ANNEX SUMMING UP BY THE CHAIRMAN

The following remarks by the Chairman were made at the conclusion of the Executive Board's discussion of the World Economic Outlook. They were made on March 19, 2003.

Executive Directors noted that the pace of the global recovery has slowed since late 2002, amid rising geopolitical uncertainties and the continued adverse effects of the fallout from the bursting of the equity market bubble. Industrial production has stagnated in the major advanced countries; world trade growth has slowed; labor market conditions have remained soft; the recovery of global fixed investment is tentative; and forward-looking indicators have generally weakened. Against this backdrop, global equity markets have weakened, and government bond yields in industrial countries have declined. At the same time, bond spreads for some emerging markets have narrowed—partly reflecting clearer signals about future macroeconomic policies in these countries—and substantial tiering has emerged.

Directors had a wide-ranging discussion on global economic prospects against the background of the pronounced geopolitical uncertainties and rapidly changing conditions. They noted that the global economy has been resilient so far and that in many industrial countries the fundamentals remain sound. On the assumption that current geopolitical uncertainties are resolved quickly, Directors agreed with the view that the global recovery should gradually reassert itself, achieving global GDP growth of just over 3 percent in 2003 under the baseline scenario. Such an outcome would be supported by a pickup in confidence, the ebbing of the headwinds to growth from the bursting of the equity bubble, the policy stimulus in the pipeline, and the inventory cycle. In addition, with corporations in both the United States and Europe having relatively high cash balances, it is possible that investment could respond relatively quickly. Nonetheless, Directors acknowledged that the considerable uncertainties and risks give cause for concern for the economic outlook, given the fragility of the global recovery and the likelihood that the resiliency of the world economy to shocks may now be weakening. Developments in the oil market will need to be monitored closely.

Directors recognized that the economic impact of conflict can be significant, although it is very difficult to quantify. Most Directors felt that a relatively rapid resolution of the conflict might do only limited damage to growth prospects—although it was acknowledged that there could still be lasting effects on some countries—while a prolonged and destructive conflict could have a severely adverse impact on global activity. Directors considered that the balance of the other risks to the outlook is principally on the downside, and that sluggish growth could persist even in the absence of a war. Three elements underpin this caution. First, the global recovery remains heavily dependent on the United States, and there is no obvious candidate to take up the slack if growth in the Unites States falters. A disorderly adjustment in response to global imbalances—involving a sharp depreciation of the U.S. dollar—remains a risk. Second, the possibility of further declines in mature equity markets cannot be ruled out, as earnings expectations remain relatively optimistic, and an adjustment in housing prices in some industrial countries is also possible. Third, despite recent progress, a number of emerging markets remain vulnerable to a deterioration in the global environment. Notwithstanding these downside risks, Directors regarded sustained global deflation as being unlikely, although they did not rule out price declines in individual countries.

With inflationary pressures in general quite moderate, Directors agreed that monetary policies in major industrial countries will need to remain accommodative. With regard to fiscal policies, the situation differs between countries. In the short run, Directors acknowledged that the scope for fiscal tightening is constrained by the current cyclical situation. Most Directors agreed that automatic fiscal stabilizers should generally be allowed to operate, although it is clear that fiscal consolidation will remain a central medium-term priority in many industrial countries with high public debt levels and mounting pressures from aging populations. Directors also urged an acceleration of structural reforms to boost confidence and domestic demand growth—particularly in Europe and Japan—in order to reduce global dependence on the U.S. and foster an orderly reduction in global imbalances.

Directors underscored that policymakers will need to remain vigilant to changing circumstances, and be flexible and ready to adapt to them as events unfold. Close international cooperation and dialogue and concerted efforts will be required to confront global uncertainties and boost global confidence. Directors considered that a strong push to advance multilateral trade negotiations under the Doha Round should be a key ingredient of such efforts. In addition, the international community, including the IMF, should stand ready to proactively advise and support member countries adversely affected by the economic implications of a conflict scenario, using all instruments available to it.

Major Currency Areas

Turning to the prospects for the major currency areas, Directors expected the United States to continue to lead the global recovery. They observed that while some U.S. economic fundamentals—notably productivity performance—have remained strong, recent U.S. economic data have been disappointing, reflecting weakening consumer confidence and spending. Several factors appear to be contributing to downside risks to the U.S. outlook. These include the possibility of war in Iraq, uncertainties about whether the bubble-period excesses have been fully worked out, and the emergence of fiscal deficits alongside the large current account deficit. Directors observed that the current stance of monetary policy is broadly appropriate, but further easing may be necessary if downside risks to growth materialize, although several noted that the scope for doing so is becoming increasingly limited. On fiscal policy, Directors viewed the U.S. Administration's recent tax proposals as having some merit from a structural perspective. Directors nonetheless generally felt that these proposals, if implemented, would significantly worsen the medium-term fiscal position, and may well be pro-cyclical if the economy picks up as expected under the baseline scenario. They underlined the importance of restoring investor confidence to underpin the recovery, and called for strict enforcement of enhanced corporate governance rules.

