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GLOBAL ECONOMIC OUTLOOK

Prepared by:

Development Policy Analysis Division
Economic Assessment and Outlook Branch

Introduction

The spring meeting of Project LINK in 2001 is held at the United Nations Headquarters, New York, 9-11 April 2001. The agenda of the meeting includes various presentations of the short- and medium-term outlook for the world economy and discussions of related international economic policy issues.

With inputs from the national LINK centres and information from other sources, as of 30 March 2001, the staff of the Economic Assessment and Outlook Branch, Department of Economic and Social Affairs (DESA), at the United Nations prepared a pre-meeting world economic forecast, using the LINK econometric modeling system. This report summarizes the main features of that exercise. The outlook projected here is an interim exercise and will be updated in the coming weeks by taking into account the discussions at the present LINK meeting and the post-meeting forecast. Most of the LINK *Country Reports*, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the web sites at both the United Nations and the University of Toronto.[1]

Overview

Three years after the 1997-1998 international financial crises, the world economy is experiencing another turbulence. The LINK baseline outlook predicts a significant slowdown in the growth of gross world product (GWP) for 2001 to a rate of 2.4 per cent, from the 4 per cent attained in 2000. The expansion of international trade is also expected to decelerate sharply to a rate of 6 per cent in 2001, about half the 12 per cent observed in 2000 (see table 1). While the forecast shows a rebound of global growth to a rate of about 3 per cent in 2002, substantial downside risks remain.

In contrast to the last global economic downturn, which was set off by financial turmoil in some developing countries and economies in transition in 1997-1998, the current one is being propelled by retrenchment in major developed economies. In the first instance, this deceleration was triggered by the United States monetary policy moves. Equity markets in the United States have plummeted and investment spending has decelerated markedly from the picture drawn in the last assessment in Oslo (2-6 October 2000). Despite the swift policy responses in some developed economies, chiefly by reducing policy interest rates, since the beginning of this year, more and more signs suggest that the slowdown in the global economy has recently been broadening and intensifying.

Policy makers worldwide, particularly in major developed economies, are facing a number of challenges: (1) ways have to be found to reverse as soon as feasible the ongoing erosion in business and, more slowly, consumer confidence; (2) the vicious circle of self-fulfilling prophecies that seems to be forming in financial markets and in some industrial sectors needs to be broken; (3) there is need to contain the impact of the downturn in manufacturing on the household sector, especially in many developed economies; and (4) it would be highly desirable to arrest the growing adverse spillover effects from developed economies to other

[1] DESA's website is: http://www.un.org/esa/analysis/link. Toronto's is: http://www.chass.utoronto.ca/link.

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

	April 2001 forecasts[a]			October 2000 forecasts[b]		
	2000	2001	2002	2000	2001	2002
Gross world product	4.0	2.4	3.1	4.1	3.6	3.6
Developed market economies	3.5	1.8	2.5	3.7	3.1	3.0
Canada	4.8	2.8	4.0	4.6	3.1	3.3
France	3.2	2.7	3.0	3.6	3.1	3.0
Germany	3.0	2.5	2.5	3.0	3.2	2.6
Italy	2.7	2.5	2.8	2.8	2.7	2.9
Japan	1.7	0.7	1.1	1.4	2.2	2.9
United Kingdom	3.0	2.3	2.7	3.2	2.6	2.1
United States	5.0	1.5	3.0	5.2	3.7	3.3
Memo items:						
EU	3.3	2.7	2.9	3.5	3.1	2.8
Euro zone	3.3	2.8	2.9	3.5	3.2	2.9
Developing countries	5.7	4.4	5.2	5.6	5.5	5.7
Latin America and the Caribbean	3.8	3.4	4.5	3.9	4.0	4.8
Argentina	-0.3	1.0	3.5	1.6	2.4	3.8
Brazil	4.1	4.4	5.0	3.9	4.4	5.5
Mexico	6.9	3.5	4.9	5.8	4.5	5.2
Africa	3.1	4.3	4.5	3.6	4.1	4.8
North Africa	3.7	5.6	4.9	4.1	5.9	5.4
Sub-Saharan Africa (excl. South Africa)	2.8	4.0	4.6	4.5	3.8	4.9
Nigeria	3.4	3.6	3.6	3.5	3.5	3.5
South Africa	3.1	3.5	3.6	2.2	2.9	3.4
South and East Asia	6.8	4.7	5.6	6.6	6.0	6.1
India	6.0	6.2	7.2	6.6	6.9	7.2
Indonesia	4.7	4.1	4.8	3.6	5.8	5.6
Korea, Republic of	8.8	4.1	5.2	8.6	6.0	6.2
Malaysia	8.5	5.0	6.2	8.3	7.5	7.3
Philippines	4.2	3.1	4.2	3.6	3.6	4.6
Thailand	4.2	3.3	4.8	5.8	5.4	5.3
China	8.0	7.3	7.2	8.4	8.5	8.0
Western Asia	5.6	3.2	4.0	4.7	4.9	4.1
Oil-exporting countries	6.0	3.3	4.1	5.0	5.2	4.2
Oil-importing countries	2.7	3.3	3.1	2.6	3.3	3.1
Economies in transition	5.9	3.6	4.7	4.0	4.6	5.2
Russia	7.7	4.1	5.2	6.5	3.9	4.8
World export volume	11.9	6.1	6.2	10.4	7.7	6.6
Export prices (all goods)	0.3	0.3	3.1	0.8	2.7	4.2
Agricultural commodities	1.8	2.6	3.4	0.2	3.8	3.7
Raw materials and ores	3.1	0.7	2.2	4.5	3.2	2.9
Oil	58.7	-5.0	4.0	59.0	-5.0	4.0
Manufactures	-4.4	0.8	3.3	-2.9	3.6	4.5

[a] Pre-meeting forecasts.
[b] Actual or revised estimates.

segments of the world economy. Otherwise, the probability of a global recession, which could wreak havoc upon many economies, will rise.

The current weakness of the world economy stems from several interrelated developments in the past year, which continue to be the crucial determinants for global economic growth in the outlook.

First, the downturn was an intended one, at least its early stage, engineered by policy makers, in the first instance in the United States and, to a lesser degree, in other developed economies as well. When the economy of the United States in the late 1990s was growing strongly at a pace that policy makers perceived to be unsustainable, as indicated by an increasingly tight labour market and growing imbalances in the economy, the Federal Reserve of the United States (Fed) decided in mid-1999 to tighten monetary policy. The ostensible aim was to moderate excess demand so as to pre-empt a resurgence of inflation. Many central banks in other developed economies followed this stance as interest rates were raised by 150 to 200 basis points (bps) within a year. Monetary policy in most developed economies maintained this tightened stance until at least the end of 2000; it continues in the euro zone, however.

