ANNEX SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the World Economic Outlook on August 27, 2003.

Executive Directors were encouraged that recent economic data in some countries and forward-looking indicators, particularly in financial markets, point to a strengthening of global growth during the second half of 2003 and in 2004, up from the generally weak level of economic activity in the first half of this year. The prospects for a gradual—albeit moderate—recovery are underpinned by reduced geopolitical tensions, the projected decline in oil prices, and—for some countries—additional policy stimulus.

Directors observed that, among the major industrial countries, the recovery will likely be led by the United States, where recent data have generally been the strongest and where there is the most policy stimulus in the pipeline. They were also encouraged by the strength of second quarter GDP data for Japan, while noting that ongoing deflation, combined with banking and corporate sector weaknesses, continue to weigh on the outlook. With the subdued activity in the euro area, Directors expected the initial pace of recovery to be moderate, and largely dependent on developments in the rest of the world. Directors noted that growth among emerging markets has, on the whole, held up reasonably well, being supported—to varying degrees—by improvements in policy performance and external financing conditions, lower oil prices, increases in non-oil commodity prices, and the apparently short-lived impact of the SARS outbreak.

Directors considered that the balance of risks to the world economic outlook has improved in recent months, and the potential for upside shocks is beginning to offset the downside risks, albeit not yet fully. On the upside, developments in financial markets may be suggestive of the prospect that activity may pick up more quickly than currently projected—particularly in the United States, where productivity growth remains robust and corporate balance sheet restructuring is most advanced. At the same time, Directors noted the significant risks that continue to weigh on the downside. One such risk is the possibility of a continuing drag on investment in the aftermath of the equity price bubble. In addition, many Directors saw the continued heavy dependence of global growth on the United States—and the associated large current account imbalances among the major regions—as heightening the risk of potentially disorderly currency movements and resurgent protectionist pressures. The continued strength of housing prices in some countries may also be at risk if interest rates continue to rise sharply. Directors also pointed to the substantial vulnerabilities still confronting key emerging market economies, and several Directors observed that geopolitical tensions—while reduced since April—remain a significant concern.

Looking ahead, in light of this still fragile global recovery, Directors called for macroeconomic policies to remain appropriately supportive, and for reinvigorated structural reform efforts to strengthen confidence and reduce vulnerabilities over the medium term. In particular, monetary policies in industrial countries should remain supportive for the time being, and—with inflationary pressures very moderate—Directors considered that most regions have scope for further monetary easing if recovery falters or inflation significantly undershoots policy objectives.

The recent orderly depreciation of the dollar was generally welcomed. Going forward, most Directors were of the view that the cooperative approach, which will continue to need to underpin the global adjustment process, would be helped by currency adjustments that are more broadly spread, with several emerging Asian economies being relatively well placed to handle greater upward exchange rate flexibility.

Directors agreed that fiscal policy will have much less room for maneuver. While automatic stabilizers should generally be allowed to operate, they stressed that greater priority needs to be given to credible, high quality fiscal consolidation, in order to address both the recent deterioration in the fiscal outlook in the largest economies and the impending pressures of population aging. Directors also called on industrial and emerging market economies to make sustained further progress in vigorously implementing ongoing structural reforms to strengthen economic growth, support domestic demand, and reduce vulnerabilities. Directors underscored the particular importance at this juncture of a successful outcome of the WTO Cancún Ministerial meeting in September in curbing protectionist pressures and achieving further trade liberalization, as this will help strengthen confidence in the economic recovery. Progress with agricultural reforms—especially among the largest industrial economies—will be critical for boosting the growth prospects for developing economies and making progress with further poverty reduction. In this context, Directors expressed strong support for the initiatives being taken by the Fund and the World Bank to strengthen their assistance in support of developing countries' efforts to liberalize their trade regimes.