While the euro area is not experiencing serious imbalances and its fundamentals remain generally strong, Directors viewed recent developments in the area with concern. Growth has continued to disappoint, and forecasts for 2003 have been revised down sharply. The appreciation of the euro, balance sheet strains, and prospective fiscal tightening in a number of countries are all likely to weigh on the regional economy going forward. Within this overall picture, the situation in Germany—where the economy has stagnated and the financial sector has come under increasing strain—was viewed with particular concern by Directors.

The ECB's recent move to cut interest rates was welcomed, and many Directors saw scope for further monetary easing to reinvigorate growth. In the fiscal area, with budgetary positions in a number of countries in western Europe having become more difficult over the past year, Directors noted that the challenge in the near term will be to avoid adding unduly to economic headwinds through fiscal retrenchment, while strengthening the credibility of the Stability and Growth Pact (SGP). To achieve this, Directors believed that structural deficits would need to be reduced toward the medium-term norm of a fiscal position of close to balance or in surplus. Most Directors supported the full play of automatic stabilizers around the consolidation path, even if this were to result in deficits in 2003 above the 3 percent of GDP deficit limit. A few Directors, however, considered that an overshooting of the deficit limit in the present circumstances is not warranted, as it might undermine confidence in the fiscal framework without bringing significant short-term benefit to economic activity.

Directors called for a greater sense of urgency by European countries to address structural rigidities in product and labor markets. While a number of important steps have been taken, they noted that European unemployment rates generally remain high, and participation rates are much lower than in other advanced countries. Most Directors agreed with the view that labor market rigidities play an important role in explaining the persistent unemployment in a number of industrial countries. This is shown by the contrasting experiences of countries that have undertaken comprehensive reforms—and observed a steady decline in structural unemployment—and those that have made little progress—and seen further increases in unemployment rates. They called for comprehensive labor market reforms in the euro area which, particularly if complemented with product market reforms, would yield significant gains in the form of lower unemployment and higher output. In this connection, Directors welcomed proposals recently put forward by the German authorities to improve incentives to work and begin dismantling excessive job protection. If the detailed measures are bold and implemented in full, Directors considered that they would have a favorable effect on business confidence and job creation.

Directors noted that the economic situation in Japan remains difficult. While the economy experienced a modest cyclical recovery during 2002, growth is expected to remain subdued in 2003. Moreover, deflation continues, and survey evidence suggests that deflationary expectations are becoming more widespread and persistent. Most Directors urged the Bank of Japan to be more aggressive in both its monetary policy actions and in its communications strategy to arrest deflation. It was noted also that the effectiveness of monetary policy would be improved by measures to strengthen the financial sector. Given the large budget deficit and high public debt levels, Directors emphasized the need for the authorities to establish a credible medium-term fiscal consolidation strategy and to implement key fiscal reforms. Most Directors were of the view that a gradual start toward fiscal consolidation is now needed, unless the authorities push ahead with a much more aggressive structural reform agenda. The recent reforms to strengthen banks and corporates were welcomed, although Directors underscored that they did not go far enough to resolve the long-standing problems in these sectors.

Directors shared insights on asset price bubbles based on recent staff work. They noted that the recent busts in equity markets have so far been quite similar to earlier episodes in terms of magnitudes, lengths, and cross-country synchronization of the price declines. Some Directors expressed concern about the substantial increase in housing prices in some industrial countries and the associated risks of busts in this asset class. Directors observed that the stock market booms in Europe and North America in the late 1990s led firms to borrow and invest well ahead of demand, thus increasing corporate vulnerability to a decline in stock prices and aggregate demand. Directors also noted concerns about the high levels of corporate debt compared with equity, especially in Europe, which could dampen investment spending during the recovery.

Emerging Markets

Directors considered that growth prospects in emerging market countries generally remain relatively favorable, although performance and prospects vary significantly within this group. Many countries are implementing disciplined fiscal and monetary policies and advancing with structural reforms, and are in a better position to withstand external shocks. Nevertheless, there remain downside risks, given the weaker outlook in industrial countries and uncertainties related to the situation in Iraq.

