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Growth and Institutions

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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 February 7–March 7, 2003, 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 $31.00 a barrel in 2003 and $25.00 a barrel in 2004, 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 1.7 percent in 2003 and 3.5 percent in 2004; that the three-month interbank deposit rate for the euro will average 2.4 percent in 2003 and 2.5 percent in 2004; and that the three-month certificate of deposit rate in Japan will average 0.1 percent in 2003 and 0.3 percent in 2004. 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 late March 2003.

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, 2001–2002 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2001/02) 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:

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, developments in international financial markets, and 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, International Capital Markets Department, Monetary Affairs Department, and Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Kenneth Rogoff, Economic Counsellor and Director of Research. The project has been directed by David Robinson, Deputy Director of the Research Department, together with Jonathan D. Ostry, Assistant Director, Research Department.

Primary contributors to this report also include Tim Callen, Luis Catão, Xavier Debrun, Hali Edison, Thomas Helbling, Maitland MacFarlan, James Morsink, Nicola Spatafora, Marco Terrones, and Cathy Wright. Nathalie Carcenac, Emily Conover, Toh Kuan, and Bennett Sutton provided research assistance. Nicholas Dopuch, Mandy Hemmati, Yutong Li, Casper Meyer, and Di Rao managed the database and the computer systems. Sylvia Brescia, Dawn Heaney, and Laura Leon were responsible for word processing. Other contributors include Anupam Basu, Tamim Bayoumi, Michael Bordo, Ximena Cheetham, Ivan Guerra, Benjamin Hunt, Aasim Husain, Iryna Ivaschenko, Laura Kodres, Manmohan Kumar, Timothy Lane, Douglas Laxton, Ross Levine, Paul Nicholson, Bright Okogu, Paolo Pesenti, Kevin Ross, Delphin Rwegasira, and Antonio Spilimbergo. Marina Primorac of the External Relations Department edited the manuscript and coordinated production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on March 17 and 19, 2003. 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

Structural reforms—a catch-all for fundamental institutional changes to improve an economy's performance—are widely acknowledged as the key to unlocking the full potential of the global economy. Examples of areas where further structural reforms are needed include scaling back remaining high tariffs in Latin America, liberalizing sclerotic labor markets in Europe, restructuring banking and corporate sectors in Japan and China, improving transparency of corporate governance in the United States, and taking steps to prepare for an aging population on much of the globe. Many countries acknowledge that structural reforms will enhance long-run growth, but at the same time legitimately point to the transition costs of implementing them. Perhaps for this reason, some observers greet calls for structural reforms with cynicism, opining that the political obstacles are too great, and that they will never happen. Perhaps such cynicism is justified when time is measured in weeks or months. However, over the broad sweep of history, one can see that the fundamental structure of the global economy is constantly evolving. For example, the shift from centrally planned to more market-driven systems dominated economic developments in many countries during the end of the twentieth century.

Economic analysis alone cannot resolve the question of whether the long-run gains are worth the transition costs for any particular reform in any particular country. But one can attempt to try to better quantify some of the long-run benefits, and thereby inform the debate. That is our aim with Chapters 3 and 4 in this issue of the *World Economic Outlook.*

Role of Institutions in Growth

Chapter 3 on growth and institutions builds on a recent resurgence of research interest on the role of institutional factors in explaining cross-country differences in economic performance. Economists have increasingly come to recognize that differences across countries in physical capital and in education levels can only go so far in explaining the vast differences observed in incomes across the world, ranging from $100 a year in parts of sub-Saharan Africa to over $40,000 a year in the richest industrialized countries. The chapter explores a variety of quantitative measures of institutional quality reflecting, for example, perceptions of the degree of corruption, political rights, public sector efficiency, regulatory burdens and the rule of law. Consistent with other recent work that also tries to control for "reverse causality" (it may also be the case that higher wealth levels promote better institutions), the chapter finds a strong positive correlation between institutional quality and per capita income. Moreover, the correlations seem strikingly robust. The reader is invited to look at Figures 3.1 and 3.2 of Chapter 3 on pages 95 and 97; indeed, the story of this chapter comes across very forcefully and succinctly in its figures. The chapter finds that if institutions in sub-Saharan Africa were to improve to levels in developing Asia, per capita income would rise by 80 percent from about $800 to $1,400 (a year). If, in turn, developing Asia's institutions rose to the average of the sample, per capita incomes there would roughly double to $2,500 a year. Beyond these striking one-time effects on a country's income levels, institutional reform can have a similar impact on future income growth rates: sub-Saharan Africa's per capita income growth could be almost 2 percent higher per year if its institutions rose to world average levels; the volatility of annual growth rates would correspondingly fall by more than 15 percent. Chapter 3 also offers a brief discussion of some general methods of how a country might go about reforming its institutions, and highlights some basic principles. For example, all successful market-based economies need institutions that protect property rights, maintain the rule of law, achieve

macroeconomic and regulatory stability, and promote social cohesion. But the chapter concludes that specific implementation, including the timing and order of reforms, is best evaluated on a case-by-case basis. Finally, the chapter explores some mechanisms whereby integration with the outside world can accelerate and strengthen the reform process. Important examples are European Union accession and World Trade Organization membership. Domestic commitment to and ownership of institutional reform are the most important keys to success, however.

