addressed	39
Commonwealth of Independent States: Managing the Challenges of Remonetization	42
Middle East: Improved Prospects, but Much Depends on Geopolitical Uncertainties and Security Situation	44
Africa: The Struggle to Reduce Poverty	47
Appendix 1.1. Commodity Markets	53
References	61
Chapter II. The Global Implications of the U.S. Fiscal Deficit and of China's Growth	63
How Will the U.S. Budget Deficit Affect the Rest of the World?	63
China's Emergence and Its Impact on the Global Economy	82
References	99
Chapter III. Fostering Structural Reforms in Industrial Countries	103
Two Decades of Structural Reforms in Industrial Countries: An Overview	104
Determinants of Structural Reforms	109
Cost-Benefit Dynamics of Reforms	124
Reform Experience and Implications for Reform Design	128
Appendix 3.1. Structural Policy Indicators	132
Appendix 3.2. Determinants of Reforms: Econometric Methods	134
Appendix 3.3. Cost-Benefit Dynamics of Reforms	139
References	142
Chapter IV. Are Credit Booms in Emerging Markets a Concern?	147
What Are Credit Booms and How Are They Propagated?	147
What Do Credit Booms Look Like?	151
Conclusion	157

CONTENTS

Appendix 4.1. Definitions, Data Sources, Methodology, and Results	159
References	164
Annex: Summing Up by the Acting Chair	167
Statistical Appendix	173
Assumptions	173
What's New	176
Data and Conventions	176
Classification of Countries	179
List of Tables	185
Output (Tables 1–6)	187
Inflation (Tables 7–11)	198
Financial Policies (Tables 12–19)	206
Foreign Trade (Tables 20–24)	215
Current Account Transactions (Tables 25–31)	223
Balance of Payments and External Financing (Tables 32–36)	238
External Debt and Debt Service (Tables 37–42)	248
Flow of Funds (Table 43)	257
Medium-Term Baseline Scenario (Tables 44–45)	261
World Economic Outlook and Staff Studies for the World Economic Outlook, Selected Topics	264
Boxes	
1.1 The Effects of a Falling Dollar	16
1.2 Housing Markets in Industrial Countries	18
1.3 Risks to the Multilateral Trading System	20
1.4 Is Emerging Asia Becoming an Engine of World Growth?	34
1.5 What Works in Africa	50
2.1 How Do U.S. Interest and Exchange Rates Affect Emerging Markets' Balance Sheets?	71
2.2 The Effects of Tax Cuts in a Global Fiscal Model	76
2.3 Can China Sustain Its Rapid Output Growth?	88
2.4 Quantifying the International Impact of China's WTO Accession	91
3.1 Structural Reforms and Economic Growth: New Zealand's Experience	117
3.2 Structural Reforms in the United Kingdom During the 1980s	119
3.3 The Netherlands: How the Interaction of Labor Market Reforms and Tax Cuts Led to Strong Employment Growth	122
3.4 Economic Integration and Structural Reforms: The European Experience	130
4.1 Does Financial Sector Development Help Economic Growth and Welfare?	149
A1 Economic Policy Assumptions Underlying the Projections for Selected Advanced Economies	174
A2 Revised Purchasing-Power-Parity-Based Weights	183
Tables	
1.1 Overview of the <i>World Economic Outlook</i> Projections	3
1.2 Emerging Market and Developing Countries: Net Capital Flows	9