Directors welcomed recent signs of a pickup in activity in much of Latin America and the improvement in market sentiment, although they noted that the situation in a number of countries remains difficult. In Argentina, the economy may now be over the worst, but policy continuity will be fundamental, and the signals that presidential candidates send to markets will be crucial in shaping expectations. In Brazil, the new government's decisive actions to maintain macroeconomic stability and fiscal discipline have helped reduce uncertainties in financial markets. Chile and Mexico are relatively more sheltered from deterioration in external financing conditions, reflecting their strong policy record and relatively high integration with the world economy. For the region as a whole, Directors emphasized the importance of sustained efforts to lower public sector debt levels and improve the maturity structure of the debt. Other key policy priorities for the region include orienting monetary policy to achieve low inflation with exchange rate flexibility, deepening domestic financial intermediation, and introducing reforms to liberalize trade, improve social safety nets, and increase labor market flexibility.

Directors commended the impressive economic performance in emerging Asia underpinned by both exports and domestic demand, with countries moving most vigorously to implement structural reforms generally seeing the most robust growth. Going forward, growth in emerging Asia will remain reliant on the global economic environment. Directors viewed the continuation of accommodative monetary policies as generally appropriate, and believed that the automatic fiscal stabilizers should be allowed to operate in most countries. Further progress with structural reform, particularly in the financial sector, was seen by Directors as necessary to underpin stronger domestic demand and help contribute to a reduction in global imbalances. Directors noted that the generally comfortable external sector positions in the region provide the foundation for pressing ahead with the unfinished agenda of structural reforms.

Directors noted that growth in central and eastern Europe has continued to be underpinned by strong foreign direct investment, as European Union accession nears. Directors saw significant challenges lying ahead, as governments look beyond accession to the requirements associated with adoption of the euro. They observed that, although the picture varies across countries, the need for fiscal restraint will likely remain a central focus of policy for most countries in central and eastern Europe to underpin market confidence and bolster growth. In Turkey, following a better than expected performance last year, economic and financial conditions have deteriorated in recent months, and Directors underscored the urgent need for the government to pursue fiscal restraint and structural reforms to sustain confidence.

Growth in oil-exporting CIS countries has been buoyed by rising energy prices. Directors expressed concern that slowing structural reforms could dampen investment spending, particularly in Russia, and weaken medium-term prospects. Directors called upon the authorities in the CIS countries to reinvigorate the reform process, including by strengthening banking systems. The seven low-income CIS countries (the CIS-7) should give priority to fostering investment toward diversifying industrial production and strengthening the services sector, in order to help address the high public debt levels that threaten fiscal sustainability.

Growth in the Middle East continued to weaken in 2002, although countries where reforms have progressed fastest experienced more rapid growth. Directors observed that the increase in oil prices is benefiting many countries in the region, but that the regional security situation is weighing on foreign investment and tourism. Over the medium term, the key policy challenge across the region will be to achieve sustained high GDP growth in order to reduce unemployment and absorb the rapidly growing labor force. Efforts to energize the private sector, liberalize trade, and develop human resources should remain at the core of the reform agenda.

Macroeconomic policy and structural reform implementation have improved in many African countries. Nevertheless, growth in Africa slowed in 2002 owing to poor weather and continuing political turmoil affecting several countries. The central challenge in Africa will be to put in place the conditions to reach the Millennium Development Goals. As stressed in the New Partnership for Africa's Development (NEPAD), this will require a substantial improvement in the climate for private investment, which in turn will depend on actions to restore peace and political stability; improve governance, infrastructure, health and education; liberalize markets and trade; and address the HIV/AIDS pandemic. Directors underscored that achieving these goals will require the financial support of the international community and greater market access for the exports of African countries.

Directors welcomed the opportunity to discuss the impact of institutions on economic performance. They observed that improvements in institutional quality are found to raise the level and growth rate of GDP per capita, and lower the volatility of growth. Based on these findings, Directors agreed that developing countries would significantly strengthen their economic performance if they improve the quality of their institutions while maintaining sound macroeconomic policies. Directors considered that some general principles may frame the strengthening of institutions. For example, successful market-based economies need institutions that protect property rights, uphold the rule of law, provide appropriate regulation of markets, support macroeconomic stability, and promote social cohesion and stability. Directors stressed that institutional design and reform will inevitably have strong country-specific elements requiring adaptation and innovation to suit local conditions. Some key elements of institutional reform include greater competition, including through trade openness, which can help rein in the power of vested interests, and stronger information flows and transparency, which can improve policy choices and reduce the scope for corruption. In addition, external "anchors," such as those associated with the EU accession process, have also proved effective for strengthening institutions. In the final analysis, Directors felt that firm domestic ownership and commitment remain the most vital ingredients for institutional reform.