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GLOBAL ECONOMIC OUTLOOK

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Preface

This "pre-meeting" global economic forecast was prepared with inputs from national LINK centers and information from other sources (all al of 15 April 2003), using the LINK econometric modeling system to produce a global situation. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centers, are available on the web sites of both the United Nations and the University of Toronto.

This report summarizes the main features of this exercise. The forecast presented here will be updated for publication in the *World Economic and Social Survey 2003* by taking into account the discussions at the LINK meeting and the post-meeting forecast.

Table of Contents

Tables

Overview

The heightened geopolitical uncertainties and risks that arose before the invasion of Iraq and the war itself took a heavy toll on the world economy. With the exception of a few countries, economic growth decelerated substantially around the world between late 2002 and early 2003. The anticipated global economic recovery was further delayed, the period of slow growth further prolonged.

Because the military action in Iraq was briefer and less extensive than widely feared, the previous downside risks associated with the conflict have been reduced substantially and the outlook for the world economy has improved accordingly. After more than two consecutive years of slow growth, the repeatedly postponed and long-awaited recovery is now forecast for the second half of 2003, with gross world product (GWP) expected to grow by 2.2 per cent for the year as a whole, compared to 1.9 per cent in 2002. In 2004, GWP is forecast to grow by 3.1 per cent (see Table 1).

Among the developed countries, the benefits of reduced geopolitical uncertainty will be greatest for North America, which will lead the recovery. Inherent weaknesses in Western Europe will temper its turnaround while Japan will continue to languish. The economies in transition are expected to build upon their recent strength. In the developing countries, recovery in Latin America and steady but limited growth in Africa will buttress external factors. Partially because of SARS, growth will moderate in South and East Asia in 2003, while the war in Iraq will be reflected in a severe slowdown in Western Asia before a recovery forecast for 2004.

Table 1. Gross domestic product and world trade
(Annual percentage change)

	April 2003 forecasts			October 2002 forecasts	
	2002 [a]	2003	2004	2002	2003
Gross world product	1.9	2.2	3.1	1.7	2.9
PPP-weighted	2.3	2.6	3.6	2.1	3.2
Developed market economies	1.5	1.7	2.6	1.3	2.3
Canada	3.3	2.7	3.8	3.2	3.2
France	1.2	1.3	2.5	1.6	3.0
Germany	0.2	0.6	2.0	0.3	1.5
Italy	0.4	1.0	2.0	0.9	2.3
Japan	0.3	0.7	0.7	-0.7	0.9
United Kingdom	1.6	2.3	3.1	1.5	2.5
United States	2.4	2.6	3.9	2.3	3.2
Memo items:					
EU	0.9	1.3	2.4	1.1	2.3
Euro zone	0.7	1.1	2.2	1.0	2.2
Economies in transition	3.5	4.2	4.8	3.4	4.0
Russia	4.3	4.5	5.0	4.0	4.0
Developing countries	3.2	3.7	4.9	3.3	4.7
Latin America and the Caribbean	-1.0	1.7	3.7	-0.9	2.8
Argentina	-10.9	3.5	4.5	-12.0	1.0
Brazil	1.5	1.8	2.8	1.4	2.5
Mexico	0.9	2.8	4.4	1.9	4.8
Africa	2.9	3.3	4.1	2.7	4.1
North Africa	1.9	3.4	4.0	1.9	4.1
Sub-Saharan Africa [b]	2.6	3.2	3.5	4.1	4.9
Nigeria	4.0	5.0	4.8	4.0	4.9
South Africa	2.4	2.8	3.4	2.4	3.4
South and East Asia	4.7	4.3	5.2	4.4	5.0
India	5.0	5.5	6.1	4.7	5.5
Indonesia	3.7	3.5	4.2	4.0	5.2
Korea, Republic of	6.3	4.4	5.9	6.0	6.1
Malaysia	4.2	4.6	6.0	3.9	5.6
Philippines	5.2	4.7	5.6	4.5	4.8
Thailand	5.2	4.3	4.5	4.1	4.2
China	8.0	8.0	7.8	7.7	7.5
Western Asia	2.7	1.5	4.0	1.9	4.4
Oil-exporting countries	1.7	2.1	4.7	1.7	4.9
Oil-importing countries	4.0	0.8	3.1	2.3	3.8
World export volume	2.0	3.8	7.0	1.6	5.7
Oil price (Brent, $/pb)	25.0	28.0	23.0	25.0	26.0

a/ Actual, or revised estimates.
b/ Excluding Nigeria and South Africa.

The uncertainties that arose prior to the invasion of Iraq had wide-ranging negative collateral economic effects on the world economy. The occupation of Iraq is believed to have reduced these uncertainties, eliminating some of them. The forecast assumed that the war in Iraq would be short and that the aftermath would see a return to normalcy by the third quarter of 2003, with the elimination of the war premium in oil prices and exchange rates and a rebound in consumer and business confidence. Not all of the effects will be symmetrical, however: some of the negative consequences of the pre-war uncertainty will linger while some earlier positive factors may have been strengthened and new ones emerged.

The *prices of oil* were temporarily pushed far higher than warranted by economic fundamentals by the possibility of conflict, leading to welfare losses and additional price pressures in many oil-importing countries. Oil prices have since fallen and are expected to fall further as global production returns to normal. This will have beneficial effects on global growth and will reduce inflationary pressures in oil-importing countries.

Most *equity markets* plummeted in early 2003, aggravating the global asset price deflation that had been in effect since 2000. There has been some recovery in the post-invasion period.

Consumer and business confidence fell before the invasion, in a number of countries to their lowest levels in a decade. The heightened uncertainties reduced both business capital spending and the hiring of workers, delivering a one-two punch to the manufacturing sector, already beleaguered in many developed economies. The latest data suggest some recovery although its depth and breadth are not yet clear. A revival of consumer confidence will boost household spending but increased business spending will also depend on longer-term considerations, notably a recovery in corporate profits.