Major Currency Areas

Turning to the United States, Directors concurred that growth prospects appear to be firming, with generally encouraging trends in recent economic data and stronger forward-looking indicators. The substantial monetary and fiscal stimulus now in place, combined with the weaker dollar, will add support to this recovery, which, in the view of some Directors, could even be stronger than currently projected. At the same time, however, many Directors considered that the downdrafts to household and business spending implied by the still-stretched balance sheets, the substantial excess capacity, the continued labor market weakness, and the risk of a fall in housing prices, as well as the vulnerabilities arising from the large current account and fiscal deficits, call for continued caution in assessing the strength and durability of the U.S. recovery. Directors agreed that U.S. monetary policy should remain accommodative for the time being, with further easing not ruled out should activity falter or deflationary pressures rise. Directors acknowledged the important role U.S. fiscal policy has played in supporting activity during the current slowdown. However, most Directors emphasized the need to put in place a credible fiscal framework that would correct the recent significant deterioration in the medium-term fiscal outlook and support a gradual correction in global imbalances. They agreed with the view that the fiscal framework should aim at restoring fiscal balance (excluding social security) over the cycle, while putting the Social Security and Medicare systems on a sounder footing to help meet the impending costs of aging populations.

Notwithstanding the tentative signs of improvement in the outlook for the euro area, Directors observed that short-term prospects for the area remain generally subdued. Among the reasons for the persistent weakness of domestic demand, Directors highlighted the continued over-leveraging of corporate balance sheets and the impact of rising unemployment on consumer confidence and spending. Some Directors cautioned that the euro's recent appreciation might constrain the pace of recovery. Looking ahead, Directors expected the area's prospects to strengthen gradually, supported by a pickup in external demand, the winding down of corporate balance sheet adjustments, and continued low interest rates. They welcomed the ECB's

interest rate cut in June, and saw scope for further easing if a sluggish recovery or further appreciation of the euro lead to an undershooting of inflation. Directors agreed that medium-term fiscal consolidation should remain a priority in the larger euro area economies. At the same time, many Directors acknowledged the challenge of striking an appropriate balance between short- and medium-term policy objectives. They agreed with the view that, where underpinned by tangible, credible, and high quality consolidation measures and structural reform efforts, a cumulative fiscal adjustment of 1½ percent of GDP over 2004–06—with the automatic stabilizers allowed to operate fully around this consolidation path—would strike such a balance. Some other Directors, however, cautioned against any departure from the commitment to achieve a steady underlying fiscal adjustment of ½ percent of GDP a year. Directors were encouraged by recent reforms in labor and product markets and pension arrangements. They emphasized that further efforts will be required to meet the Lisbon Summit targets, prepare for the economic and fiscal pressures of aging populations, and enhance Europe's contribution to balanced and sustained world growth.

Directors welcomed the pickup in economic activity in Japan since mid-2002. The outlook remains clouded, however, by entrenched deflation and weaknesses in the corporate, financial, and public sector balance sheets. While acknowledging progress in tackling the economic challenges facing Japan, Directors reiterated that a bold and broad-ranging strategy will remain key for laying a firm foundation for sustained medium-term growth. Priorities should include forceful measures to strengthen the banking sector—particularly through accelerated disposal of nonperforming loans and targeted use of public funds to recapitalize weak but systemically important banks—and rapid corporate restructuring—including through effective use of the new Industrial Revitalization Corporation. While welcoming the Bank of Japan's recent initiative to buy asset-backed securities, most Directors saw a need for a more aggressive monetary policy approach to tackle deflation effectively. This could include purchases of a wider array of assets, allowing monetary policy to work both through asset prices and through liquidity growth accompanied with a clear public communications strategy committing to end deflation in a limited time period. Many Directors were, however, concerned that extending such purchases to foreign currency assets might result in an unwarranted depreciation of the yen. To address the rapid buildup in public debt and impending pressures from population aging, Directors underscored the need for an ambitious and fully elaborated medium-term strategy to restore Japan's public finances to a sustainable basis.