As more signs of a sharper-than-desired downturn emerged in the beginning of 2001, monetary authorities in developed economies started to ease the monetary policy stance by reducing policy interest rates. The Fed led also this modification with three cuts in policy interest rates, totaling 150 bps, in the first quarter. The ongoing monetary easing in more and more developed economies should exert some braking power on the slowdown in the global economy. However, the lag between a reduction of interest rates and its effects on the economy is normally at least six months, but possibly longer than that, meaning that signs of a recovery will surface, at best, during the second half of 2001.

Second, the impact of declining values in global equity markets, led by the plunge in the value of technology stocks, has been palpable. The NASDAQ index in the United States, which is heavily weighted by technology shares, by March 2001 had fallen by more than 65 per cent from its peak a year earlier (the decline from peak to trough was over 71 per cent in just over a year). This downturn has more recently been spreading to broader indices, such as the S&P500. The majority of world equity markets registered substantial losses for 2000 and during the first quarter of 2001, and no end to the contraction in equity values seems to be on the discernable horizon. For example, the Nikkei-225 in Japan has recently reached its lowest level in 16 years.

Reflecting concerns about the strong appreciation in equity values in the waning years of the 1990s, the discussions at the LINK meetings of the past two years have revolved to a large extent around the potential risks embedded in the apparent overvaluation of share prices especially in the United States. These issues have been investigated intensively elsewhere as well. For example, a LINK model simulation, the details of which were reported at previous meetings, indicated the danger of a collapse of major equity markets in developed countries for the buoyancy of the global economy. The magnitude of the negative wealth effects on consumers and the severe adverse effects on business investment, as simulated, seem similar to what has recently been crystallizing in the world economy, particularly in the United States. Actually, the deceleration in business investment in the United States has been even sharper than the magnitudes earlier simulated.

The collapse of the value of technology stocks in the United States has also substantially depressed the pace of initial public offerings, in particular for technology companies. The magnitudes of venture capital funds available for nursing such start-ups have contracted rapidly, in part because of declining equity values, which inhibits recycling, but also because investors have become more cautious about undertaking risky ventures than was the case during the second half of the 1990s in particular.

Meanwhile, strains have also built up in other financial markets. Corporate borrowing tightened in the second half of 2000, as yield spreads in bond market rose and banks raised their standards for business loans, particularly in the United States. Yield spreads for external borrowing of emerging markets have also widened markedly. International bond issuances by major developing countries and economies in transition faltered in the last quarter of 2000, falling to their lowest level since the 1995 crisis in Mexico because of the economic and political turmoil in Argentina and Turkey in particular. The "contagion" effects have so far been limited for other countries in the group, largely because many of these economies have since the 1997-1998 crisis significantly reduced their short-term external debt and expanded their foreign reserves. Also the more flexible exchange rate regimes adopted over the last two years by many of these economies have made them less exposed to the danger of speculative attacks.

By the end of the first quarter of 2001, the slide in global equity markets is showing no sign of abatement, let alone reversal. Equity prices in some major developed markets remain overvalued as compared to the long-term historical average price-earnings ratios, in part because of the plummeting profit outlook for many companies, even those in the "old economy." The gloom in global equity markets is expected to continue to impose negative effects on the world economy, especially on consumer and business sentiments, at least for the immediate future.

Third, the information and communication technology (ICT) revolution seems to have reached a consolidation stage. For the United States and many other economies, the boom in spending for ICT investment in the late 1990s was arguably the crucial driving force for their strong overall economic performances. As addressed in recent LINK meetings, the economy-wide diffusion of ICT contributed to a noticeable rise in productivity growth in the United States, but much less in other developed economies because their ICT-investment spree started later and soared only more recently.

The so-called new economy, which is predicated on the ICT revolution, appears to be in a quandary. On the one hand, development of new applications for existing technologies has lagged the pace of ICT capacity-building in recent years. Also, the original expectations embedded into a number of ICT-based new business models have failed completely. For example, a large number of e-retailing businesses on the Internet could not deliver on the expected profits. They have since gone out of business, are on the brink of bankruptcy, or are struggling for survival. As a result of the apparent overinvestment in ICT in recent years, there has recently been a sharp drop in capital spending by many businesses: in contrast to rates of 30 to 40 per cent in ICT-investment spending in several recent years, investment spending on ICT in the United States was almost flat in the last quarter.

On the other hand, some analysts argue that the slow development of new ICT applications, especially those for consumers, and the unsatisfactory e-business results were precisely on account of underinvestment in ICT: the bandwidth, or speed of telecommunications over networks, is the bottleneck that has been curbing new applications for consumers and businesses. The technology for broadband transmission is already in place, but the existing network infrastructure needs to be overhauled, requiring much more investment spending than most telecommunication-service providers can currently mobilize as they are in sizeable debt[2] on account of the heavy investment spending of the past decade.

While ICT will continue to be the driving force for the global economy in the medium to long run, it remains unknown how long it will take to complete the current adjustment and consolidation in major developed economies.

Fourth, persistently high prices of oil since early 2000 have gradually been feeding into the world economy by lowering consumer welfare and squeezing business profits of non-oil sectors. The prices of oil surged in September 2000 to their highest level, nearly $40 dollar per barrel (pb), in a decade. Since the early 1970s, every sharp rise in oil prices (such as in 1973-1974, 1979-1980, and 1990-1991) that could be sustained for some time invariably triggered a significant slowdown in growth and even recession in many developed economies. As pointed out in the last LINK report, besides the welfare losses, high oil prices sustained for a period of 6 to 12 months are usually closely associated with a sudden downward shift in consumer and business sentiment. A similar event may recently have happened again, particularly in the United States.

Although oil prices have softened somewhat since the beginning of 2001, two aggressive cuts in production quotas by the Organization of Petroleum Exporting Countries (OPEC) in early 2001 have reduced the likelihood of a substantial fall in oil prices, something that might otherwise have provided a prop to global economic growth.

Lastly, even without the above factors, moderation in the pace of growth could have been anticipated in any case for many developing countries and economies in transition that had been most affected by the financial crises of 1997-1998. The brisk recovery in many of the crisis-affected economies—at a double-digit annual pace for many economies between 1999 and mid-2000—would have been unsustainable no matter developments in the global economy. Reflationary policies would have had to be replaced by demand impulses. And the strong impetus from external demand since early 1999 would have diminished in any case. As a result, that rapid acceleration from early 1999 until the first half of 2000 was expected to run out of steam; policy makers and observers had hoped that the slowing acceleration could be halted at a stable platform for sustainable growth. However, the downturn in major developed economies since late 2000 has exacerbated the moderation of the buoyancy of economic activity in these recovering economies beyond what would otherwise have taken hold. In effect, many of these

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[2] For example, European telecoms paid massively for third generation telecommunication licenses, which triggered downward pressure on the equity prices of the companies concerned and the collapse of other auctions.

economies remain fragile: domestic recovery is not on firm ground, post-crisis financial restructuring has proceeded slowly, and corporate sectors are still overly indebted.

As mentioned, many developing countries and economies in transition may be less vulnerable to external financial shocks than a few years ago. However, they are not at all exempt from external demand shocks when they have to compete for exports in markets of major developed economies that are undergoing a substantial slowdown.