Some sectors, notably *international tourism and airlines*, which had not yet recovered from the shock of 11 September 2001, were again particularly adversely affected by the threatening international political environment. While the political veil has been lifted, these same sectors now find themselves suffering the consequences of the SARS virus.

Although several of the earlier negative manifestations of the former geopolitical uncertainty have already been measurably reduced, the earlier setbacks are likely to have some lingering effects on the world economy. While many of these are expected to dissipate by mid-2003, the extension of the period of slow growth has had some longer-term effects that will take longer to peter out. The increase in unemployment, notably longer-term unemployment, will be one of the factors that will reduce the acceleration in growth below that usually seen in cyclical upturns.

In the developed countries, the negative forces will be countered by a number of positive factors, namely the continuing effects of earlier macroeconomic policy stimuli; inventory replenishment; and some wealth effects from the large increases in house prices in some economies. While these factors are likely to boost the world economy in the second half of 2003, maintaining the upward momentum of the recovery into 2004 will require more fundamental improvements in the form of increased business capital spending, growth in employment and a revitalization of international trade and capital flows, particularly for developing countries.

At the same time, a number of current features of the world economy present downside risks to the recovery:

- Although the war in Iraq has reduced geopolitical uncertainties, it has not completely removed them – future developments in West Asia cannot be foreseen and there are also problems outside the region;

- The outbreak of SARS has already reduced growth prospects for a number of Asian developing countries but the full extent and impact of the current outbreak of the disease remain unknown;
- The global recovery continues to depend heavily on the strength of the United States but the large external deficits of the United States both limit the room for further increases in United States net import demand in the short run and pose challenges for global economic and financial stability in the longer run. On the other hand, China and some other Asian developing economies have been increasing their contribution to global growth;
- There continues to be overcapacity in some industrial sectors and, while this phenomenon was initially heavily concentrated in the ICT sector, it has been extended to sectors that have been most acutely affected by the geopolitical developments of the past two years (such as airlines and tourism) and a number of other industries (such as automobiles);
- The present slowdown has resulted in increased unemployment in many countries; this will dampen consumer demand (which has been critical in limiting the extent of the slowdown) and hence business confidence.

Persistently weak international economic environment

Particularly when contrasted with the 1990s, both world trade and capital flows currently lack dynamism, reflecting and contributing to the overall weakness in the world economy. Having declined in 2001, world exports increased by only 2 per cent in 2002 and are not expected to exceed 4 per cent growth in 2003, although growth of some 7 per cent is forecast for 2004**.** The anticipated recovery in the developed countries, particularly the United States, is key to the recovery of world trade but demand for imports in East Asia, particularly China, is also expected to be strong. At the other end of the spectrum, the decrease in imports experienced in Latin America in 2002 is expected to be reversed as key economies in the region recover somewhat.

The nature of the non-economic shocks to the world economy (the terrorist attacks of 11 September 2001, the threat of conflict in Iraq and, potentially, the outbreak of SARS) have all been particularly detrimental to world trade, above all trade in such services as travel and tourism. Not only is the rate of growth of trade lower, but the ”trade intensity of growth”, having tended to increase from around 2 towards 3 as a result of globalization in the 1990s, is expected to be closer to the lower figure in 2003.

Specific trade disagreements, a lack of progress in the Doha round of trade negotiations and, in early 2003, international political tensions cast a pall over the immediate prospects for necessary further improvements in the global trading system. On the other hand, there have been a number of new regional and bilateral trade agreements and initiatives that have prompted increased bilateral trade flows. Overall, however, international trade has retreated from its high ground of the late 1990s.

International financial flows have been lackluster for the past few years and no major improvement is expected in the short term. With the global economic slowdown and the bursting of the bubble in equity markets, there has been a lull in large cross-border mergers and acquisitions between companies in the developed countries. For developing countries, 2002 was the sixth consecutive year in which capital outflows and payments abroad associated with earlier inflows exceeded the corresponding receipts.

Investors and lenders increasingly differentiate among developing countries that participate in international capital markets which reduces the risk of financial contagion. However, the result is that some countries have both easy access and low costs while others encounter high costs if they are able to raise funds at all. Overall, new private financial flows to developing countries declined in 2002, but there was a general trend towards lower borrowing costs as the year progressed. In the first half of 2002, interest rates for some Asian borrowing countries declined while those for a number of Latin American countries increased, but this divergence fell as the year progressed.

Foreign direct investment (FDI) flows to developing countries, with the notable exception of China, declined in 2002 as a result of global economic conditions and the slowdown in privatizations. A major resurgence of FDI flows to developing countries seems unlikely in the shor term. FDI flows to Eastern European economies, on the other hand, continued to be robust, prompted not only by cost considerations but also by the prospect of EU entry; these flows are likely to be sustained.

In the early part of 2003, the poor prognosis for equity markets in developed countries caused investors seeking higher yields to act as a "push" factor that generated some increase in financial flows to developing countries. Private financial flows to developing countries may continue to increase as the global geopolitical environment improves and the world economy gains momentum. At the same time, these same developments are likely to prompt some recovery in domestic financial markets in developed countries; this may reduce the incentive to channel funds to developing countries, but is unlikely to eliminate it as yields in developing countries will continue to be higher than in developed countries (in contrast with the situation before the "equity bubble" burst).

Net official financial flows were substantial in 2002 but this was largely because of large loans to a few countries facing financial crises. There were pledges of increased aid during the year, suggesting additional flows to the poorest countries in the near future.

Despite the slow growth of the global economy and international trade, as well as deflationary pressures in some countries, some *commodity prices* increased in 2002, although most remained below the levels of the late 1990s. Having been rising for more than a year, *oil prices* reached a 12-year high in mid-February 2003. In addition to the war premium, there was tightness in world oil markets because of reduced production (initially in Venezuela because of the strike and subsequently in Nigeria), increased global demand and resulting lower inventories. At the end of February 2003, total oil stocks of the OECD countries were at their lowest level since March 2000. The invasion of Iraq immediately reduced supply further. Nevertheless, oil prices fell, largely because the damage to Iraqi oil fields was limited so that the disruption to the oil supply from the region was expected to be far less than previously feared.

