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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 July 1–28, 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 $28.50 a barrel in 2003 and $25.50 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 1.3 percent in 2003 and 2.0 percent in 2004; that the three-month interbank deposit rate for the euro will average 2.2 percent in 2003 and 2.4 percent in 2004; and that the three-month certificate of deposit rate in Japan will average 0.1 percent in 2003 and 0.2 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 August 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, 2002–03 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 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, 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, 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 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 Celine Allard, Tim Callen, James Daniel, Xavier Debrun, Hali Edison, Dalia Hakura, Thomas Helbling, Maitland MacFarlan, Enrique Mendoza, James Morsink, Nicola Spatafora, Marco Terrones, and Cathy Wright. Paul Atang, Nathalie Carcenac, Emily Conover, Carolina Gutiérrez, Toh Kuan, 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 Tamim Bayoumi, Nicolas Blancher, Eduardo Borensztein, Barry Bosworth, Chakriya Bowman, Ximena Cheetham, Susan Collins, Ugo Fasano, Ivan Guerra, Aasim Husain, Zubair Iqbal, George Kopits, Paolo Mauro, Christian Mulder, Susanna Mursula, Paul Nicholson, Bright Okogu, Carlos Piñerúa, Alessandro Rebucci, and Ratna Sahay. 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 August 25 and 27, 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

Although relatively good data are now available on external debt levels for emerging market countries, consistent cross-country data on domestic debt are not so easily obtained. Until 15–20 years ago, this data deficiency was not a big issue, since very few emerging market countries were able to market domestic debt in any significant amounts anyway. The wave of financial liberalizations of the past 15 years has led to a sea change in this situation, however, as Chapter III in this issue of the *World Economic Outlook* illustrates. Emerging market country governments, having widely relaxed financial repression, are now issuing domestic debt at market interest rates in record quantities. Indeed, as the chapter documents, average public debt levels in emerging markets are equal to or exceeding those of many industrialized countries, as a percentage of GDP. Is this a concern? Well, given that the revenue base of the average emerging market country government is much smaller than that of the average industrialized country government, and given that most of the debt crises of the past 10 years have involved domestic debt (albeit sometimes dollar-denominated), the issue certainly merits attention.

The basic finding of Chapter III is that despite current near record-low risk spreads on emerging market debt—the present environment is extraordinarily benign thanks in part to still-low industrialized country interest rates—many countries need to be alert to the possibility that financing problems may arise over the medium term. The chapter looks at sustainability from a number of perspectives, though of course there is no magic cutoff number above which debt becomes unsustainable. Nevertheless, the historical evidence strongly suggests that there will be widespread problems if, over time, emerging market countries do not take measures to rein in expenditures and increase revenues, especially if debt levels continue to rise. Simply put, the current benign financing environment provides a window of opportunity in which countries with particularly acute debt problems need to begin steering debt ratios to safer ground, ideally taking quality measures such as strengthening the tax base and reducing unproductive expenditures. Dealing with long-term pension sustainability, a problem that is of course hardly unique to developing countries, is also critical. (By the way, the *World Economic Outlook* has looked extensively at industrialized country debt issues in the recent past, and we will surely revisit this issue again.)

Despite the increase in public debt, some developing countries are experiencing a rise in external assets. Indeed, many economies, especially in Asia, have been building massive claims on industrial economy governments in the form of foreign exchange reserves. Overall, in the wake of the Asian crisis of the late 1990s, this has to be seen as a welcome development. A comfortable level of reserves gives emerging market economies some measure of padding to deal with shocks and other financial problems that inevitably occur. A question that is increasingly coming to the fore, however, is whether this accumulation of reserves is starting to go too far, especially given the gaping imbalances in global current accounts that we have been warning about in these pages for some time now. So we decided to try to investigate the issue econometrically, to see if one can quantitatively rationalize the recent rise in reserves in terms of any standard explanations. The short answer—given in the second essay of Chapter II, "Are Foreign Exchange Reserves in Asia Too High?"—is that, allowing for some countries' desire to maintain relatively fixed exchange rates, the accumulation until the end of 2001 could be regarded as explainable, or in line with fundamentals. The further run-up in reserves over the past 18 months, however, is much harder to rationalize. Clearly, some element of the reserve increase (which, as the essay shows, is now heavily concentrated in Asia) can be attributed to the same factors that are keeping emerging market debt spreads so narrow. Industrialized country interest rates touched 40- and 50-year lows in 2003, inducing investors to seek higher returns elsewhere. The depreciation of the dollar has also been a factor, as many Asian currencies are linked to the dollar. Going forward, the question is at what point the reserve accumulation should slow or even reverse. From a multilateral perspective, there is a strong case for broadly sharing the burden of adjustment to the inevitable closing of the U.S. current account deficit, and some re-equilibration of real exchange rates has to be part of any solution. However, our analysis suggests that many Asian countries should seriously consider allowing greater exchange rate flexibility even from a domestic perspective, not least because of the high cost of continuing to pile up low-yielding claims on industrialized country governments.

Another reason to adopt a somewhat more flexible exchange rate is to be able to better absorb fluctuations in the exchange rates of the G-3 currencies. The third essay in Chapter II, "How Concerned Should Developing Countries Be About G-3 Volatility?" looks at the impact of G-3 exchange rate volatility on emerging markets and finds that, on the whole, it is less dramatic than one might have expected. However, for countries with relatively fixed exchange rate systems, especially if fixed to a single currency, G-3 exchange rate volatility can be quite problematic. Even a relatively small amount of exchange rate flexibility can be quite helpful.

Finally, with the Bank-Fund annual meetings scheduled to be held in Dubai, it was natural for us to decide to include one essay specifically on the Middle East. The first essay in Chapter II is entitled "How Can Economic Growth in the Middle East and North Africa Region be Accelerated?" The essay, which builds on work on growth and institutions from the last World Economic Outlook, explores different reasons why per capita income growth in the Middle East and North Africa region has been so weak over the past 20 years. The most interesting finding of the chapter perhaps is the differences across the region. In those economies that derive a large share of their income from oil, the large size of the government sector has been the overriding problem, stifling private sector growth and making it hard to diversify production. In countries where oil revenue is significant but not dominant, poor institutions and corruption are the biggest single hindrance to growth. In many of the remaining countries, both issues—overly large governments and poor institutions—are problematic.

We realize that beneath the technical material in analytic Chapters II and III lie many controversial, difficult issues. We do not pretend to have any pat answers, much less of a one-size-fits-all variety. Nevertheless, in the IMF's role in surveillance of the global economy, we cannot afford to shrink away from problems simply because they are difficult. We cannot afford to avoid coming to any tentative conclusions simply because the issues are controversial. We have done our best in these pages to present the issues in the clearest terms using what we believe to be the best available research methods. Nevertheless, we welcome critical comment, and hope that these essays will stimulate others to continue investigating these issues, as they are fundamental and require continued discussion and debate.

Kenneth Rogoff
Economic Counsellor and Director, Research Department