In addition to the above major circumstances leading to weakening global economic growth, other, more regional and local, factors too have recently exerted adverse effects on some economies. Several countries have suffered from severe earthquakes and droughts. Escalated military conflicts and political turmoil in some regions and within some countries have substantially impeded economic activity and reduced incomes for the countries involved. The outbreak to epidemic levels of bovine spongiform encephalopathy (informally known as mad cow disease) and of foot-and mouth disease in Western Europe amount to a sizeable supply-shock for some economies and continue to pose a threat for international trade and tourism.

The economy of the United States has been at the heart of the current weakness in the global economy. Some new features of the ongoing cyclical downturn in the United States deserve to be underlined because they bear important implications for the prospects of recovery in the world economy, both its arrival and strength.

In the past few decades, recessions in the United States were consistently preceded by a surge in inflation as cyclical imbalances were transformed into price pressures. The current downturn, however, was not led by a sharp rise in inflation. Instead, its main feature was the interrelated decline in corporate profits, tightening of credit conditions, and decrease of investment spending. During the recent boom years until the first half of 2000, annual corporate profits in the United States on average grew at a double-digit pace. In the last quarter of 2000, however, corporate profits registered a decline of about 10 per cent; the same rate of decline is estimated for the first quarter of 2001. Some analysts believe that the link among inflation, policy response, and growth typical of previous business cycles has diminished in the current business cycle of the “new economy.” The latter’s dominant feature, hence the key determinants of the new business cycle, is built around the dynamics of corporate profit, availability of credit, and investment spending.

In this allegedly new business cycle, the shift from boom to bust can be much faster than in the “old,” more conventional cycle. Firms may take aggressive actions to restore profits by shedding labour and inventory, and by cutting capital spending, triggering a chain reaction for other firms and other economic agents to lower their expectations about future earnings. In turn, the already fragile stock markets decline further in response to the worsening earnings’ projections, causing a broader deterioration in consumer and business sentiment. The initial slowdown in manufacturing would thus be magnified and spread to other sectors, such as consumer spending, sending the economy into a recession. Some analysts have also warned that monetary policy has become less effective in terms of reversing the downturn under current circumstances.

Therefore, the biggest downside risk for the global economic outlook is a deeper and more prolonged slowdown in the United States, as there is no other economy or group of economies that could provide enough support to offset the deflationary effects imposed on the global economy by protracted slow growth or a recession in the United States. The second largest economy, Japan, itself is facing the threat of recession. Many developed economies in Europe, though their economic situation is undoubtedly still firmer, are also slowing down. Through direct and indirect international linkages, which have been steadily enhanced during the 1990s, a recession in the United States would be transmitted to many other economies. Its impact would be amplified through international multipliers and pull down the feasible pace of global economic expansion onto a much lower expansion path than projected in the baseline outlook.

World economic growth: the slowdown deepens and broadens

The downturn in the pace of global economic growth, beginning in the second half of 2000, could have been entirely anticipated. The two LINK meetings of 2000 featured it as such with a strong probability. However, the rapidity, breadth, and depth of the declines had not been envisaged. In effect, developments in the world economy since mid-2000 have been close to the track depicted in the LINK alternative downside scenario mentioned in the last two years, rather than on the track as projected by the last LINK baseline and discussed in the associated *Global Economic Outlook*.

Compared with the last LINK forecast, released in October 2000, the current outlook has marked down the global growth rate for 2001 by a substantial proportion. The growth rate of GWP in 2001 has been trimmed by 1.2 percentage point. While the largest downgrading has been for the United States—by more than 2 percentage points—the growth rates for the three major regional groups have all been pruned by close to 1 percentage point or more, reflecting the broadening pessimism about the global economy.

Developed economies

The group of developed economies, particularly the economy of the United States and to a lesser degree also many economies in Western Europe, had provided a strong prop to the global recovery and economic expansion in the period following the Asian crises. In contrast, these economies are now leading the evolving global slowdown. After a strong pace of 3.5 per cent in 2000, aggregated GDP growth for the group is expected to decelerate significantly to 1.8 per cent in 2001, followed by a moderate rebound to 2.5 per cent in 2002. Although the downturn in the United States has been by far the most pronounced among this group, signs for a general weakening across many other developed economies have recently become more prominent.

The LINK baseline outlook still predicts no recession for the *United States*, namely no decline in GDP level for two consecutive quarters. But growth for the first half of 2001 might well turn out to be flat. With an expected rebound in the second half of 2001, growth for the year as a whole is forecast to be 1.5 per cent, down sharply from the 5 per cent attained in 2000.

Growth is expected to recover further in 2002, to 3 per cent, although the risks for a less favourable scenario remain considerable.

Indeed, the momentum of the deceleration in the United States since mid-2000 has been extraordinary: the GDP growth rate dropped from the 5.6 per cent in the second quarter to 1 per cent in the fourth quarter. The downturn has been led by a sharp adjustment in capital spending, especially investment outlays on ICT. Growth in ICT spending plunged from an annual rate of about 40 per cent in the last few years to almost zero in the fourth quarter of 2000. Tightening financial conditions, declining equity values, and squeezed corporate profits have placed formidable constraints on business investment. In contrast, the slowdown in household spending has thus far been much milder. The fast pace of monetary easing since the beginning of 2001 is expected to provide support for a rebound in late 2001. The various measures of tax reduction currently being considered in the Congress indicate that the next fiscal budget will provide stimulus to growth in 2002.

The near-term situation, however, continues to be disquieting as the decline in equity markets has been broadening from technology stocks to other economic activities; business confidence and consumer sentiment remain far below their peak levels, though more so for the former than for the latter, in spite of the latest improvements; excessive production capacity is still accumulating; and corporations have announced their intention to lay off more of their present labour complement. The combination of these cyclical problems with some structural weaknesses, such as the large current account deficit and the extremely low household saving rate, bodes ill, signaling pronounced downside risks for a recession or a protracted period of anaemic growth: if the household sector were to start rebuilding savings, the implied lowering of the income propensity to consume would exacerbate the downturn.

The second drag on the outlook for the group of developed economies is *Japan*, where the economic situation is on the whole no better than that of the United States. After a decade-long stagnation, the economy managed to register slow growth of 1.7 per cent in 2000; however, more recent indicators point to a sharp downturn in a broad range of economic activities since the beginning of 2001. GDP is expected to grow by less than 1 per cent in 2001, with only a marginally higher pace for 2002.

The slow economic recovery of 2000 in Japan from the 1998 recession was led by the corporate sector, driven by rapid economic recovery in many Asian developing economies and a rise in ICT-related investment spending. Nevertheless, the recovery was unbalanced, as the household sector remained weak. Unfavourable employment and income conditions resulted from the ongoing corporate restructuring. Furthermore, the negative wealth effects from the decade-long deflation in equity and property prices curbed consumer spending. At the same time, some structural problems (including the mounting volume of non-performing loans in the financial sector, excessive capacity in the corporate sector, and the large government debt) continue to bear negatively on the situation.