The forecast assumes that the underlying tightness in the oil market will ease in the second half of 2003 as both Iraq and Venezuela (and, to a lesser extent, Nigeria) gradually return to their previous production levels and world oil inventories are replenished. A modest excess supply is expected to keep oil prices at the lower band of the OPEC target price range of $22-$28 pb during the last quarter of the year. For 2003 as a whole, Project LINK has assumed oil prices to average $28 pb, compared to an average of $25 pb in 2002.

The prices of many *non-fuel commodities* rose over the course of 2002, although the average for the year was lower than in 2001 in several cases. Much of the upward pressure during the year was attributable to the weakening of the dollar but adverse weather conditions reduced the supply and increased the prices of a number of agricultural commodities. There was a remarkable surge in the price of cocoa, primarily because of the conflict in Cote d'Ivoire, the largest producer. Oilseed prices increased substantially, mostly because of adverse weather conditions. The prices of most minerals and metals regained upward momentum towards the end of the year after mid-year setbacks reversed the gains that the strengthening of global growth had brought early in the year.

In 2003 and 2004, most non-fuel commodity prices are expected to strengthen modestly as the global economic recovery gains momentum. One emerging aspect of several commodity markets is the increasing role played by China as an importer of raw materials for its rapidly expanding industrial and export sectors. A slippage in Chinese growth could have disproportionately large negative effects on some non-fuel commodity prices.

Directly associated with the sustainability of the external deficits of the United States is the exchange rate of the United States dollar vis-a-vis other major currencies, particularly the euro and the yen. Since it peaked in January 2002, there has been a broad-based decline in the trade-weighted value of the dollar against major currencies. However, the fall was particularly marked against the euro, particularly in late 2002 and early 2003 when it fell to $1.10 per euro in March from $1.05 in January. Against the Yen, the depreciation was far more modest. In the forecast, it is assumed that the movement in first quarter was primarily due to war concerns so that, after the situation is resolved, the rate will return to a range centred around 1.05 per euro, where it will remain for the rest of 2003. For 2004 and 2005, a gradual depreciation of the $US against the euro is assumed, with the rate reaching $1.10 per euro by the end of 2005. The exchange rate of yen against the dollar is assumed remain around 120 in the forecast.

Macroeconomic policies

Fiscal policies

Countries able to do so have maintained accommodative policies in the face of the sluggish economic conditions, but many economies have had difficulties in adopting stimulative measures because of budget balances that have been deemed excessive.

Fiscal policy in the United States is currently stimulatory and will remain so, with federal spending expected to grow by 10 per cent in 2003, offsetting the drag of zero growth in spending by state and local governments. A further tax reduction is expected, but this is unlikely to be as large as initially proposed. The budget deficit for the United States is expected to reach $330 billion in 2003 and $400 billion in 2004. In Canada, the fiscal stance is expected to be neutral, or slightly stimulatory, and the government budget will remain in small surplus, or at least balanced, in 2003-2004.

Japan's fiscal position continues to deteriorate. Official short-term projections suggest that there will be a revenue gap of about 40 trillion yen in the 2004 fiscal year and that new bond issuances could reach 45 trillion yen annually by 2006. Current debt levels and the prospect of record issuances of new government bonds make any sizable fiscal stimulus unlikely because it would imperil the government's financial position and increase the risk of a further downgrade in sovereign debt by international rating agencies.

Western European fiscal policy was slightly expansionary in 2002 and is expected to be, at best, broadly neutral in 2003 and 2004. Some of the region's largest economies—France, Germany and Italy—are under considerable pressure to consolidate their budgetary positions to meet the 3 per cent deficit ceiling embodied in the Stability and Growth Pact. Others, starting from more balanced positions, are able to allow more free play of their automatic stabilizers or, in the case of the UK with its low debt to GDP ratio, will embark on significant public investment in 2003 and 2004.

Structural fiscal deficits remain a problem for Eastern European countries and no improvement is expected in the medium-term. Structural changes in the fiscal system have been delayed but privatization revenue is often used to finance budget deficits. EU accession will aggravate the problem by imposing additional costs to improve infrastructure and the environmental on all prospective members.

The Baltics' fiscal and monetary policies are determined by the Maastricht criteria. Despite increased expenditures in 2003 related to their impending NATO and EU accession, their fiscal deficits will remain below the criterion of 3 per cent of GDP.

Persistent fiscal deficits continue to be a problem for some of the highly-indebted CIS countries and debt servicing remains a major strain on these countries' finances. Recognizing the need for more debt relief, the IMF, the World Bank, the ADB, and the EBRD have launched the "CIS-7 Initiative to Reduce Poverty, Promote Growth and Sustainable Debt Levels in 7 CIS countries"[1]. In contrast, the Russian Federation enjoyed its third year of fiscal surplus in 2002, but some loosening is expected in 2003 because pre-election spending already reflected in the draft budget reduces the surplus to 0.6 per cent of GDP compared to 1.6 per cent for 2002.

Slow growth weakened the fiscal positions of most developing countries in 2002 but there continued to be a broad dichotomy between developing countries with relatively sustainable macroeconomic positions and those with macroeconomic disequilibria and/or other, often external, constraints. At least in the short term, the former have been able to use monetary and fiscal instruments in the appropriate counter-cyclical manner during the present period of slow growth; the latter group has had to give priority to addressing their more fundamental difficulties and this usually requires using these policy instruments in a restrictive, currently pro-cyclical, manner, rather than as a means of offsetting the present sluggish conditions. China and most economies in East Asia and, to some extent, South Asia belong to the first group, whereas several economies in Latin America and Africa could be placed in the second group. This dichotomy is likely continue in 2003 and will contribute to a continuation of the divergent growth outcomes, and hence widening income disparities, across regions and countries. If the period of slow growth is further extended, the number of developing countries that are able to continue pro-cyclical policies without developing unsustainable internal or external imbalances is likely to diminish, to the detriment of both their own growth and that of other countries.