1.3	Advanced Economies: Real GDP, Consumer Prices, and Unemployment	10
1.4	Major Advanced Economies: General Government Fiscal Balances and Debt	12
1.5	Selected Economies: Current Account Positions	14
1.6	Selected Western Hemisphere Countries: Real GDP, Consumer Prices, and Current Account Balance	30
1.7	Selected Asian Economies: Real GDP, Consumer Prices, and Current Account Balance	33
1.8	EU Accession Countries: Real GDP, Consumer Prices, and Current Account Balance	40
1.9	Commonwealth of Independent States: Real GDP, Consumer Prices, and Current Account Balance	42
1.10	Selected Middle Eastern Countries: Real GDP, Consumer Prices, and Current Account Balance	45
1.11	Selected African Countries: Real GDP, Consumer Prices, and Current Account Balance	49
1.12	Nonenergy Commodity Prices	55
1.13	Volatility and Correlation of Spot and Futures Prices	58
1.14	Forecast Performance	60
2.1	Cumulative Percentage Point Contributions to Budget Turnaround	65
2.2	Effects of Fiscal Policy on Output (VAR Estimates)	68
2.3	Estimates of Multipliers from Macromodel Simulations	68
2.4	Estimates of Effect of FY2004 Budget Proposals from Small-Scale Models	69
2.5	Selected Studies on the Impact of Deficits on Real Interest Rates	69
2.6	Correlations of G-7 Real Interest Rates (1977–2002)	70
2.7	MULTIMOD Alternative Scenarios	79
2.8	China: Tariffs, 1982–2002	83
2.9	China: Market Share in Major Export Markets	84
2.10	Trade-Related Impact of Faster Chinese Integration, 2020	92
2.11	Impact of Faster Chinese Integration on South Asia’s Output and Trade Volumes, 2020	94
2.12	Impact of Faster Chinese Integration on Sectoral Gross Output, 2020	95
2.13	Impact of Faster Chinese Integration Assuming Structural Rigidities, 2020	95
2.14	Impact of Faster Chinese Integration Combined with More Rapid Global Trade Liberalization, 2020	96
2.15	Projected Average Annual Growth Rates of Population, GDP, and Factors of Production Under the Fast Integration Scenario, 2002–20	98
2.16	Regions and Sectors Identified in the Model	98
2.17	Elasticities of Substitution in Demand for Goods and Factors of Production	99
3.1	Aggregate Structural Policy Indicators and Their Components	106
3.2	Correlation Matrices for Changes in Structural Policy Indicators	109
3.3	Econometric Analysis: Summary of Results	110
3.4	Determinants of Product and Labor Reforms	137
3.5	Determinants of Trade and Tax Reforms	138
3.6	Determinants of Financial Reforms	138
3.7	Determinants of Structural Reforms, Five-Year Averages	139
3.8	Impact of Structural Reforms on Log Real Per Capita GDP	140
3.9	Standard Deviations of Cross-Country Distributions of Reform Indicators	141
3.10	Impact of Structural Reforms on Unemployment	142
4.1	Credit, Capital Inflows, and Financial Liberalization	154

CONTENTS

4.2 Cyclical Correlations with Real Credit in Emerging Market Economies	155
4.3 Emerging Market Economies, Nontradables Sector	163

Figures

1.1 Global Indicators	2
1.2 Current and Forward-Looking Indicators	4
1.3 G-7: The Differing Nature of the Recovery	5
1.4 Global Exchange Rate Developments	6
1.5 Developments in Mature Financial Markets	7
1.6 Emerging Market Financial Conditions	8
1.7 Fiscal and Monetary Easing in the Major Advanced Countries	11
1.8 Global Outlook	13
1.9 United States: Growth, Consumption, and Personal Incomes	23
1.10 Euro Area: Implications of Persistent Inflation Differentials	25
1.11 Japan: How Does the Current Recovery Compare With the Past?	28
1.12 Unemployment, Income Inequality, and Poverty in Latin America	31
1.13 Emerging Asia: Foreign Reserve Accumulation	36
1.14 EU Accession Countries: Current Account Balance and Foreign Direct Investment	39
1.15 Commonwealth of Independent States: Remonetization and Credit Growth	43
1.16 Middle East: Reduction in Uncertainties Boosts Prospects	46
1.17 Sub-Saharan Africa: Growth and Poverty	48
1.18 Oil Prices, Futures, and Production	53
1.19 Oil Inventories	54
1.20 Nonenergy Commodities	56
1.21 Semiconductor Markets	57
1.22 Spot and Futures Prices	59
2.1 United States: Fiscal Balance	64
2.2 United States: Fiscal Risks	65
2.3 Structural Fiscal Balances of Advanced Countries	66
2.4 Main Simulation Scenarios	74
2.5 GDP in Alternative Scenarios	80
2.6 Output and Trade During Periods of Rapid Integration	83
2.7 China's Exports and Imports	84
2.8 Current and Capital Accounts, and Financial Markets During Periods of Rapid Integration	85
2.9 Determinants of Growth: Savings, Investment, Human Capital, and Sectoral Reallocation During Periods of Rapid Integration	86
2.10 Required Structural Adjustment	93
3.1 Cumulative Reform Efforts Across Sectors	107
3.2 Regulatory Regimes in 1975 and 2000 Across Countries	108
3.3 Structural Reforms and Initial Structural Conditions	111
3.4 Cross-Border Spillovers	113
3.5 Openness to Trade and Reforms	114
3.6 More Reforms in Bad Times?	115
3.7 Fiscal Adjustment and "Difficult" Reforms	116
3.8 Product and Labor Market Reforms	121