The fragile economic recovery in early 2000 was halted by the sudden slowdown in the external demand from the United Sates and other economies. In recent quarters, net exports plunged, industrial production faltered, corporate earnings stagnated, and stocks prices declined to their lowest levels in 16 years. Some unorthodox measures adopted by the central bank of Japan at the end of the first quarter, as discussed in the "monetary policy" part of the assumptions underlying the forecast, and yen depreciation are expected to provide some stimulus to the economy, but these measures cannot substitute for the reforms that need to be implemented in order to resolve the lingering structural problems that have been bedeviling the Japanese economy for over a decade.

Compared with Japan and the United States, many developed economies in *Europe* remain relatively resilient, although none could escape a notable markdown in the growth outlook that had been sustained through much of 2000 and early 2001. Aggregate GDP growth for all European developed economies is expected to moderate from the 3.3 per cent in 2000 to 2.7 per cent for 2001, followed by just over 3 per cent for 2002.

The *euro-zone* economies registered robust growth in 2000, with aggregate GDP growing by 3.3 per cent, the strongest in nearly a decade. A mild moderation in the pace of economic activity had taken hold since mid-2000, as high oil prices and tightening monetary policy started to restrain demand. However, exports maintained a strong pace throughout the second half of 2000 in spite of the downturn in the United States, largely on account of the margin of manoeuvre afforded by the apparently undervalued euro. Meanwhile, household demand has remained relatively strong, as the improving employment situation has boosted disposable incomes and supported consumer confidence.

In the outlook, the expected moderation for the euro zone is mainly based on the anticipated weakening of external demand. This has become more evident since early 2001, in particular on account of the United States. At the same time, high oil prices, though softening somewhat recently, continue to pass through other sectors to restrain demand. While the plunge of equity values in stock markets in these economies is expected to exert a negative impact on consumption through wealth effects, the impact for most economies in the euro zone will be much smaller than that in the United States, because the contribution of the net wealth effect from appreciating equity values to growth has been much lower there than in the United States. Some monetary easing is expected if signs of slowdown persist. Recent tax cuts in many euro-zone economies are expected to provide some support for economic growth.

It bears to point out that the euro-zone economies have shown different performances in spite of similar external shocks. While a marked deceleration in GDP growth from 2000 to 2001 had been expected for the economies of Finland, Germany, the Netherlands and Spain, the slowdown in other economies such as France and Greece is expected to be less pronounced, although even in these countries the pace of growth currently expected is about 0.5 percentage points below what had been held out for most of 2000 into early 2001. If the prevailing deflationary conditions last longer than anticipated or intensity, the growth slowdown in Europe could well be more pronounced than in the baseline forecast. In any case, there are some risks for a reversal of the convergence trend in growth and in other macroeconomic magnitudes observed over the last few years.

A noticeable moderation in growth outlook has also been observed for other *European economies* such as Austria, Denmark and Switzerland. GDP growth for 2001 in these countries is anticipated to be significantly below the achievements of 2000 as exports of these economies are expected to slow down significantly. Whereas growth in Ireland will also decline by a full percentage point, it is still expected to reach 7.4 per cent in 2001—in line with the country's remarkable performance for several years in a row. Although signs of the impact from the external downturn on the United Kingdom have not so far been significant, some signs of weakening in manufacturing activities have recently come to the fore. But a broader-based deceleration in growth over the course of 2001 is unavoidable. GDP growth is expected to decelerate from 3 per cent in 2000 to 2.3 per cent in 2001. In addition to the expected adverse effects through its close economic linkages with the United States, the slowdown in the United Kingdom will be compounded by the current negative shocks from the foot-and-mouth disease. Although the share of livestock activities in aggregate GDP in many European countries is low, perhaps half of the share of 2-3 per cent for agriculture as a whole, the overall economic consequence of the latest outbreak of the foot-and-mouth disease, taking into account the current output and capital-stock losses in agriculture, current-income losses in trade and tourism, and the rise in inflation, should not be underestimated.

Elsewhere in the group of developed economies, a significant slowdown has already become clear for Australia and Canada. While the impact of the weakening of the United States economy has been the main factor for Canada, a decline of 0.6 per cent in GDP for Australia in the fourth quarter of 2000 was largely on account of falling housing construction resulting from new tax arrangements and from the post-Olympics adjustment. Monetary policy in both Australia and Canada has been easing rapidly, and tax reduction in Canada is expected to provide additional support for domestic demand. Declining investment spending in these two economies has been leading the slowdown. The deceleration of growth in New Zealand has so far been less pronounced. But GDP growth for all three countries is expected to ease appreciably in 2001, with the growth rate for Australia being forecast as the lowest: less than 1 per cent.

Developing economies

The outlook for many developing economies has recently been deteriorating, albeit at varying degrees, because of the weakening prospects of the developed economies, particularly the sudden downturn in the United States. Their feasible performance will be further impacted as the slowdown in the United States and other developed economies spreads and possibly intensifies. The transmission is occurring through several channels such as reduced exports to the United States, stagnant capital inflows into the region, weakening commodity prices as output demand flags, and fluctuations in international and local investors' risk aversion.

The external vulnerability of developing economies does not only depend on how closely the economy is linked to that of the United States or of other developed economies. It is also a function of the robustness of domestic economic structures and soundness of economic policy in these economies. For the group as a whole, GDP growth is expected to slow down from the 5.7 per cent in 2000 to a rate of 4.4 per cent in 2001, followed by a rebound to 5.2 per cent for 2002.

Aggregate GDP growth in Africa increased marginally from 2.9 per cent in 1999 to just over 3 per cent in 2000, well below earlier expectations. This disappointing performance should not continue into 2001 as growth is expected to accelerate to over 4 per cent, in spite of the adverse external environment. Even without significant further shocks from any of the adverse exogenous circumstances discussed earlier, growth in 2001 will not reach levels necessary to reduce poverty by a significant margin.

Economic performance of many *African* countries has been highly dependent on three major exogenous or non-economic factors: weather conditions, international prices of commodities, and political stability within a country or in a sub-region. Growth rates have significantly diverged across countries in the region as the impact of the cited factors varies from country to country. But the majority of African economies registered positive growth in 2000. They will have some room for manoeuvring in domestic economic policies and international assistance can alleviate some of the adversities these countries have been encountering.

High oil prices benefited oil-exporting economies in the region such as Algeria, Angola, Libya, Nigeria and the Sudan, with the corollary that they hurt oil-importing countries. Those enjoying swollen oil revenues are expected to continue to prop up investment and consumption in 2001. On the other hand, the higher import bill for oil, declining prices of agricultural commodities such as coffee and cocoa, and unfavourable weather conditions such as flooding and drought have led to lower growth for many other economies in the region. This has been especially marked for those oil-importing countries that have suffered from declining export prices, for primary commodities in particular, but risen import prices, especially for energy. With a moderate decrease in oil prices and some improvement in a number of commodity markets, the situation should improve somewhat in 2001 in some of the oil-importing countries.