Fiscal policy continued to be "pro-active" in China in 2002, with expenditures growing faster than GDP. The newly released budget suggests a less stimulatory policy stance for 2003. Fiscal policy in most East Asian economies also remained broadly accommodative in 2002 and, except for Indonesia and the Philippines (which have excessive public debt burdens), there continues to be room for policy stimuli. In view of the prevailing uncertainties, macroeconomic policy in these economies is expected remain flexible in the coming months, but some tightening is likely towards the end of 2003 as growth accelerates.

Fiscal policy in most countries in South Asia (except Bangladesh) has also remained expansionary, despite concern about their large fiscal deficits. In India, the budget for fiscal year 2003/04 includes tax cuts and other incentives and increased spending on infrastructure. Although the budgets for most of these countries continue to stress fiscal consolidation, political resistance, increased spending on security and the need to support growth will hamper strict adherence.

Most African and Latin American countries are expected to continue giving priority to addressing their fiscal imbalances in 2003, rather than using fiscal policy in a stimulative fashion.

[1] CIS 7 includes Armenia, Azerbaijan, Georgia, Kyrgyzstan, the Republic of Moldova, Tajikistan and Uzbekistan.

Monetary policies

Monetary policy in the world economy has remained largely accommodative since the end of 2000 (see table 2), with some further monetary easing in some cases in the light of the heightened geopolitical tensions in late 2002 and early 2003. Most central banks are expected to maintain their accommodative stance at the current level until mid-2003. Moreover, in many economies, there remains room for further monetary easing, if the recovery again fails to materialize.

Table 2. Changes in policy interest rates

	Level at 11 April 2003 (per cent)	Change from Dec. 2000 (basis points)
Developed countries		
United States	1.25	-525
Canada	3.00	-275
Japan	0.00	-25
Euro	2.50	-225
United Kingdom	3.75	-225
Sweden	3.50	-50
Norway	5.50	-150
Switzerland	0.25	-325
Australia	4.75	-150
New Zealand	5.75	-75
Economies in Transition		
Czech Republic	2.50	-275
Hungary	6.50	-525
Poland	6.00	-1300
Developing Countries		
Brazil	26.50	1075
Mexico	8.38	-879
Chile	2.75	-525
China	5.31	-54
Hong Kong SAR	2.75	-525
Indonesia	11.31	-311
India	6.25	-175
Philippines	7.00	-650
Republic of Korea	4.25	-100
Thailand	1.75	25
Taiwan Province of China	1.63	-300

Source: JP Morgan

The Federal Reserve (Fed) of the United States held policy interest rates at their lowest levels in four decades for most of 2002 and then reduced them by a further 50 basis points in November. The forecast assumes that the Fed will maintain this rate until the fourth quarter of 2003 and gradually tighten thereafter as the economy gathers momentum. Monetary conditions in Canada have already started tightening as a result of increases in interest rates by the Central Bank and appreciation of the Canadian dollar against the United States dollar. CBC is assumed to hold interest rates at their current level until the end of 2003.

The overnight call rate of the Bank of Japan (BoJ) continues to be virtually zero and is assumed to remain so. Nevertheless, the broad money supply continues to grow much more slowly than the monetary base. In 2002, BoJ raised the target for its main policy instrument, the outstanding balance of current accounts held at the Bank, by about 5 trillion yen to around 10-15 trillion yen and injected more liquidity into financial markets when the war with Iraq started.

In Western Europe, monetary and fiscal policies have become moderately stimulative. The ECB lowered its policy rate to 2.5 per cent in the first quarter of 2003, with both real and nominal short-term rates now at their lowest levels since the creation of EMU. However, the impact of this stimulus has been dampened by the appreciation of the euro. Moreover, countries with lower rates of inflation than the EU average, such as Germany, face higher than average real rates of interest, and thus relatively tighter monetary conditions. Since part of the earlier drop in confidence in Western Europe is believed to reflect deeper problems, the balance of risks is on the downside. Consequently, a further easing of 50 basis points is assumed in the second quarter of 2003. Thereafter, as growth strengthens and downside risks diminish, a gradual return to a more neutral stance is assumed.

Monetary policy in the CEE region was relaxed in 2002 and early 2003, mostly to weaken exchange rates but also, in the Czech Republic, to fight deflation and, in Poland, to revive the economy.

Although the Russian Central Bank (RCB) has an official policy of targeting inflation, it tends to target the real exchange rate in order to protect domestic producers, with the result that inflation tends to exceed the official target (currently 10 – 12 per cent). The RCB has recently announced that it will allow 4-6 per cent real exchange rate appreciation in order to curb inflation.

With low inflation (and even deflation in some economies), monetary policy will remain accommodative in East Asia and China, facilitated in part by the U.S. interest rate cuts. Limited inflationary pressures led South Asian countries to continue to ease their monetary policy in 2002; they are expected to maintain soft monetary policies for a while. Monetary policy remained unchanged in 2002 in most West Asian oil-exporting countries. Interest rates in these countries will continue to follow those in the United States. There was also monetary easing in most oil-importing countries in this region, except for Turkey. In Latin America, on the other hand, monetary policies continue to be restrictive or have been tightened in response to inflationary pressures.

Regional highlights

Developed countries

The uncertainties associated with the possibility of conflict in Iraq were a major factor causing GDP growth in the *United States* to plummet from 5 per cent at the beginning of 2002 to 1.4 per cent in the fourth quarter. Other indicators suggested further deterioration in the first quarter of 2003: payroll employment continued to fall; consumer confidence dropped to its lowest level since 1993; consumer spending weakened; retail sales declined; and the indices for activity in both the manufacturing and services sectors plunged into the range reflecting contraction.