Emerging Markets

Directors noted that growth has remained relatively robust in most emerging market regions, with stronger macroeconomic policies and structural reforms, as well as the strengthening in the major industrial countries contributing to improved prospects in an increasing number of countries. Nevertheless, prospects and vulnerabilities still vary widely among the emerging market economies, and policy efforts backed by measures to strengthen underlying institutions and reduce financial vulnerabilities need to be more widely deployed.

Directors welcomed the emerging recovery in Latin America, which has been helped by stronger global growth, substantial real exchange rate depreciations, and improved emerging bond market conditions. Directors were encouraged by the rebound in economic activity in Argentina, but stressed that sustained progress will require implementation of credible plans to restore solvency to the public finances and restructure the sovereign debt, strengthen the banking system and restructure the private corporate debt, and adequately protect the poor. In Brazil, steady policies have helped strengthen financial market confidence and reduce interest spreads, and the government's continued reform efforts and fiscal discipline will remain critical to underpin confidence and the recovery of domes-

tic demand. For the region as a whole, Directors underscored the continued need for macroeconomic and structural reforms to enhance countries' ability to withstand economic shocks. The reforms should include, first and foremost, further steps to reduce public debt to more manageable levels, as well as measures to strengthen banking systems and central bank autonomy to pursue low inflation. In addition, trade, labor market, and regulatory, judicial, and institutional reforms will need to be pursued to improve productivity, equity, and governance. Directors considered that the current favorable financial market conditions provide a welcome opportunity for national authorities in the region to press ahead with ambitious reforms that they should not fail to seize.

Directors welcomed the quick recovery of emerging Asia from the slowdown in the first half of 2003 stemming largely from the war in Iraq and from SARS, and commended the appropriate and timely policy actions taken by a number of countries. Although domestic demand has been increasingly supportive of activity in many countries in recent years, the global cycle remains the preponderant determinant of cyclical developments in the region. Directors felt therefore that policies that promote stronger domestically sourced growth will remain a priority for the region. They welcomed the staff's analysis of the accumulation of foreign reserves in emerging Asia, which should help better inform the debate about desirable policy choices for the region going forward. The analysis suggests that for emerging Asia as a whole, reserve accumulation until 2001 had appeared broadly consistent with fundamentals. Directors noted the further increases in reserves in 2002–03. They acknowledged that these increases need to be assessed in light of country-specific characteristics, including the benefits perceived by many countries in holding high levels of reserves as insurance against crises in the context of continuing vulnerability to external shocks and an unfinished reform agenda. Some Directors looked forward, in this context, to further analysis of the level of reserve adequacy in emerging market economies. Most Directors nevertheless supported the view that at this point some slowdown in the rate of accumulation of reserves in several countries in emerging Asia may be desirable, both from a domestic and a multilateral perspective. In these countries, allowing greater exchange rate flexibility would confer a number of benefits in support of ongoing reforms, by reducing risks of future crises, making domestic growth less dependent on the vagaries of the global cycle, and raising consumption opportunities for residents in cases where exchange rates may be undervalued. Several Directors acknowledged that the choice of exchange rate regimes and the timing of any changes in these are matters for national policy decisions.

Economic prospects for the countries in central and eastern Europe continue to be generally favorable, although growth will likely depend heavily on the pace of the euro area recovery. Directors agreed that early and substantial progress on fiscal consolidation will be essential in many countries, given already difficult fiscal positions and pressures arising from population aging and EU accession. Going forward, a key challenge facing EU accession countries will be to continue to make strong progress on the broad reform agenda to help ensure their successful EMU participation.

Growth in the CIS countries has been buoyed by robust consumption growth, and Directors agreed that prospects for the region remain generally favorable provided structural reforms are accelerated. Reform priorities should include measures to foster private sector development and strengthen financial regulation and supervision.