Economic activity in a number of African countries was severely disrupted by military conflicts and political instability in 2000. Some renewed hopes for resolving or improving some regional conflicts, such as the war between Ethiopia and Eritrea, and the civil war in the Democratic Republic of the Congo, have recently been warranted. At the same time, the economic outlook for South Africa, the largest economy in Sub-Saharan Africa, improved noticeably, as GDP growth accelerated from 1.8 per cent in 1999 to above 3 per cent in 2000. It is expected to reach 3.5 per cent in 2001, a pace that should be sustained into the following year.

The rapid pace of recovery of many economies in *South and East Asia* from 1999 through the better part of 2000 was halted abruptly by the sudden downturn of the United States economy since the second half of 2000. Aggregate GDP growth for this group (excluding China) is expected to slow down significantly from the 6.8 per cent of 2000 to 4.7 per cent in 2001, followed by an improvement to a pace of 5.6 per cent in 2002.

Because many economies of this region are highly integrated in the international economy, they are vulnerable to the current external demand shock, as indicated by the sharp fall in export growth of several East Asian economies, from an annual rate of over 20 per cent in the first half of 2000 to a single-digit rate in the first quarter of 2001. As a result, industrial production, particularly ICT-related products, in these export-oriented economies has also suffered a marked deceleration. This has been more pronounced in the economies of the Republic of Korea, Taiwan Province of China and Thailand, for all of which ICT-related products amount to a substantial proportion of their overall exports. In these economies, industrial production has already registered an absolute decline or no growth.

Furthermore, collapsed stock markets, rising unemployment, and weakening consumer confidence are expected to curb private consumption in many Asian economies. The probability of a replay of the 1997-1998 financial crises in the region, however, is not high. Many of these economies have improved their current account balance and liquidity in the form of foreign exchange reserves over the last recovery phase, though some pockets of fragility in corporate sectors remain a cause of concern.

Meanwhile, the outlook for China and India—the two largest, continent-size economies in the region—is positive. GDP growth in China is expected to be resilient, though slightly moderating from 8 per cent in 2000 to 7.3 per cent in 2001. Strengthening domestic demand supported by more accommodative macroeconomic policies will offset the expected slowdown in exports. India is expected to maintain a rate of growth at above 6 per cent, as the anticipated rebound in agricultural output from the unfavourable conditions in the last growing cycle is expected to offset the notable slowdown in ICT-related sectors.

Elsewhere in the region, a moderation by 1-2 percentage points in growth for 2001 as compared to 2000 is expected for economies such as Bangladesh, Nepal, Pakistan and Sri Lanka. The deceleration has various reasons, ranging from the expected decline in exports, to dampened rural income from crop failure of the previous growing year, and to continued political instability.

After a solid recovery in 2000, economic growth in *Latin America and the Caribbean* is moderating somewhat. GDP growth for the region is expected to slow from the 3.8 per cent of 2000 to 3.4 per cent in 2001, but to rebound to 4.5 per cent in 2002. Whereas these magnitudes suggest that the present situation does not differ much from that in 2000, the region is, in fact, facing worsening external conditions. Exports, especially to the United States, which provided strong support for the region's recovery in 2000, are now anticipated to slow substantially; private capital inflows are expected to decline; the cost of international borrowing is inching up, as the yield spreads of the region's debt are widening; and international prices of many commodities that the region exports are softening. The impact of these adverse effects is expected to vary significantly among the individual countries of the region.

Growth in a number of economies such as Mexico and several countries in Central America and the Caribbean is expected to decelerate sharply because of the close trade linkages of these economies with the United States. Other countries such as Brazil that have recently improved their economic fundamentals and have lower shares of exports to the United States are expected to be affected much less. In the case of Brazil, whose economy accounts for about 40 per cent of the region's total GDP, the continuing strength of internal demand will be the main factor propping up growth in 2001. A few economies such as Ecuador and Venezuela may be able to continue or even to accelerate their recovery. Major uncertainties and the downside risks within the region continue to be concentrated for Argentina, where market confidence is still declining while economic agents await the new policy measures currently being formulated to resolve the unsustainable public debt and revive internal private-sector demand.

Economic growth for many countries in *Western Asia* is set to slow down after a very strong performance of 2000 due to the high oil prices. GDP growth is expected to be 3.2 per cent in 2001, down from the 5.6 per cent registered in 2000, but to rebound to 4 per cent in 2002. A surge of 60 per cent in oil prices in 2000 significantly benefited the oil-exporting economies in the region and led to a sharp increase in government spending, business investment, and private consumption. However, oil prices are expected to soften in 2001 because of the slowdown in global demand, despite the aggressive cuts in production quotas agreed upon by OPEC members. Therefore, a combination of lower prices and reduced production will lead to lower oil revenues for these economies. In contrast, growth performance for the oil-importing countries in the region has been mediocre, though Israel and Turkey performed well. The outlook for this group of countries as a whole is little changed from their performance in 2000, though Israel and Turkey, given their external dependence on ICT trade and the evolving financial and economic crises, respectively, will not be able to repeat their recent good performance in 2001. Meanwhile, the escalating conflicts in the region, especially in Israel and between Israel and the Palestinian Authority, have not only caused considerable losses for the economies directly involved, they have also negatively affected neighbouring economies.

Elsewhere in the developing group, the outlook for Turkey has been downgraded significantly below the picture drawn during the last LINK exercise. The two financial shocks since November 2000 have lowered reserves by a substantial amount, led to severe losses in the banking sector, and forced the floating of the exchange rate, entailing a sharp depreciation of the exchange rate. A new economic package, supported by an IMF programme, is expected to be ready by mid-April. Its focus will be on restructuring the banking sector. Tight monetary and fiscal policies, however, are expected to depress economic growth, at least in 2001.

Economies in transition

The group of *the economies in transition* registered strong growth in 2000. Aggregate GDP surged to 5.9 per cent from the 2.7 per cent registered in 1999. The outlook for the group, however, points to a marked moderation, with the growth slowing to a pace of about 3.5 per cent in 2001, as most driving forces behind the strength of the last year have either faded or been reversed. Especially the weakening external environment does not bode well for many of these economies.

Many economies of the *Commonwealth of Independent States (CIS)* experienced in 2000 their best performance since the beginning of the transition. For the first time in a decade, all countries registered positive growth. Led by the Russian Federation, which registered 7.7 per cent growth in 2000, the strong recovery in the region was mainly attributable to—it was certainly triggered by—two major factors: high prices of oil and gas and the substantially undervalued Russian rouble. Persistently high prices for oil and gas over the course of 2000 significantly bolstered export revenues for the Russian Federation and a few other CIS members. That, however, provided a lift to domestic demand, including strong investments (and not just in the hydrocarbon sectors) for the first time in nearly a decade and an upturn in consumer demand as real wage rose, unemployment fell, and transfer arrears were all but eliminated. Of course, it stimulated production in its own but also in other sectors. And it led to improvements in both external and internal balances. The strong recovery in the Russian Federation also created a favourable environment for other CIS countries.

