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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 19–August 16, 2002, 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 $24.40 a barrel in 2002 and $24.20 a barrel in 2003, 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 2.1 percent in 2002 and 3.2 percent in 2003; that the three-month certificate of deposit rate in Japan will average 0.1 percent in 2002 and 2003; and that the three-month interbank deposit rate for the euro will average 3.4 percent in 2002 and 3.8 percent in 2003. 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 2002.

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, 2000–2001 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2000/01) 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 Affairs Department, and the Fiscal Affairs Department.

The analysis in this report was coordinated in the Research Department under the general direction of Kenneth Rogoff, Economic Counsellor and Director of Research. The project was directed by David Robinson, Deputy Director of the Research Department, together with Tamim Bayoumi, Division Chief, World Economic Studies Division.

Primary contributors to this report also include Luis Catão, Xavier Debrun, Hali Edison, Thomas Helbling, Maitland MacFarlan, James Morsink, Silvia Sgherri, Marco Terrones, Stephen Tokarick, and Cathy Wright. Augusto Clavijo, Emily Conover, Toh Kuan, and Bennett Sutton provided research assistance. Nicholas Dopuch, Mandy Hemmati, Casper Meyer, Yutong Li, Di Rao, and Anthony G. Turner managed the data base and the computer systems. Sylvia Brescia, Viktória Kiss, and Laura Leon were responsible for word processing. Other contributors include Anupam Basu, Andrew Berg, Peter Breuer, Jean-Pierre Chauffour, Ximena Cheetham, Manmohan Kumar, Guy Meredith, David Parsley, Andrew Rose, Antonio Spilimbergo, Krishna Srinivasan, and Shang-Jin Wei. 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 September 3 and 4, 2002. 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 issue of the *World Economic Outlook* (WEO) contains two chapters on trade and its links with finance. Why so much emphasis on international trade in what is, after all, a quintessentially macroeconomic publication? A narrow explanation would be that forecasts of world trade have always been a central element of the WEO. Although these forecasts tend to attract somewhat less attention than our growth forecasts, they are absolutely fundamental to our picture of the global economy and its linkages—for example, global trade growth is a key variable we look at in assessing whether a global downturn should be judged a recession (see Box 1.1 in the April 2002 *World Economic Outlook*). But our real reasons for concentrating more on trade and its links with finance run much deeper. In our view, these linkages are inseparable, a fact that has recently come to the fore of thinking on international financial policy.[1] They are also timely issues, given renewed concern about the international debt problems facing some emerging markets that are relatively closed to trade,[2] the continuing multilateral negotiations on lowering tariff barriers under the Doha round (including the recent grant of "fast track" negotiating authority to President Bush), and heightened concerns that prolonged exchange rate misalignments may be exacerbating protectionist pressures in some major countries.

Much of the concern about exchange rate misalignments has focused on the U.S. current account deficit of about 4 percent of U.S. GDP. However, as one country's deficit is another country's surplus, it is best to look at this issue from a broader multilateral perspective. There is now a gap of some 2½ percent of *global* GDP between the current account surpluses of continental Europe and east Asia (dominated by the euro area and Japan, respectively) and the deficit countries, dominated by the United States. Indeed, relative to the size of trade flows, the present nexus of current account imbalances has risen to levels almost never seen in industrial countries in the postwar era. We do not view this as a problem specific to deficit countries, or to surplus countries; rather, it is a problem of the system as a whole. The first essay in Chapter II assesses the risks that these imbalances will unwind quickly, resulting in larger, and potentially disruptive, short-term exchange rate movements than if the imbalances unwind slowly. There is no easy prescription for mitigating these risks, though these concerns strengthen the case for policymakers in deficit countries to pursue medium-term fiscal consolidation, and for policymakers in surplus countries to press ahead rapidly with structural reforms to make their economies more flexible and to boost growth. Expanding global trade would also help, since the more open economies are to trade, the less exchange rate adjustment is required to achieve a given current account reversal.

Markets for basic agricultural commodities such as grain are often thought of as textbook examples of highly organized competitive markets in which prices respond rapidly to divergences between demand and supply. So it is something of a paradox that there are so many countries in which domestic agricultural markets are among the most heavily subsidized and protected. As the second essay in Chapter II notes, agricultural support by the industrial countries amounts to over 30 percent of agricultural output! Quantitatively, the largest burden of these subsidies falls on consumers and taxpayers in industrialized countries, but unfortunately the effects also fall heavily on the rest of the world, including many poor countries, most notably in sub-Saharan Africa. The essay documents these costs, which

[1] "Promoting Sustained Growth and International Financial Stability," address by Horst Köhler, IMF Managing Director, to the National Press Club, April 17, 2002.