3.9 Response of Real GDP Per Capita to a One-Standard-Deviation Increase in Reform Indicators	126
3.10 Response of Unemployment to a One-Standard-Deviation Increase in Reform Indicators	128
3.11 An Empirical Model of Reforms: Convergence Toward a Target	135
4.1 Financial Deepening and Development	148
4.2 Credit Booms Versus Episodes of Rapid Credit Growth	152
4.3 Emerging Market Credit Booms, 1970–2002	153
4.4 Credit Booms in Emerging Markets	155
4.5 Selected Macroeconomic Variables During Credit Booms	156
4.6 Selected Financial Variables During Credit Booms	157
4.7 Selected Microeconomic Variables of the Nontradable Corporate Sector	158
4.8 Corporate Leverage During a Credit Boom	159

ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during February 13–March 12, 2004, except for the currencies participating in the European Exchange Rate Mechanism (ERM2), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A1); that the average price of oil will be \$30.00 a barrel in 2004 and \$27.00 a barrel in 2005, and remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 1.3 percent in 2004 and 3.5 percent in 2005; that the three-month interbank deposit rate for the euro will average 2.1 percent in 2004 and 2.6 percent in 2005; and that the three-month certificate of deposit rate in Japan will average 0.1 percent in 2004 and 0.4 percent in 2005. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through early April 2004.

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

- . . . to indicate that data are not available or not applicable;
- to indicate that the figure is zero or negligible;
- between years or months (for example, 2002–2003 or January–June) to indicate the years or months covered, including the beginning and ending years or months;
- / between years or months (for example, 2002/03) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to $\frac{1}{4}$ of 1 percent point).

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

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

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



FURTHER INFORMATION AND DATA

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

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

World Economic Studies Division
Research Department
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431, U.S.A.
E-mail: weo@imf.org Telefax: (202) 623-6343

PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, of developments in international financial markets, and of the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department, the International Capital Markets Department, the Monetary and Financial Systems Department, and the Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Raghuram Rajan, Economic Counsellor and Director of Research. The project has been directed by David Robinson, Deputy Director of the Research Department, together with James Morsink, Division Chief, Research Department.

Primary contributors to this report also include Nicoletta Batini, Tito Boeri, Tim Callen, Xavier Debrun, Tarhan Feyzioglu, Dalia Hakura, Thomas Helbling, Enrique Mendoza, Nikola Spatafora, Luigi Spaventa, Marco Terrones, Charles Wyplosz, Cathy Wright, and Yongzheng Yang. Hussein Allidina, Paul Atang, Nathalie Carcenac, Sarma Jayanthi, Toh Kuan, Paul Nicholson, and Bennett Sutton provided research assistance.

Nicholas Dopuch, Mandy Hemmati, Yutong Li, Casper Meyer, and Ercument Tulun managed the database and the computer systems. Sylvia Brescia, Celia Burns, and Dawn Heaney were responsible for word processing. Other contributors include Bas Bakker, Tamim Bayoumi, Dennis Botman, Enrica Detragiache, Simon Gilchrist, Aasim Husain, Laura Kodres, Petya Koeva, Manmohan Kumar, Hans Peter Lankes, Douglas Laxton, Gian Maria Milesi-Ferretti, Sam Ouliaris, Thomas Rumbaugh, Todd Schneider, Abdelhak Senhadji, Arvind Subramanian, Kenichi Ueda, and Harm Zebregs. Marina Primorac of the External Relations Department edited the manuscript and coordinated the production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on March 29 and 31, 2004. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

FOREWORD

This is the first *World Economic Outlook* since I took over from Ken Rogoff as Director of the Research Department. I thank David Robinson, James Morsink, members of the Research Department, and all the other IMF staff who worked hard to bring this to you.