In the outlook, however, the prices of oil are expected to soften somewhat and the effects of the Russian rouble devaluation are fading. As a result, the pace of growth for the region is expected to moderate to about 4 per cent in 2001. Meanwhile, structural reforms in the region remain challenging and bear some uncertainties.

The good performance of the three *Baltic* economies in 2000 was largely driven by strong external demand from the European developed economies and from the Russian Federation. For example, Estonia registered 32 per cent growth of export volume in the year. Now, as external demand in Western Europe is expected to moderate, growth in these economies will need to rely more on domestic demand, which will have to be strengthened. The recent trend of easing monetary policy and progress with economic restructuring are likely to boost investment gradually. GDP growth for this region is expected to be 4.7 per cent in 2001, slightly below the 5 per cent recorded in 2000.

The improved growth for the economies of *Central and Eastern Europe (CEE)* in 2000 was also highly dependent on the strong demand from Western Europe. Continued strong inflows of foreign direct investment (FDI)—some 10 per cent of GDP in the Czech Republic, for example—mattered too. In effect, domestic demand remained subdued in many economies, non-exporting sectors registered much lower growth than the average, and agriculture was adversely affected by harsh weather conditions across the region. In the outlook, as external demand is weakening, signs of a sharp deceleration in exports and industrial production already appeared in some countries of the region in the last quarter of 2000 and early 2001. As a result, the focus of policy has shifted towards boosting domestic demand. Interest rates have been cut in some major economies in the region since the beginning of 2001; however, government deficits in many economies will limit the room for fiscal stimulus.

International trade: its expansion decelerates sharply

The pronounced slowdown in GWP is being accompanied by a drastic deceleration in world trade. After a very strong momentum that had lifted world trade growth from 5 per cent in 1999 to about 12 per cent in 2000, growth of world trade, measured by export volume, is expected to decline significantly to about 6 per cent in 2001 and 2002.

In effect, during the current global economic downturn, international trade linkages have been the main channel transmitting the sharp adjustment in the United States economy to the rest of the world and amplifying the first-round slowdown for a widening circle of economies. The impact through other international linkages, such as financial flows and equity market correlations, is not negligible, but much smaller than what prevailed in the last global downturn of 1997-1998, when the “contagion” effects through financial markets dominated, at least during the early stages of the Asian crisis.

As mentioned in the last LINK *Global Economic Outlook*, the brisk growth rate of global trade in 2000 was driven by three major sources. First, strong import demand from developed economies, particularly the United States, whose double-digit import growth had been powered by the strong dollar and robust domestic demand. Second, there was a surge in import demand from the many developing countries and economies in transition recovering from the previous financial crises beyond the intensity of what could normally have been anticipated for that phase of their recovery; to all intents and purposes, the economic recovery in these countries had been maturing faster than had earlier been anticipated. Third, import demand from oil-exporting countries increased sharply on the strength of sizeable windfall revenues from high oil prices and the U.S. dollar. Turning into 2001, however, some of these cited import forces have been abruptly reversed and the strength of others has been petering out more gradually, yet in combination reinforcing the significant slowdown in the growth of global trade.

The marked deceleration in United States imports is one major driving force dragging down growth in world trade. It is expected to drop from 13 per cent in 2000 to just 3 per cent in 2001 in real terms. Inasmuch as United States imports grew at an average annual rate of over 10 per cent since 1995, the country's share in global trade reached about one fifth in 2000 in U.S. dollar terms. As a result, the impact of the deceleration by 10 percentage points in forecast United States imports is having palpable consequences for the rest of world.

On top of the shock from the United States, imports from Japan are also expected to slow down markedly, from 10 per cent in 2000 to about 3 per cent in 2001, driven by weakening domestic demand and the large depreciation of the yen.

In contrast, import demand of many European developed economies is expected to maintain the same pace of about 5-6 per cent as in 2000 for two reasons. First, the slowdown of most European developed economies has been much less pronounced than the sluggishness in Japan and the sharp downturn in the United States, and has been largely caused by external shocks rather than on account of endogenous problems. Second, intraregional trade accounts for more than 60 per cent of total Western European trade.

Import demand of other developed economies is expected to decelerate to varying degrees. The contraction is likely to be most significant for Canada, dropping from 12 per cent in 2000 to just 1 per cent in 2001. This sharp deceleration is not just because of weakening domestic demand, but largely on account of the large share of intra-industry trade between Canada and the United States. The deceleration in the imports of the United States from Canada will simultaneously induce a large slowdown in Canadian imports from the United States.

The import demand of most developing economies is also expected to slow down from 16 per cent in 2000 to about 7 per cent in 2001. Since this rate remains above the average global import growth rate forecast, these countries will on balance be supportive of world economic activity in 2001. In general, import growth of many oil-exporting developing economies is expected to decelerate less significantly, as the increased revenues from the high oil prices in 2000 and 2001 continue to support fairly strong import demand. Import growth in other developing economies, however, is expected to slow down more pronouncedly.

Across the sub-regions, the most significant slowdown in import demand will be in the economies of South and East Asia, where it will fall from near 20 per cent in 2000 to about 7 per cent in 2001. Other groups are expected to see their growth of imports lowered by 3 to 5 percentage points below 2000 levels.

At issue is which country or group will see its export growth slow down the most in consequence of the sharp adjustment in United States imports. Table 2 provides a benchmark. The impact on the export growth of Canada should be substantial, as 86 per cent of Canadian exports went to the United States in the base year (1999). The impact on Japan, Latin America and Asian developing economies should also be significant, as exports to the United States accounted for 20 to 30 per cent of their total exports. By contrast, the effect on European developed countries should be relatively small—only 8.7 per cent of European exports flow to the United States. Similarly, the direct impact should also be less significant for economies in transition as about 5 per cent of their exports flow to the United States. Of course, there will be secondary effects through the trade multipliers.

Table 2. Share of exports going to the United States
(In per cent of 1999 U.S. dollar values)

World	18.1
European Union	8.7
Canada	86.0
Japan	31.2
Economies in Transition	5.3
Eastern Europe	3.5
Developing countries	27.3
Latin America and the Caribbean	52.2
Africa	14.2
Western Asia	15.0
East and South Asia (including China)	24.0

In the outlook, growth of exports for developed economies as a group is expected to moderate slightly from 10 per cent of 2000 to about 5.5 per cent in 2001. Although a substantial deceleration in the export growth for both Japan and the United States is expected, export growth of the European developed economies is likely to hold at 7 per cent, because these countries trade mostly among themselves and, on present growth forecasts, internal demand will continue to prop up such an expansion.