With the "war overhang" largely eliminated, the economic outlook has improved, although to an uncertain degree. Sustainable household spending remains central to the post-war recovery in the United States. Although the household sector was weak during the pre-war period, factors that bolstered it over the past two years remain in effect: interest rates are still at historical lows and there is no sign of a collapse in the housing and residential construction markets. Meanwhile, depressed consumer confidence is recovering. The strength of the recovery will, however, also depend on the pickup in business spending, which contracted significantly during the 2000-2001 downturn. A strong recovery in business spending, particularly on equipment and software, is expected in late 2003 and 2004. Both current monetary and fiscal policy are also stimulatory. With these driving forces, the baseline forecast is for 2.6 per cent GDP growth in 2003, strengthening to 3.9 per cent in 2004.

In *Japan,* the economy continues to be fragile, with GDP growing only 0.3 per cent in 2002. The difficulties of the deflationary spiral persist as asset prices continue to decline, aggravating the severe problems in the bank sector and in the real economy. Developments regarding Iraq and other geopolitical uncertainties have exacerbated the economic weaknesses. Nevertheless, there was a stabilization in indicators of business sentiment in the first quarter of 2003, prompting a rise in business projections of future capital spending, supported by a recovery in corporate profits and an anticipated replenishment of inventories. Business investment is expected to grow by 1-2 per cent in 2003, recovering from a decline of 3 per cent in 2002.

Other aspects of the economic outlook remains somber. Housing investment is sluggish and public investment is expected to decline further. The prospects for household consumption are also discouraging. Household income continues to decline because of decreasing wages as firms maintain their efforts to reduce personnel expenses. The prospects for improved growth in the Japanese economy therefore remain highly dependent on exports, but these are volatile. Strong exports were the major factor preventing the economy from falling into recession in 2002, but their momentum moderated notably in the first quarter of 2003. GDP growth in Japan is forecast to be less than one per cent for both 2003 and 2004.

Following growth of only 0.9 per cent in 2002, *Western Europe* is expected to grow 1.3 per cent in 2003, with acceleration to 2.4 per cent in 2004. Much of the current weakness comes from the economic impact of the Iraq war - depressed confidence, further delay to the resumption of more robust consumption and investment spending, and generally weaker world demand. The extended period of below trend growth has led to higher region-wide unemployment (8.7 per cent in February 2003) and further slippage of governments' fiscal positions, with a number of states either approaching or exceeding the deficit threshold of 3 per cent of GDP imposed by the EU's Stability and Growth Pact. Consumption is expected to strengthen slowly in 2003 and 2004 as inflation falls and confidence improves, but will be held back by higher unemployment. Business investment is forecast to rebound in the second half of 2003, but will be hampered by weak corporate balance sheets and the slow acceleration in foreign demand.

Economic growth in *Australia, Canada, and New Zealand* has been stronger than in other developed economies, but is expected to moderate in all three in the near term. Outperforming other major developed economies for the past two years, growth in *Canada* slowed down noticeably by the end of 2002, largely because of weaker exports, most notably a decline in automotive shipments to the United States. However, final domestic demand, particularly household expenditure, continued to expand at a robust pace. Exports and business investment are forecast to recover in 2003, but the need for structural adjustment and lagging productivity growth are likely to limit growth. In addition, monetary conditions will become less accommodative because of currency appreciation, as well as higher interest rates.

In both *Australia and New Zealand*, strong domestic demand has offset the weak external sector in the past two years. The business sector in Australia has outperformed that in most other developed economies. High profitability and low debt levels have contributed to robust capital spending and strong growth in employment. Employment growth and increases in real wages have, in turn, boosted household income, leading to strong household spending. In New Zealand, there was a surge (and possible peak) in immigration in 2002, causing population growth of some 2 per cent. Together with a conspicuous rise in the incomes of farmers in the past two of years, this stimulated consumer demand.

The housing sector has been particularly buoyant in both of these economies; this contributed to both strong construction activity and the rising prices of houses, the wealth effects of which helped sustain consumer spending. The rapid rise in house prices over the past few years, and the possibility of a large downward adjustment, has been a concern in some quarters and a decline may have begun in Australia: approvals for construction of private houses have been declining for a few months.

Economies in Transition

Growth in *Central and Eastern Europe* (CEE) decelerated to 2.5 per cent in 2002 but is expected to strengthen to about 3 per cent in 2003. The slowdown in 2002 was primarily a result of the fall in the growth of exports, itself caused to a large extent by currency appreciation but also by weak business confidence and weak import demand in the EU. Both private and public consumption in the region grew at about 4 per cent. An expansionary fiscal policy, triggered by parliamentary elections throughout the region in 2002, played a stimulatory role, in addition to rising household incomes and lower interest rates. A repetition of such a scenario in 2003 is unlikely, since monetary and fiscal authorities in the region are becoming concerned about fulfilling the eurozone entry criteria. By the end of 2002, there were some indications of strengthened industrial production in Central Europe, but the highest growth in 2003 is expected in Southeastern Europe, where high rates of investment following a number of privatization deals will boost growth in Bulgaria and Romania. More generally, growth is expected to be supported by continuing FDI flows and associated investment, and possibly by some relocation of production from the EU to the region

The economies of the *Commonwealth of Independent States (CIS)* continued to be largely sheltered from recent global economic uncertainties, recording strong growth each year since 2000. Robust domestic demand in both the Russian Federation and Ukraine as well as rising oil prices, and corresponding hydrocarbon investment in the Caspian region have been the primary causes of this expansion. Oil output in Russia achieved a record 7.62 million barrels a day in 2002, reaching the state’s current export capacity. This will continue to constrain Russian economic expansion. In Ukraine, growth has moderated, yet private consumption has continued its expansion. Further east, many CIS states in central Asia continue to surge due to large oil and gas investment (as in Kazakhstan and Azerbaijan), while smaller economies (such as Tajikistan and Armenia) benefit from expansion in their mining and metals sectors. Growth for the region as a whole is projected to be 4.6 per cent in 2003, accelerating to 5 per cent in 2004.

Strong domestic demand, combined with export flexibility, has allowed the *Baltic countries* to continue their recent growth despite their close linkages to the lacklustre EU market.

