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September 2005

Building 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 July 8–August 5, 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 \$54.23 a barrel in 2005 and \$61.75 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 3.6 percent in 2005 and 4.5 percent in 2006; that the three-month euro deposits rate will average 2.1 percent in 2005 and 2.4 percent in 2006; and that the six-month Japanese yen deposit rate will yield an average of 0.1 percent in 2005 and of 0.2 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 early September 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, 2003–04 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 $\frac{1}{4}$ 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, Thomas Helbling, Kalpana Kochhar, Kenneth Kuttner, Subir Lall, Douglas Laxton, Gian Maria Milesi-Ferretti, Sam Ouliaris, S. Hossein Samiei, Martin Sommer, Nikola Spatafora, Marco Terrones, and Toh Kuan. Paul Atang, Nathalie Carcenac, Stephanie Denis, Angela Espiritu, Manuela Goretti, and Yutong Li provided research assistance. Laurent Meister, Mahnaz Hemmati, 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 Tamim Bayoumi, Arvind Subramanian, Robin Brooks, Ralph Bryant, Marcos Chamon, To-Nhu Dao, Marc de Fleurieu, Maria González, Simon Johnson, Alejandro Justiniano, Kornélia Krajnyák, Chris Lane, Andrei Levchenko, Davide Lombardo, Akito Matsumoto, Enrique Mendoza, Paul Nicholson, Christopher Otrok, Alessandro Prati, Catriona Purfield, Francesca Recanatini, James Robinson, Kenichi Ueda, and Susanna Mursula. 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 August 31 and September 2, 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. A few core staff members put it together, but in doing so they rely heavily on staff around 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 has proved tremendously resilient over the last few years. Disease, natural disasters, and soaring oil prices have only caused minor blips in an overall picture of healthy growth. Despite the ravages wrought by Hurricane Katrina on the U.S. Gulf Coast, and the spillover effects on the rest of the world, global growth forecasts for 2005 are unchanged since the April *World Economic Outlook*, while the growth projections for 2006 have been revised downward only slightly. This robust overall outlook, however, hides a number of serious imbalances. Let me start with a framework, overly simplistic no doubt, which draws on the findings in Chapter II to think about how we got here.

The current situation, I believe, has its roots primarily in a series of past crises, in particular, the emerging market crises in Asia and Latin America, the Japanese banking crisis in the 1990s, and the information technology boom and bust in a number of industrial countries around the turn of the millennium. Excessive investment was at the heart of all these crises, and the natural reaction was a sharp falloff in investment and only very cautious recovery since then. The policy response to this muted investment, and the outcomes, have differed across countries. In some industrial countries, notably the United States, accommodative fiscal and monetary policies have spurred credit-fueled consumption growth. By contrast, in a number of emerging markets, historically lax policy has become far less accommodative. Primary surpluses have emerged for the first time in some countries. Monetary policy has been tight. Most countries have brought down inflation, in some cases aided by adopting inflation targets (see Chapter IV—as an aside, countries need not develop the entire apparatus for inflation targeting in advance; what is important is they have the commitment to drive change after the launch).

With corporations in emerging markets cautious about investing and governments prudent about expenditure, growth has primarily been export led. The positive gap between savings and investment has led a number of emerging market countries to run current account surpluses for the first time.

We should celebrate the implicit policy coordination that has enabled us to weather these crises, which might otherwise have been much more serious. Industrial country governments used their greater monetary and fiscal room for maneuver to adopt the expansionary policies that helped emerging markets—whose governments needed to display austerity—grow their way out of difficulty.

Some see this state of affairs, with rich countries consuming more and being supplied and financed by emerging markets, as a new world order. I see it as a temporary and effective response to crises, which now needs to be reversed. The world economy thus needs to make two kinds of transitions. First, consumption has to give way smoothly to more investment, as past excess capacity is worked off and as policy accommodation in industrial countries is withdrawn. Second, the locus of domestic demand has to shift from countries running deficits to countries running surpluses so as to reduce the current account imbalances that have built up.

