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ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during January 31–February 28, 2005, except for the currencies participating in the European exchange rate mechanism II (ERM II), 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 $46.50 a barrel in 2005 and $43.75 a barrel in 2006, 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 3.3 percent in 2005 and 4.1 percent in 2006; that the three-month euro deposit rate will average 2.3 percent in 2005 and 2.9 percent in 2006; and that the six-month Japanese yen deposit rate will yield an average of 0.1 percent in 2005 and of 0.4 percent in 2006. 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 end-March 2005.

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, 2003–2004 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2003/04) to indicate a fiscal or financial year.

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

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

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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 Tim Callen, Division Chief, Research Department.

Primary contributors to this report also include Nicoletta Batini, Roberto Cardarelli, Dalia Hakura, Thomas Helbling, Subir Lall, Sam Ouliaris, Martin Sommer, S. Hossein Samiei, Nikola Spatafora, and Marco Terrones. Paul Atang, Angela Cabugao, Nathalie Carcenac, Stephanie Denis, Toh Kuan, Yutong Li, and Paul Nicholson provided research assistance. Mahnaz Hemmati, Laurent Meister, Casper Meyer, and Ercument Tulun managed the database and the computer systems. Sylvia Brescia, Celia Burns, and Seetha Milton were responsible for word processing. Other contributors include Reena Aggarwal, Maud Bökkerink, Michael Bordo, Hamid Davoodi, Aasim Husain, Dermot Gately, Jean-Jacques Hallaert, Panagiotis T. Konstantinou, Ayhan Kose, Philip Lane, Douglas Laxton, Chee Sung Lee, Gian Maria Milesi-Ferretti, Prachi Mishra, Dirk Muir, Christopher Otrok, Jens Reinke, Andrea Richter Hume, Calvin Schnure, Irina Tytell, and Linda Tesar. 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 21 and 23, 2005. 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

The *World Economic Outlook* is a cooperative effort. The core staff members, who tirelessly put together the *World Economic Outlook,* are few, but by drawing on staff elsewhere they access the vast fount of knowledge embedded in the IMF. I thank David Robinson, Tim Callen, members of the World Economic Studies Division, and all the IMF staff from other divisions and departments who worked together to bring this *World Economic Outlook* to you.

The world economy enjoyed one of its strongest years of growth last year. The robust growth is expected to continue this year, albeit at a more moderate pace. One of the most heartening aspects of the growth has been the performance of the poorest countries, including those in sub-Saharan Africa.

As encouraging as the higher growth rate is the finding in the first essay of Chapter II that the volatility of economic growth has decreased in most developing countries over the past three decades. The fact that volatility remains higher than in industrial countries, however, suggests that there is still room for improvement. The essay finds that output volatility in developing countries is driven by country-specific factors rather than regional or global factors—particularly in sub-Saharan African countries. Greater expenditure restraint during cyclical upturns, more developed financial sectors, and structural reforms that diversify the production base will reduce volatility further and enhance growth performance.

One recent development that serves to dampen volatility in developing countries is the growth in remittances described in the second essay in Chapter II. For many countries, remittances have been a large and growing source of foreign exchange that has proven to be more stable and less procyclical than other external sources of finance. Remittances can also aid macroeconomic stability, mitigate adverse shocks, and reduce poverty. Given these benefits, the essay emphasizes the need to encourage additional remittances, for example by reducing the cost of sending remittances as well as impediments to their flow. Any regulation prompted by concerns about the risk of terrorism or money laundering will have to be carefully thought out, so that these flows can be better monitored without causing them to dry up or go further underground.

Let me turn now to a more worrying aspect of global growth—the continuing divergent patterns of growth. Both the euro area and Japan are growing more slowly than the other major regions of the world. This has not helped global current account imbalances, which are continuing to widen.

The current account imbalances probably have their roots in two investment booms and busts. In east Asia, excessive investment growth in the early 1990s collapsed after the Asian crisis in 1997–98. Savings, on the other hand, did not, leaving east Asian economies with an excess of savings over investment—a current account surplus, which had to be invested elsewhere. In the United States, the last years of the twentieth century were ones of rapid productivity growth and increasing investment. Capital was drawn in from abroad, bidding up asset prices in both the stock market and housing market. U.S. households, feeling wealthier, reduced savings further, continuing a decade-long trend of falling household savings. Thus the counterpart of Asian current account surpluses was increased U.S. investment and lower savings—a U.S. current account deficit.

The bursting of the IT bubble led to a significant fall in U.S. investment. Ordinarily, this should have led to a narrowing of the U.S. current account deficit. It did not because the United States adopted expansionary fiscal policies, in part to stimulate the economy. Moreover, the Federal Reserve also followed extremely accommodative monetary policies, so that even though the stock market lay moribund, housing prices (and real estate investment) continued increasing. With public savings falling steeply and household savings continuing their decline, the fall in investment was met by an even greater fall in savings, and the U.S. current account widened steadily.

What about other areas of the world? Partly as a response to the investment excesses during Japan's bubble years in the late 1980s, and partly because Japan was in transition to a slower-growth aging economy, investment fell significantly in Japan over the 1990s. Savings also fell in tandem (in no small measure as a result of public dissaving as efforts to stimulate the economy continued). Thus Japan's current account surplus stayed fairly constant as a share of GDP despite the fall in investment. In China, the infrastructure needs of an economy experiencing explosive growth prompted immense investment, especially in the past few years. However, both the demographic transition and the transition from an uncompetitive protected socialist economy to a competitive market economy with few safety nets have given citizens the incentive to save more, so savings have more than kept pace. Thus, China's current account surplus remained fairly constant until recently, though with the recent slowdown in investment, it has started increasing considerably. Finally, large euro area countries like France and Germany also experienced a slowdown in investment after the IT crash. But the differing response of savings (falling in France; rising in Germany partly because housing prices have not been buoyant, partly because labor market reforms and pension reforms may have increased anxieties and thus the propensity to save) account for why Germany's current account surplus has grown substantially while France's has not.