In contrast, growth of exports from many developing economies is expected to slow markedly, as the United States is the destination for 27 per cent of their overall exports, from about 15 per cent in 2000 to 5.5 per cent in 2001. Across the sub-groups, export growth in South and East Asia is expected to slow by more than 10 percentage points. But several economies of the group, including the Republic of Korea, Taiwan Province of China and Thailand, must reckon with even larger decelerations because a large share of their exports is ICT-related. Latin America is expected to experience a moderation in export growth by about 5 percentage points.

For many developing economies with a large share of so-called "processing trade," including China, Mexico and other countries in Asia and Latin America, both their exports and imports are likely to decelerate significantly in the current global downturn. The level of processing trade depends directly on the state of affairs in the transnational companies that contract for such trade. When the latter's export orders slow down, imports of parts and materials will also decelerate. Such a contraction in the volume of processing trade may well not have a comparable impact on GDP growth, since the margin of value-added in processing trade is typically low. However, unemployment would rise and could thus exert indirect effects on feasible GDP growth.

The direct impact of the downturn in the United States is expected to be limited for both exports from and imports by many economies in transition. While export growth for many CEE economies is expected to slow from above the 10 per cent recorded in 2000 to 7-8 per cent, export growth of the CIS is expected to moderate from 8 per cent in 2000 to 1 per cent in 2001.

A significant upturn or downturn in the global economy usually involves an adjustment in external balances across countries. The current downturn could signal the beginning of adjustment in the large United States trade deficit. Over the last decade, trade and current account deficits in the United States have been growing constantly, to reach $450 billion on current account in 2000, or 4.5 per cent of GDP. Slower aggregate growth will narrow external deficits. Its significance for the rest of the world depends on the magnitude of the adjustment as well as the manner in which it is brought about.[3]

In other developed economies, while Japan and most European developed economies other than Spain and the United Kingdom continued to register sizeable external surpluses in 2000, Australia and New Zealand maintained large external deficits relative to their GDP. In the outlook, the United States trade deficit is expected to shrink only marginally. As the total value of imports of the United States is about one third larger than the value of its exports, exports need to grow much faster than imports over many years to reverse the deficits. For the developed economies as a group, a small improvement in the external balance is expected for 2001.

External balances for most developing economies actually improved over the course of 2000. The crisis-affected economies in Asia continued to rebuild their foreign reserves on the strength of large external surpluses in many cases. Many oil-exporting developing economies in Africa and Western Asia enjoyed a remarkable increase in export revenues. While trade balances in many Latin American economies also improved in 2000, current account deficits relative to GDP for several of the large economies remained large. In the outlook, some deterioration in the external balance is expected in 2001 for almost all developing economies.

For the economies in transition, a large increase in external surplus for the CIS, especially for the Russian Federation, was in contrast to a general deterioration in external deficits for most CEE economies. In effect, several major economies in CEE are running a deficit at about 5 per cent of GDP. The Baltic countries, however, experienced a substantial improvement in 2000 in their current accounts, although they still recorded deficits. While the surplus for Russia is expected to decline somewhat in 2001, deficits for the Baltic and CEE economies are expected to widen.

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[3] Some core issues related to adjusting the United States external deficits with its potential impact on the global economy are explored in Pingfan Hong, "Global implications of the U.S. trade deficit adjustment" (New York: DESA, February 2001, mimeo).

External financing for developing countries and economies in transition: no improvement

The amount of capital flows and the cost of borrowing for these economies are determined by various factors, including their domestic fundamentals and economic and financial developments in major developed countries. Currently, the unsettled state of financial markets in developed countries seem to be the dominant force. In consequence of the large sell-off in equity markets of developed countries and the deteriorating outlook for global economic growth, external financing conditions for developing countries and economies in transition have been experiencing greater obstacles since the second half of 2000. However, the present situation continues to be much better than what prevailed in 1997-1998, if only because the current economic setback precisely emerged in developed countries, the United States in the first instance.

In the baseline outlook for 2001, a slight increase in net private capital flows to emerging markets is expected, although the level will still be far below the peaks registered prior to the 1997-1998 Asian financial crisis. However, the ongoing monetary easing in many developed economies is reducing the cost of external borrowing to some degree. But the uncertainties and risks of such financing are inextricably linked to developments in financial markets and the overall economic health of major developed countries. The substantial moderation of export growth for developing countries and economies in transition discussed above is likely to increase their demand for external financing in 2001. On the other hand, continued poor performance in major financial markets may further weaken confidence of international investors, thus raising the hurdles for securing access to external financing. As a result, the overall assessment in the outlook of external financing conditions for emerging markets remains cautious.

Total net capital flows to emerging markets registered a small decline in 2000 from the previous year, as a moderate rise in net private flows was offset by a decrease in official flows. In addition, the composition of inflows of and the conditions for access to external financing across regions have exhibited different trends. In the outlook, net private flows are expected to increase slightly, while official flows are anticipated to rise markedly as a result of the financial assistance packages for Argentina and Turkey.

FDI in 2000 fell to $128 billion[4] from $143 billion in 1999. It nevertheless continues to be the most stable and the largest component of total capital flows to developing countries and economies in transition. As in earlier years, for the developing countries, the bulk of inflows remains highly concentrated on just a few large economies in Asia and Latin America. The decline in overall flows of FDI in 2000 stemmed almost exclusively from the near 30 per cent drop in flows to Latin America.[5] Asia registered a slight decline in 2000, as investment to the Republic of Korea and Thailand fell; but FDI to China, which receives about one third of the total FDI to developing countries and economies in transition, remained at the same level. In contrast, FDI to Africa and to economies in transition continued to rise, though from a low base.

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[4] All capital flow data in this section follow the definition of the Institute of International Finance (IIF).

[5] Note, however, that much of this was attributable to the reclassification of one large FDI transaction for an oil company in Argentina in 1999.

FDI is expected to increase slightly in 2001, as an upturn in foreign investment commitments has recently been registered.

Similarly, portfolio equity flows to developing countries and economies in transition were also subdued in 2000, largely on account of the sharp retrenchment in equity markets in developed economies, especially in the second half of 2000. Equity markets in the two groups of countries have become increasingly interlinked, leading to a high correlation in their fluctuations. In effect, average prices of equity markets in developing countries and economies in transition as a whole, when measured in U.S. dollars, fell by 30 per cent in 2000, worse than the average performance of equity markets in core developed economies. This result owes much to the fact that many equity markets of developing countries are technology intensive, and thus highly correlated with the performance of the NASDAQ market in the United States. That plummeted precipitously during 2000 and has continued to shrink in early 2001.