These economies grew by 6.3 per cent in 2002 as they responded to robust demand from CIS states to offset decreased demand from the EU. Though industrial output has experienced some difficulties in the past few years—due primarily to unexpected delays in various deliveries from the Russian Federation—growth is expected to be 5.7 per cent in 2003, with domestic demand remaining the catalyst.

Developing countries

Africa's GDP growth is expected to reach 3.3 per cent in 2003, from 2.9 per cent in 2002, and is projected to continue accelerating to 4.1 percent in 2004. Exports are expected to increase as global economic growth picks up in the second half of 2003. Projected price increases for almost all categories of export commodities will additionally strengthen export revenues and GDP growth in many countries.

Reduced OPEC quotas and sluggish international demand dampened North Africa's performance in 2002, but these economies will grow more vigorously in 2003. Oil-exporters, such as Algeria and Libya, will benefit from higher OPEC quotas and the momentary price spikes in the early part of the year, while Morocco and Tunisia will continue their recovery from the negative impacts of the terrorist attacks of 2001. Sub-Saharan Africa is forecast to sustain the rate of economic growth experienced in 2002, which was largely driven by domestic factors. Most countries benefited from increased agricultural output, lower inflation, and significant growth in non-agricultural sectors such as agro-based industries and distributive trades. These positive forces are expected to continue in 2003.

Notwithstanding the above, the outlook for many African states remains clouded by events in the Middle East and the persistence of instability in some sub-regions. The Israel-Palestinian conflict will adversely affect growth in Egypt, keeping the pressure on the currency and increasing its inflation rate. Although Africa continues to benefit from the HIPC initiative, official financial flows to the continent may also decline if the rebuilding of Iraq and Afghanistan create competing demands for attention by the international community. Meanwhile, the Côte d'Ivoire situation will depress growth throughout West Africa, aggravating the repercussions of the disruption in oil production in Nigeria. The delayed recovery in Europe and North America adds to the uncertainty.

East Asia's rebound from the sharp slowdown in 2001 started to ease in the second half of 2002. Export growth, however, held up well as strong intra-regional trade—particularly surging imports by China—cushioned downward pressures forces. As indicated above, supportive monetary and fiscal policies also contributed in most countries.

Sluggish external demand persisted in the first quarter of 2003 and prospects for the region have been further dimmed by the outbreak of the "severe acute respiratory syndrome" (SARS). The epidemic has already begun to adversely affect trade and tourism-related industries in a number of economies, particularly Hong Kong SAR and Singapore. Assuming the quick containment of SARS, growth is expected to pick up in the second half of the year. Improved import demand from the United States and continuing robust demand from China will support export growth, while broadly accommodative policies, lower oil prices and improving confidence will strengthen domestic demand and boost industrial production, particularly in export-oriented industries. Exports of information (ICT) products, which are important to generate a durable industrial recovery, are however, unlikely to fully recover until well into 2004. For the heavily export-oriented economies of Hong Kong SAR, Republic of Korea, Singapore and Taiwan, Province of China, out-sourcing to China and other low cost countries will continue to weigh on employment and domestic demand. In Indonesia and the Philippines, domestic demand is likely to be constrained by the need to reduce fiscal deficits and by security concerns due to terrorism, while the resurgent nuclear controversy with the Democratic People's Republic of Korea (DPRK) is likely to impose a toll on domestic demand in the Republic of Korea.

Growth in *China* accelerated towards the end of 2002, with both domestic demand and the external sector expanding rapidly. Despite some perennial challenges, such as large-scale unemployment, widening income gaps, and inefficiency and fragility in the financial system, GDP is expected to grow by 8 per cent in 2003, repeating its performance of 2002.

Domestic demand remains pivotal for growth in China. To date, fixed investment growth has been leading domestic demand. Fuelled by policy stimuli and a surge in foreign investment, investment has increased in all sectors and regions, although housing continues to expand most rapidly and the policy-induced growth of investment in western areas of the country remains higher than elsewhere. Household spending has been growing less quickly, particularly in rural areas. However, policies are expected to shift gradually from stimulating investment to supporting consumption so that household spending, particularly on housing and durable products, will continue to accelerate.

Both exports and imports grew by more than 15 per cent in 2002 and continued to accelerate in early 2003. Driven partly by the depreciation of yuan vis-à-vis many currencies (because of its peg to the United States dollar), exports grew more than 30 per cent (year-on-year) in the first quarter. Meanwhile, the value of imports surged by about 45 per cent, in part due to significantly higher oil costs. As a result, for the first time in many years, the trade balance registered a deficit at the beginning of 2003. The recent trade performance is unlikely to be sustained, but both exports and imports are forecast to increase by nearly 20 per cent in 2003. With robust domestic demand and reduced trade restrictions, imports will grow faster than exports and the trade surplus will be lower than in 2002.

Although uneven, mainly because of different climatic and security conditions, there was a modest increase in *South Asia*'s growth in 2002 and the region's near-term prospects are positive. Growth in India moderated due to crop failure in 2002 but Pakistan and Sri Lanka have been recovering gradually. There have also been signs of improvement in Nepal, but the security problem continues to weigh on the economy. For the region as a whole, growth is expected to be supported by both domestic demand and exports. Exports in most countries will continue to grow in the first half of 2003 and are expected to increase further as external demand picks up in the second half of the year. Domestic demand is also expected to strengthen, supported by lower interest rates, rising exports and a better harvest. Sectoral performance will be more balanced and stronger growth will emerge by mid-2003, particularly in Bangladesh and India, as weather conditions normalize. The outlook for 2004 is for stronger and more balanced growth across the region, with its strength being subject to structural constraints, including fiscal deficits. In addition to sharing the global uncertainties mentioned earlier in this report, major risks to the regional outlook are the military tension between India and Pakistan, political instability and adverse climatic shocks.