Potential Quantitative Impact of Structural Reform on Unemployment in Europe

Chapter 4 also looks at institutional reform, but from the much narrower perspective of labor markets. A particular focus is placed on continental Europe, where generous unemployment compensation, centralized wage bargaining processes, strict employment protection (e.g., large firing costs), and high taxation of labor income all contribute to unemployment rates far exceeding those in the United States. (Countries that have significantly reformed their labor markets, such as Britain and the Netherlands, already have much lower unemployment rates than most of continental Europe.) The chapter finds that if European labor market competitiveness were to converge to the U.S. level, European unemployment rates would fall dramatically (overall, by over 3 percent in the euro area). Consumption and investment would rise by more than 5 percent over the medium term. If European product markets were similarly brought to U.S. levels of competitiveness, the gain in output in Europe would double to roughly 10 percent. These results were arrived at by two very distinct approaches that produced surprisingly similar results. The first approach was based on comprehensive data on international labor market institutions covering 20 OECD countries over four decades. Importantly, the data base includes many episodes that opponents of labor market reform often cite as evidence that reform is unnecessary, including the 1960s and 1970s, as well as examples from the Scandinavian countries. The second approach was based on the IMF's new "Global Economy Model" that is being developed to back up and ultimately replace the older framework now in use. The new model embodies the "New Open Economy Macroeconomics" approach that is increasingly coming to supplant the older Keynesian framework incorporated in most existing models, including the IMF's.[1] The analysis draws on parallel research being done simultaneously in other institutions such as the European Central Bank, the Bank of England, and the Board of Governors of the Federal Reserve System in the United States, as well as research cooperation across the staffs of these and other institutions. With the new Global Economy Model, it will be possible in principle to look not only at the long-term effects of labor market reform but also at the dynamics of the transition process. Trying to quantify transition costs is very important since, as we have already noted, concern over adjustment costs is an important obstacle to structural reform in many countries.

Conjunctural Studies: Corporate Leverage Positions and Lingering Effects of the Bursting of the Asset Bubble

Last but not least, Chapter 2 contains two essays that address crucial conjunctural issues. First, during the boom of the 1990s, as during most boom periods, there was a considerable buildup of corporate debt in both the United States and Europe; Japan, of course, is a different story. To what extent is it now the case that corporations have successfully "deleveraged," that is, rebuilt their balance sheets? Rather than just look at aggregate economy-wide measures, the study looks at historical evidence across

[1]See Obstfeld and Rogoff (1995, 1996) and the surveys by Lane (2001) and Engel (2002).

detailed microeconomic firm-level data in order to better quantify the effects across firms and identify problems across industries. The study also asks to what extent high debt buildups might still today be inhibiting investment. The study shows that, historically, high corporate leverage has had a strong and unambiguous negative effect on investment. Though the data for the study end in 2001 and very recent data are not available, the staff's assessment is that corporate leverage remains a problem in many regions. Of course, with interest rates now being at historical lows, the interest burden associated with the high leverage is much less, allowing firms to retain higher "after-interest" cash flows. However, although cash positions have strengthened, the gain does not appear to have been nearly enough to fully restore firm balance sheets; this is not to mention the further problems many firms are experiencing from the need to inject cash into pension schemes that have become seriously underfunded owing to the past year's world-wide stock market declines. Thus, the bottom line of the study is that corporate leverage remains high in some regions and is likely to weigh on any recovery in investment, with the effect being even stronger in Europe than in the United States. Indeed, as a result of the increase in leverage since 1999, investment spending in the euro area in 2001 is estimated to have been 1.3 percent of GDP lower than it would have been otherwise, with a smaller effect in the United States. These results would be magnified if extended through 2002, given the further drop in equity prices and its impact on leverage ratios.

A second critical element hanging over the global economy is the aftermath of the asset price bubble of the 1990s. The other essay in Chapter 2 analyzes the extent to which the bubble's aftermath has worked its way through the system, so that headwinds stalling the recovery can be expected to diminish over time. The good news is that the equity price decline experienced thus far is not atypical of the "busts" that have followed other equity price "booms." The bad news is that price increases for housing in some industrial countries have clearly reached a threshold that can be described as a housing "boom" and 40 percent of all housing booms are followed by busts, with housing price drops that typically average 25–30 percent. The cumulative output losses that follow housing busts can be quite dramatic, with lost GDP averaging 8 percent, though spread out over two to three years.

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Kenneth Rogoff
Economic Counsellor and Director, Research Department