There are reasons to worry whether these transitions will take place smoothly. First, with spiraling asset prices fueled by global liquidity, goods prices kept quiescent by excess capacity and global trade, and interest rates held down by muted investment, domestic and external imbalances have been easily financed. Traditional signals such as inflation, interest rates, and exchange rates have not started

flashing. Instead, bottlenecks are developing elsewhere, as in oil supplies. It may well be that easy finance has given economies a longer leash, and traditional signals have become overly anchored. The concern then is that when they change, as change they must, they will do so abruptly, with attendant consequences to growth. Alternatively, other signals such as oil prices will step in to do the job.

Second, while domestic demand is picking up, far more is needed in emerging markets and oil producers. But a low-quality government-led, or finance-fueled, investment binge is not the answer—we have already experienced the consequences of those in the past. Instead, structural reforms to product, labor, and financial markets are needed, so that high-quality private sector investment can emerge. It is here that the good may have been the enemy of the perfect. Strong exports and decent government policies have led a number of countries to generate growth without the necessary deep-rooted reforms that would have created strong, sustainable domestic demand. These countries are overly dependent on demand elsewhere, which in turn is fueled by unsustainable processes. This worry about whether transitions will take place smoothly is what leads me to believe that, despite a central scenario of robust growth, the risks are weighted to the downside.

Clearly, for world growth to be sustained, domestic demand in countries running current account deficits (notably but not exclusively the United States), stimulated by policy accommodation and easy financing conditions, will have to be cooled at a measured pace. Domestic demand will have to be strengthened in surplus countries, not through unsustainable expansionary policies but through structural reforms. The precise actions vary from country to country (see Appendix 1.2) but, taken together, they can give financial markets the confidence that a resolution of the imbalances is in the cards, which will make markets willing to continue financing a smooth transition. A welcome by-product of shared responsibility is that it will help each country's policymakers guide the domestic debate away from the finger-pointing and the protectionist solutions that otherwise come naturally and which would be the surest way to precipitate the unhappy outcomes that we all seek to avoid.

Let me turn to the poorest countries. It is good that industrial countries are contemplating more, and better, financial assistance to poor countries. But it is important not to pin all our development hopes on one instrument: aid. If there is anything that more than 50 years of modern development economics has taught us, it is humility about how little we really know. In the 1960s, everyone would have picked India over South Korea as the likely growth star. In the period after the 1980s, few would have given Mauritius or Botswana a chance of attaining east Asian rates of growth.

Though no one has the "magic bullet" for growth, there are some things that do seem important. These include sensible macroeconomic management, with fiscal discipline, moderate inflation, and a reasonably competitive exchange rate; laws and structural policies that create an environment conducive to private sector activity with low transaction costs; and opening up the economy to international trade. In addition, an educated population that sees opportunities in growth and competition is undoubtedly an asset.

Chapter III offers additional reasons why some of these environmental factors may be important. While it has become commonplace to say that institutions are important for economic growth, the predominant view among economists has been that a country's institutions are largely predetermined by its historical past—for example, by the nature of its colonizers. Chapter III provides refreshing evidence that institutions do indeed change, sometimes quite rapidly. And these institutional transitions are associated with substantial increases in private sector investment and economic growth. For example, institutional transitions in Benin and Zambia were associated with an increase in growth rates of 4 percentage points or more. The chapter finds that institutional transitions are more likely to take place in countries that have high education, are located near other countries with good institutions, and are more open to trade. This means that, in addition to providing aid, the outside world should encourage policies that create these institution-friendly environments in poor countries. Rich countries can help,

for example, by reducing the impediments they place in the way of poor country exports and coaxing these countries to lower their own trade barriers.

From the perspective of both reducing global imbalances and fostering development, one much-needed area of collective action is the Doha Round. World Trade Organization members have not yet reached even so-called first approximations of an agreement. As a result, the preparation of the Hong Kong SAR Ministerial meeting in December becomes more difficult. Countries need to pay more than just lip service to liberal trading arrangements. In particular, large nations must take the lead in fulfilling their responsibilities to the world community by reaching a bold agreement to which the rest of the world can subscribe.

Raghuram Rajan

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