The net effect of the worldwide fall in investment (e.g., in China) and the different response of savings has been large and growing current account deficits in the United States, and large surpluses in emerging Asia and Japan, as well as in individual countries in the euro area. Recently, surpluses have also emerged in the Commonwealth of Independent States and the Middle East on the backs of rising commodities prices.

As Chapter III in this *World Economic Outlook* suggests, the expansion of cross-border financial flows have allowed real imbalances like the ones I have just described to be financed more easily. Yet it is hard to think that this situation where young, relatively poor countries of the world save more than they invest while the rich aging countries of the world do not is a long-run sustainable equilibrium. At this stage of world demographic evolution, as Chapter III in the last *World Economic Outlook* suggested, the reverse flow seems more appropriate. Apart from the small but costly risk of an abrupt unwinding of the large and growing current account imbalances, the inconsistency of current account imbalances with plausible long-run equilibria makes it necessary to shrink the imbalances.

Before describing policies, let me turn to another concern. I started this introduction noting the strong growth in the global economy. Clearly, strong growth always carries with it the risk of hitting supply constraints. Rising spot oil prices and futures prices have put us on notice. Chapter IV of the *World Economic Outlook* indeed notes that the oil market will remain vulnerable to shocks in the medium run, given that supply and demand will remain roughly in balance, allowing limited prospects for building spare capacity. Particularly noteworthy is that transport demand is likely to take off in a number of emerging markets including China, where per capita income is reaching the level where car demand explodes. Higher oil prices, and the greater likelihood they will persist, now suggest the risks to the WEO growth projections should be weighted to the downside.

Both the large current account imbalances and the limited spare capacity in oil are risks that are typically in the background, but come to the forefront every so often with foreign exchange or oil price movements. Even though exchange or price volatility grabs the attention of politicians for a while, the policies needed to tackle the underlying problems require not just expenditure of political capital, but also sustained political effort over a much longer period. Clearly, the danger is that the consequences have to become far more obvious and painful before the necessary will is found to act.

What policies are necessary? Start with current account imbalances. In the United States, corporate investment is recovering as the excesses of the past are worked off, so it is imperative that savings increase. A credible program for medium-term fiscal consolidation is of the essence. The worldwide increase in real long-term interest rates as investment increases and as the extremely lax monetary conditions—which seem to be holding down long-term rates—tighten will also help. Not only will higher rates directly increase incentives to save, but they may also slow the growth rate of asset prices such as those of housing, leading to greater indirect incentives to save. Since these effects are likely to be larger in the United States, they will help narrow imbalances.

In emerging markets (apart from China), by contrast, the onus will be on increasing both the quantity and quality of investment. Key to this will have to be improvements in the investment climate, coupled with financial sector reform that allows resources to be allocated better. And in countries like Germany and Japan, structural reforms to labor, product, and financial markets can increase the efficiency of investment and growth potential. As the growth rate of these countries increases, their domestic demand can help make up for the necessary slowing in the growth of domestic demand in the United States, as they did so effectively the last time the U.S. current account deficit narrowed, in the late 1980s.

Exchange rates will play their part in guiding adjustment. Thus far, however, the depreciation of the dollar since end-2001 has had little effect on the current account imbalances. In part, this may be because a variety of changes documented in Chapter III have made trade less responsive to changes in exchange rates. Another explanation is that much of the depreciation of the dollar has taken place against economies that have been cyclically weak. In particular, depreciation against the fast-growing economies of emerging Asia has been limited. Since the reserve buildup by some of these economies is creating difficulties in monetary management, and since the distortions needed to maintain relatively fixed exchange rates in the face of appreciation pressures are coming in the way of financial sector development, the benefits of fixity are rapidly waning and the costs mounting. More exchange flexibility will be in everyone's interest.

One cannot ignore the fact that a number of emerging markets started building reserves to buffer themselves against the shocks emanating from international financial markets. While financial sector development will make their economies more resilient to shocks, we also need to ask whether international financial arrangements to borrow offer adequate comfort to emerging economies. A common pool of reserves is less costly than individual buffers, so part of the reform agenda has to be to find ways to enhance confidence in existing common pools like the International Monetary Fund.

On the oil front, Chapter IV offers a number of policy prescriptions that might help reduce volatility in oil markets. These include measures to make the oil market work better, reduce obstacles to investment, increase buffers, and improve conservation. As with the current account imbalances, multilateral cooperation can be very helpful in furthering some of these measures.

Despite the near certainty of rising interest rates, and the possibility of significantly higher oil prices, world economic conditions are still favorable. This is an ideal time to undertake the reforms that are needed to bolster medium-term prospects. As I have argued, there seems little sense of urgency in political circles, in part because the consequences of the imbalances have not been painful as yet, and in part because many of the reforms will bear fruit only in the medium term, while in the short term some of them may be painful. Politics is about the short term, however, so the timing of pain and gain in such reforms is exactly the opposite to that typically preferred by politicians. Every once in a while, however, true leaders emerge who rise above ordinary politics and focus beyond the here and now. It is on them that we must rest our hopes for reform.

Raghuram Rajan
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