Western Asia's economic performance was poor in 2002 as oil production declined in most oil- exporting countries in response to OPEC's reduced quotas and the uncertainties of the pre-war period resulted in declines in foreign direct investment, tourism revenues and consumer and investment confidence. In addition, the escalating conflict between Israel and Palestine caused growth in Israel to contract and the Palestinian economy to collapse, with spillover effects on other countries in the region.

The Iraq war has had devastating effects on the region, particularly on Iraq itself. While the damage to oil infrastructure appears to have been limited, much Iraqi physical infrastructure has been destroyed or subject to vandalism and looting. Iraqi oil production has been suspended and the return to former levels of oil production and exports may take several months.

Regional prospects for 2003 remain bleak, but are expected to improve in 2004 as oilfield development and several petrochemicals projects come on stream. The reconstruction of Iraq will provide additional stimuli to the region's growth, although growth prospects in the remaining oil-exporting countries in the region are not encouraging. Prior to the war in Iraq, OPEC raised its oil production quotas twice in 2003, mainly to compensate for the fall in Venezuela's production and the anticipated loss of Iraqi supplies. Countries with spare capacity (mainly Saudi Arabia and, to a lesser extent, the United Arab Emirates) increased oil production sharply, largely exceeding their OPEC quotas. Nevertheless, oil prices increased and reached a 12-year high in mid-February 2003. The subsequent fall in oil prices and mounting fears of a possible oil glut have prompted OPEC to call for an emergency meeting on 24 April 2003. If OPEC decides to reduce oil output, growth in oil exporting countries in the region will be modest.

Israel and Turkey (by far the largest oil-importing economies of the region) are expected to barely grow and thus will not be able to provide much growth stimulus for the region.

After contracting 1.0 percent in 2002, some of the major countries in *Latin America* are making a mild economic recovery and the region's GDP is forecast to grow by 1.7 per cent in 2003. Besides the constraints imposed by the international environment, domestic economic or political problems in such countries as Argentina, Bolivia, Colombia or Venezuela, represent serious constraints to the recovery.

Signs of a recovery based on strong import-substitution are present in Argentina. The exchange rate, prices and bank deposits regained some stability in the second half of 2002. Industrial production, particularly of manufactures, benefited from the depreciation, and has continued to recover well into 2003. The intensity of the recovery, however, will remain limited by the problems in the financial sector and the country's continued isolation from international financial markets. Neighbouring Paraguay and Uruguay, deeply affected by the crisis in Argentina, will contract again in 2003.

The sharp depreciation of Brazil's currency in 2002 has strengthened industrial production although recent signs point to softer activity during the first quarter of 2003. The expected moderate improvement in growth in 2003 will be supported by a mild recovery in domestic consumption as inflation pressures subside and interest rates are lowered accordingly. The external sector is expected to make a positive net contribution to growth again in 2003, albeit of a slower magnitude than last year.

In the north of the region, the contribution of the external sector to growth will be largely determined by the extent and pace of the recovery in the United States. In Mexico, private consumption was a major contribution to overall activity in 2002 and maintained its momentum during the first quarter of 2003. However, signs were pointing to deceleration in the external sector and manufacture output.

Growth in the region remains heavily dependent on the volume of foreign capital flows. FDI continues to be the major source of external finance but inflows remain generally weak while portfolio flows have been volatile. In Venezuela, the Government tied the local currency to the US dollar and imposed new foreign exchange restrictions in February 2003 in an attempt to stem capital flight and stop the rapid depreciation of the bolivar, both of which were a result of the crisis at the end of 2002.

Growing worldwide unemployment

The continuation of slow growth in most of the world has been accompanied by an increase in those lacking jobs, although, even in some developed countries, the full extent of the deterioration has not necessarily been reflected in unemployment data. The service sector continues to be a source of growing employment opportunities, with a temporary setback brought on by the setbacks to the labour-intensive tourism sector. This has had a particularly deleterious impact on small, heavily tourism-dependent economies. On the other hand, heightened security concerns have benefited employment in that sector.

The unemployment rate in the United States has remained about 5.8 per cent for the past year, up from the lows of 4 per cent before the downturn. However, the situation in the labour market has been worse than indicated by the unemployment rate: there was a net loss of half of million jobs in the fourth quarter of 2002 and the first quarter of 2003. A measurable improvement in labour market is not expected until 2004.In contrast, employment in Canada grew robustly in 2002, although growth softened in early 2003.

In the EU-15, unemployment rose from a low of 8.0 per cent in December 2001 to 8.7 per cent in February 2003 and is expected to increase further in the balance of 2003.

The employment situation in CEE countries remains difficult, since the growth of labour productivity in the industrial sector exceeds the rate of growth of output and also because of the low mobility of the population and an underdeveloped housing market. Unemployment also remains high in most CIS countries but changes are difficult to follow because of lack of reliable data. An important exception is the Russian Federation where unemployment declined from 8.6 per cent in September 2002 to 7.2 per cent in January 2003.

The limited available data point to uneven trends in employment in developing regions in 2002, largely reflecting the divergences in growth. There were signs of improvements in employment in several countries in East Asia, although current unemployment rates in all of them remain higher than before the Asian crisis. China has been an exception to this trend of high growth combined with lower unemployment because of its fast labour force growth, the large labour surplus in rural areas, and on-going structural reforms. China’s official urban unemployment rate rose to 4 per cent by the end of 2002.

The employment situation remains precarious in Western Asia, particularly in the Occupied Territories where 50 per cent of the labour force is unemployed. In Latin America, slow growth or outright recession in 2002 and the beginning of 2003 has constrained job creation. High unemployment and underemployment continue to represent a drag on the recovery of domestic demand in many countries in the region. In Argentina, the unemployment rate remains around 18 per cent, with poverty affecting over 50 per cent of the urban population. In Mexico, significant employment losses in the manufacturing export sector, linked to stagnant external demand during 2001 and 2002, are yet to be reversed.