A theme that runs through the chapters and essays in this Outlook is the importance of enhancing the ability of economies to cope with adversity. As we describe in Chapter I, the outlook for the world economy is among the rosier we have seen for a decade. There are, of course, risks, but it is precisely for this reason that the time is propitious to attempt to make economies more resilient.

One set of risks is geopolitical. In the past few years, the world has successfully overcome the economic consequences of two terrible shocks, the terrorist attacks of September 11, 2001, on the World Trade Center and the Pentagon and the SARS epidemic. Both had the potential to destroy confidence and thereby economic activity, not just in the short run but even into the medium term. That they did not was due, in no small part, to policy—the expansionary policies followed both in the United States and in East Asia helped restore life to these economies, and they are now driving world growth. It would, however, be overly optimistic to say that we have seen the last of these kinds of risks.

Another risk is more traditional: external competition, which is constantly changing its face and becoming keener. As economies like China grow and integrate via trade into the world economy (Chapter II), they draw in goods from other countries thus contributing to growth elsewhere. This is a facet of China's growth that has been underemphasized. They also sell cheap goods, thus enhancing the purchasing power of consumers the world over. But, of course, these emerging economies also compete with established producers both in the developed and the developing world. With technology helping some services overcome the barriers of distance and political boundaries, such competition is reaching areas that have never faced competition before. The wrong political response to cries for help is to erect protectionist barriers—that will only take the world into the darkness of an eye for an eye. The right response for the far-sighted politician is to create resilience.

One source of resilience is the ability to use policy. The United States could respond to the events of September 11 so effectively with expansionary policies because it had a fundamentally sound fiscal house and because it had room for monetary expansion. Unfortunately, those policy bullets are now largely spent. The best way to insure against future shocks is to restore the ability to use policy. On the fiscal side, this means a more rapid fiscal consolidation than currently envisaged. Not only will it be good for the United States as a form of insurance, as Chapter II indicates, it will also be good for long-run growth and make the United States better prepared to meet the unavoidable long-run fiscal costs of the aging population. It will also help growth in other countries of the world as the United States absorbs less of world savings.

Another way to enhance resilience is to increase the underlying flexibility of economic agents. This means enhancing the ability of firms to be created at low cost, which entails reducing bureaucratic entry barriers as well as increasing access to finance. It also means reducing the cost to exit, by improving bankruptcy law and removing the state protection of favored firms. It means increasing labor market flexibility, which requires enhancing the ability of firms to hire and retain only the workers they want. It also means improving the skill levels of workers so they can find new jobs if the old ones don't work out, and making their health insurance portable so they are not locked in to bad jobs.

These kinds of structural reforms, as Chapter III indicates, are most easily done in times like the present. The prospect of likely economic growth makes the expected costs of potential dislocation

resulting from reforms smaller, while the recent stagnation makes the need for reform more salient. Reforms are also easier if the pot can be sweetened somehow—for instance, if citizens get some tax breaks as they are asked to bear greater uncertainties. All this may seem like common sense, but organized common sense (with a touch of general equilibrium) is what good political economy is about.

Of course, good times bring added risk: recall the old saw that the roots of every bust lie in the boom that preceded it. Chapter IV examines the characteristics of credit booms, defined as periods of abnormal increase in credit. Not all periods of high credit growth lead to credit booms—high credit growth can be “normal” in an economy with a high trend growth. But the ones that do invariably end up in financial crises, with a substantial fall in output. This suggests that an important source of resilience for an economy is to build strength in the banking sector, not just by infusing capital, but also by creating the right incentives for bankers and supervisors.

There is therefore much work for policymakers. Of course, in putting together the *World Economic Outlook*, we have the luxury of being able to offer advice without having to carry it out. Nevertheless, as Chapter III indicates, we are doing more analysis on the practical difficulties of implementing policy. I hope you learn as much from reading this Outlook as we did in putting it together.

Raghuram Rajan
Economic Counsellor and Director, Research Department