[2] See also Chapter II of the April 2002 *World Economic Outlook*.

are particularly large for certain commodities such as cotton. It argues that industrial countries should be in the vanguard of multilateral efforts to get rid of farm subsidies given the large resources at their disposal and the small size of their farm sectors. In addition to the direct benefits, such an initiative would promote similar reforms in developing countries. This is of particular importance as the adverse effects of developing countries' own trade restrictions are significantly larger than the costs imposed by industrial country protection, not just on agriculture, but also on manufactures and services.[3]

The Asia crisis in 1997 and successive crises in Latin America have underlined the role of healthy corporate and bank balance sheets in maintaining financial stability. The third essay in Chapter II looks at trends in corporate health and financial vulnerabilities across 18 emerging markets, focusing particularly on differences between east Asian firms and their emerging European and Latin American counterparts. Two results from this study are particularly noteworthy. First, policies that promote openness to foreign investors have a positive effect in helping corporations reduce their leverage (debt to equity ratios) and to extend the maturity of their debts. This is not to deny the heightened risks of exchange rate mismatches, but, in terms of debt maturity and composition, openness helps rather than hurts. Second, leverage also seems to have much to do with the level of domestic financial development. In particular, corporations in countries at intermediate levels of financial development often have particularly high leverage ratios compared to countries with more primitive or more advanced financial systems, in part because their financial systems tend to be primarily based on bank lending and other debt instruments. The essay suggests that a higher level of economic development may help explain why east Asian firms still tend to have higher leverage ratios than their counterparts in emerging markets in Europe and Latin America, even after the Asian debt crisis of the 1990s. (Another likely factor is the increased ability of corporates to borrow in countries with more stable macroeconomic policy histories.) Past a certain point, however, as a country develops and its financial system matures, equity markets often become more important, leading to lower leverage ratios. If east Asian countries are indeed on the cusp where further level development begins to lead to lower leverage ratios, then this differential may abate in the coming decade.

Globalization is one of the major forces affecting the world. The relationship between its two main facets—trade integration and financial market integration—is the focus of Chapter III. Historically, international trade and finance have generally moved hand in hand. Empirically, the two are reinforcing each other, with greater financial integration tending to increase trade, and more trade requiring larger international financing. Indeed, the chapter finds that the benefits from opening up to the rest of the world are greatest in terms of reduced macroeconomic volatility and fewer financial crises when progress is made on opening to both trade and finance. Theoretically, there is also a fairly clear link. It is now well known that a fall in trade costs can significantly expand financial market integration measured by the level of risk sharing across countries. Indeed, one can potentially explain much of the differences in the level of capital market integration across countries by trade frictions broadly defined to include not only transport and tariffs, but also other factors such as differences in language and legal systems.[4]

While a steady fall in trade costs has certainly been the driving force for global integration throughout modern history, the roots of the change have differed somewhat over time. During the last great era of globalization, 1870–1914, integration was driven mainly by changes in technology. During the modern post–World War II era, however, policy has been at least as important. While financial and trade integration have generally moved in broad correspondence, there have been cases where policy-driven

[3]Jagdish Bhagwati, "The Poor's Best Hope," *The Economist*, June 22, 2002, pp. 24–26.

[4]See Maurice Obstfeld and Kenneth Rogoff, 2000, "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" *NBER Macroeconomics Annual 2000* (Cambridge, Massachusetts: MIT Press).

liberalization in financial markets has leaped ahead first, and where the supporting changes needed to achieve trade integration never materialized. This can lead to problems, including financial crises, as was discussed in Chapter II of the April 2002 *World Economic Outlook*, and as we discuss again here.

Given the importance of opening up to finance and trade, Chapter III also contains a detailed investigation of why some regions seem to trade so much more than others. Much of the analysis is based on the so-called "gravity model" of trade, which controls for factors such as country size, distance from trading partners, and policy restrictiveness. Overall, the results suggest that while trade policy restrictiveness is quite important in explaining the lower trading levels of developing countries compared with their industrialized brethren, other factors, such as the level of economic development and inherited geography, turn out to be even more important. Low income per capita is central to explaining the relatively low level of "South-South" trade; as consumers in poor countries use a relatively narrow range of products, such countries will naturally trade less with each other, even relative to income. Many countries also suffer from the problem of geographic isolation and, in some cases, being landlocked. Indeed, geography alone accounts for roughly 40 percent of the difference in trade levels across countries. Trade and balance of payments restrictions, on the other hand, appear to account for between 10 and 20 percent of the shortfall in bilateral trade flows. We can conclude from this that, over the next century, we are likely to see increased globalization not only due to continued improvements in the global transportation and communications system, and active policy measures to reduce trade restrictions, but also simply due to further economic development. Globalization is not only a source of growth; it is a natural outcome of it.

Kenneth Rogoff
Economic Counsellor and Director, Research Department