Directors observed that growth in the Middle East has picked up, largely on account of higher oil prices and production. The oil market outlook points, however, to potential risks to fiscal and growth prospects for the major oil exporters, while geopolitical tensions continue to affect the outlook for the region as a whole. Directors agreed that the key policy challenge facing the region will be to accelerate medium-

term growth and absorb the rapidly growing labor force. They generally welcomed the staff's analysis of the growth performance in the Middle East and North Africa (MENA) region over the last two decades for its insights on how best to meet this challenge. The analysis suggests that efforts to reduce the relatively large size of government consumption and to strengthen institutions could, in many countries in the region, significantly contribute to a pickup in economic activity. The importance of policies aimed at broadening labor market participation and of strengthening the role of the financial sector in supporting private sector investments was also highlighted.

Directors were encouraged that growth in Africa has remained remarkably resilient during the global downturn, reflecting improved macroeconomic policies, higher commodity prices, and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. Nevertheless, prospects for 2003 are likely to be dampened by adverse weather conditions and prevailing geopolitical uncertainties and civil unrest, although Directors acknowledged the progress being made with resolving conflicts in the region. Directors expressed concern that, on current projections, growth in Africa will remain far too low to meet the Millennium Development Goals. They saw the sustained implementation of the multifaceted strategy embedded in the New Partnership for Africa's Development (NEPAD) as key to strengthening the region's outlook. This should include policies aimed at reducing conflict and improving political governance; the promotion of competition, trade, and foreign investment, underpinned by measures to improve macroeconomic policy frameworks; and renewed efforts to develop the health care, education, infrastructure, and agriculture sectors. Directors underscored that the domestic reform efforts will need to be supported by additional external assistance, including higher aid flows, debt relief, and—most important of all—the opening of industrial country markets more fully to developing country exports.

Directors considered the staff's assessment and analysis of public debt in emerging market economies to be a timely contribution to ongoing efforts to identify key sources of vulnerability. The analysis notes that, after rising quite sharply in recent years, public debt in emerging market economies, at about 70 percent of GDP on average, now exceeds the average level in industrial countries. Directors recognized that the sustainable level of public debt varies among countries, depending on the characteristics of each country, and that generalizations based on debt thresholds should be avoided. Most Directors nevertheless shared the view that, for many emerging market economies, the level of debt that can prudently be held without giving rise to possible sustainability concerns is often quite low. Moreover, high public debt levels may adversely affect economic activity and constrain the flexibility to use fiscal policy as a policy tool. In highlighting some of the policy conclusions of the staff's analysis, Directors emphasized that strong and sustained fiscal and structural policy reforms—sometimes in combination with an initial debt restructuring—will be key to restoring public debt sustainability. These should include, in most cases, tax and expenditure reforms; steps to improve the credibility of fiscal policy; measures to limit fiscal risks—including from exchange rate and interest rate movements and contingent liabilities; improved debt management; and reforms to boost sustainable growth. Some Directors pointed to financial market inefficiencies that may help explain over-lending to governments accumulating rapidly rising public debts.

Directors also welcomed the staff analysis of the impact of industrial country exchange rate volatility on developing country economic performance. They generally endorsed the conclusion that the negative effects of this volatility on trade, capital inflows, and the likelihood of exchange rate crises in developing countries, appear on average to be quite limited. Nevertheless, the spillovers tend to be larger in countries where the currency is pegged to a specific industrial country currency, where external

debt is high, and where there is a substantial mismatch between the currency composition of debt and of trade. In many cases, more flexible exchange rate regimes and steps to reduce external debt—together with access to effective hedging instruments in currency markets—will therefore need to be part of efforts to reduce vulnerabilities.

Finally, Executive Directors placed on record their strong appreciation for Kenneth Rogoff's contributions to the IMF's multilateral surveillance over the past two years, both through the World Economic Outlook and through his stimulating presentations on World Economic and Market Developments, which were highlights of the Board agenda.