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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 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 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 James Morsink, Division Chief, Research Department.

Primary contributors to this report also include Nicoletta Batini, Tito Boeri, Tim Callen, Xavier Debrun, Tarhan Feyzioğlu, 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 rosiest 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 to 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