Mixed inflation performance and outlook

Excessive inflation characterized a diminishing number of countries in 2002 while the possibility that deflation might become more generalized fell as the year progressed. Higher oil prices raised inflation in many countries while devaluation – which applied mainly to currencies with a link to the dollar – was another widespread source of higher prices. With generally weak growth, inflation is a major concern in relatively few countries in 2003.

Inflation in the United States rose to an annual rate of about 3 per cent in the first quarter of 2003, mainly because of the higher oil prices. Inflation in Canada in the past year was above the Central Bank's target of 2 per cent, causing the Bank to raise interest rates four times over the year. In both countries, the inflation outlook is benign, particularly in the face of retreating oil prices.

Inflation in Western Europe remained above the ECB's ceiling of 2 per cent in 2002, but is expected to decelerate slowly during 2003 and 2004. The price of oil, together with poor weather and animal diseases, were important inflationary impulses, some of which were passed into wage growth in excess of productivity gains. Core inflation reached 2.5 per cent in mid-2002, but has since moderated. Weak demand, the appreciation of the euro and falling oil prices all point to a gradual diminution of inflationary pressures in 2003 and 2004.

Inflation in the CEE region decelerated in 2002 and inflation targets were undershot. Post-transition lows were reached in some countries (and deflation in the Czech Republic at the beginning of 2003), as a result of nominal currency appreciation, economic stagnation in Poland, and conservative monetary policy in Slovakia for most of the year. Inflation in the region is expected to decelerate further in 2003.

Average inflation in the CIS region continued declining, reaching 14.4 per cent in 2002 compared to 18.5 in 2001. Inflation dropped to very low levels in several countries (less than 1 per cent in Ukraine, for example), but remained stubbornly high in 2002 in Belarus, Uzbekistan and the Russian Federation (where it was 15.1 per cent, compared to the Central Bank's target of 12 per cent).

In the Baltic region, inflation declined to about 1.6 per cent in 2002 due to the effect of the appreciation of the regions' two euro-pegged currencies on food and import prices. Inflation is forecast to inch up to about 2.5 per cent in 2003 as a result of a slight loosening of fiscal policies and continued strong domestic demand.

Inflation accelerated in 2002 in most developing regions, with the exception of East Asia where China and some other economies experienced deflation. The acceleration usually reflected either devaluation, higher oil prices towards the end of the year or adjustments in administered prices that were required either because of contractual commitments or to keep fiscal accounts in check. The deterioration was greatest in Latin America, where inflation exceeded its target in such countries as Brazil, Colombia and Mexico, largely because of developments on the supply side. Very few countries, however, experienced double-digit inflation as prudent macroeconomic policies (and subdued demand conditions in some countries) helped keep price pressures in check. As a result of such policies and barring unexpected shocks, inflation in developing countries is expected to return to its declining trend in 2003.

Policy challenges, uncertainties and risks

The over-riding task for policy-makers in the short-term is to ensure that global economic growth returns to a level that is sufficient to produce an increase in per capita output in the developing countries, particularly the poorest among them. Japan remains mired in low growth and Western Europe continues to look to a recovery in the United States to provide stimulus to its own growth. There are pockets of growth in other regions, particularly in East Asia and the CIS, but prospects are mostly limited without a sustained recovery in the developed world. The world economy therefore continues to rely heavily on a recovery in the United States for the necessary return to higher growth and is vulnerable to the risks and uncertainties that face that country. Although uncertainties were reduced in the weeks before this forecast, they were not eliminated.

Despite the apparent success of the invasion of Iraq, some *geopolitical risks* remain. Developments in the Western Asia region remain uncertain. As demonstrated by the attack in

Bali, there is a lingering possibility of further terrorist acts, with the added risk that the invasion of Iraq may prompt some form of reaction. Recent experience shows that such acts can have large effects on confidence and hence on short-term growth. The prevention of terrorism and its asymmetrically high costs also reduce productivity growth over the medium term and thereby reduce longer-term growth potential.

Although *oil prices* have declined since the invasion of Iraq, they remain highly volatile. Adverse geopolitical developments could cause another upturn in prices with adverse consequences for the world economy. A more optimistic view is the potential small over-supply could cause prices in late 2003 and 2004 to be lower than assumed in the forecast, with beneficial effects on global growth and inflation in oil-importing countries, particularly the developing countries among them.

The unavoidable eventual adjustment of the *United States' external deficits* has been described as "an accident waiting to happen", but the nature and speed of that accident, as well as its timing, remain to be seen. If it takes the form of a sudden and substantial depreciation of the U.S. dollar, it would both impose real economic shocks on both the United States domestic economy and the rest of the world, probably compounded by some disorder in global financial markets. Because of the heavy dependence of the global recovery on import demand from the United States, a correction in the near future would have particularly adverse effects. A continued depreciation of the dollar should reduce the risk of an abrupt adjustment in global financial markets in the medium term but the appreciation of other currencies would have an adverse effect on exports – currently the most vigorous component of demand for some of the world's largest economies. On the other hand, the longer the deficits and the over-valuation of the dollar persist, the larger the risks associated with the subsequent correction.

A separate but related risk is that posed by the burgeoning *US fiscal deficit*. While this does not pose any immediate risk (to the contrary, here again increased government expenditures in 2003 are an appropriate countercyclical measure), difficulties are likely to arise in the medium term through crowding-out effects. These will include higher interest rates with adverse effects on consumption as well as investment expenditure.

Now recovering from the Iraq crisis, a further prolonged depression in major *equity markets* seems unlikely. However, there is widely perceived to be a *housing bubble* in a number of countries. It is feared that a bursting of this bubble could have negative wealth effects, as well consequences for the housing and construction industry itself. The nature of the housing market suggests that, in isolation, the impact of any such wealth effects on private consumption would be less than that caused by an equivalent decline in the price of financial assets, but the experience of Japan is salutary.

SARS is already having a measurable negative impact on the Asian economy and, if it persists and spreads, has the potential of adversely affecting the world economy as a whole. Once again, the airline industry and tourism are particularly vulnerable but international trade in general would be negatively affected.