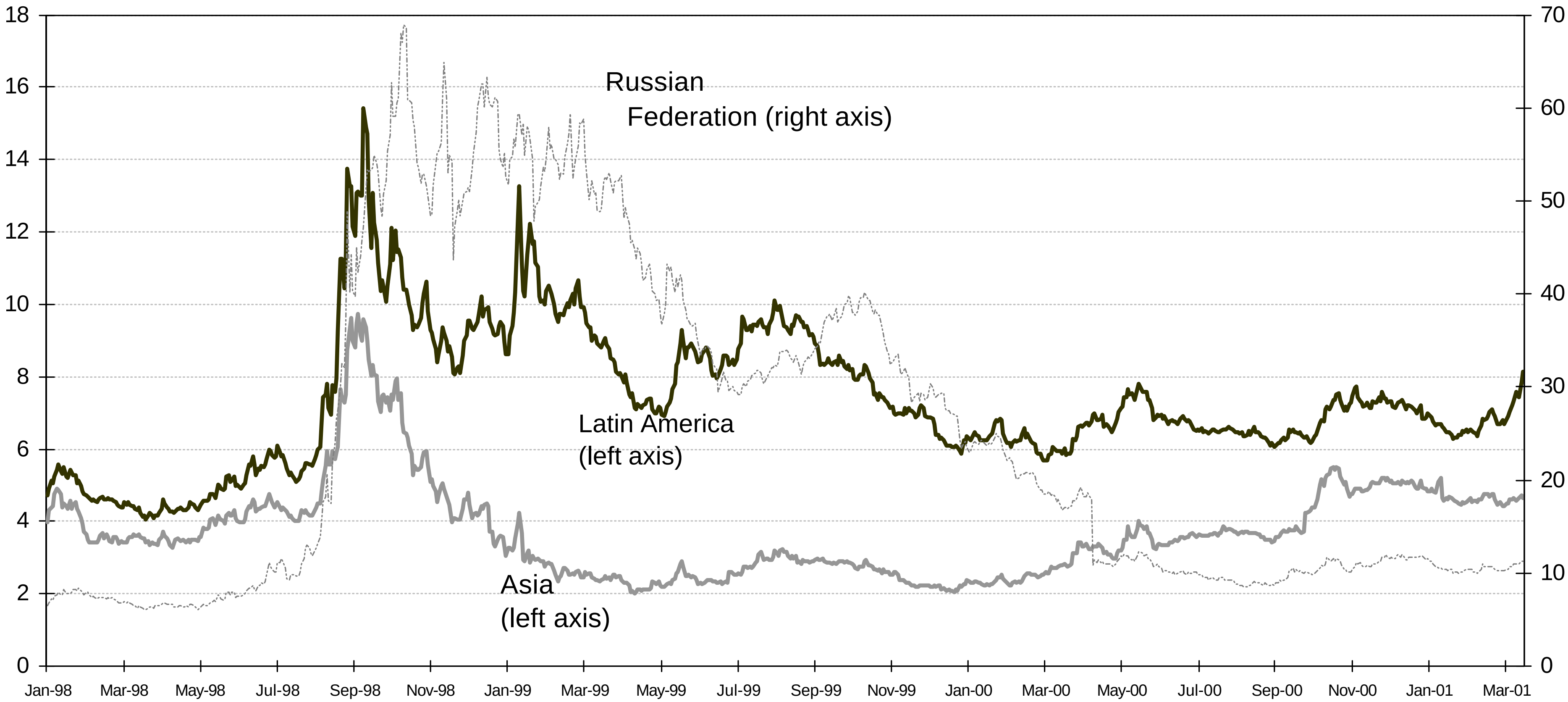
Except China and a few other countries, equity markets in most developing countries and economies in transition registered negative returns. As a result, many of these countries experienced net outflows of portfolio equity investment. Brazil and China were two exceptions. Portfolio equity inflows into these countries rose markedly in 2000, driven by offshore equity issues. The situation became worse in the first quarter of 2001, however, as global equity markets experienced a broader downward adjustment. Therefore, the outlook for portfolio equity flows to these emerging markets is not upbeat.

The group experienced net outflows to international commercial banks, whose lending shrank for the third year in a row since the Asian crisis of 1997. Net payments to these banks totaled $16 billion in 2000, less than the $43 billion in 1999 and $54 billion in 1998. The outflows have been concentrated in South and East Asian economies, especially Indonesia and Thailand. Net payments to banks are expected to be flat in 2001, as bank lending to some countries has turned positive.

Net flows of non-bank private sector lending to these countries also fell in 2000 to $20 billion from $28 billion in 1999, largely because of the financial crises in Argentina and Turkey since the last quarter of the year, which substantially limited access to international capital markets for other countries in the group. In effect, bond issuance by these countries picked up in early 2000, but faltered in the fourth quarter. The latter turned out to be the weakest quarter since the 1995 Mexican crisis. While a large part of the decline in net non-bank lending was concentrated in Latin America, some Asian countries such as India and the Republic of Korea were able to register a slight increase. By region, Latin America still dominated bond issuance in 2000, led by Argentina, Brazil and Mexico. Turkey was also one of the largest issuers earlier in 2000. By sector, issuance by the public sector accounted for 87 per cent of bond issues during the year. A further decrease in non-bank lending to developing countries and economies in transition is expected in 2001, as access to bond issues in international capital markets by some large borrowers will be limited.

The borrowing cost for those countries, as measured by yield spreads on J. P. Morgan Emerging Market Bond Index (EMBI), has been on an upward trend since the beginning of 2000 (see chart 1). A significant widening in the spreads occurred between September and November

Chart 1. Yield Spreads on Emerging Market Bonds,
2 January 1998 to 23 March 2001
(Percentage points)



Source : Data of JPMorgan Co.,New York.

as confidence of international investors was adversely affected by the strains in global financial markets stemming from the sell-off in world equity markets and the financial crises in Argentina and Turkey. There has been some improvement in the spreads since central banks in some major developed countries started to cut interest rates at the beginning of 2001. Another widening happened in March 2001, however, as uncertainties continued to mount due to the turmoil in Argentina. Nevertheless, the average spreads for developing countries and economies in transition are still much narrower than at the peak of the 1997-1998 Asian and Russian crises, implying a noticeably different degree of risks aversion on the part of international investors. Meanwhile, the sub-indices of the spreads reflect differentiation across regions and countries: spreads for Russia have improved significantly since early 2000, partly reflecting the improved liquidity conditions from increased oil revenues; the widening spreads in March 2001 were concentrated for Argentina, whose contagion effects have so far been limited. In the outlook, spreads are expected to move downward over 2001.

Inflation: remains under control

The slowdown in the pace of economic growth worldwide can be expected to remove some of the upward inflationary pressures that built up in the second half of 2000 in many economies. The global inflation outlook for 2001 therefore remains intrinsically benign. However, headline inflation rates in many countries may still move upward in the near-term as the pass-through of the high energy prices observed since early 2000 to other economic activities is likely to continue in the first half of 2001.

Headline inflation rates in many developed economies have shown a noticeable rise since the second half of 2000. Most economies, except Japan, registered annual inflation rates in the range of 3 to 4 per cent in 2000, about 1 percentage point higher than the inflation rates observed in 1999; the same pace continued in the first quarter of 2001. High oil prices, rising food prices, and the upward drift in unit labour costs have been the main causes for the rise in inflation in these countries. In addition, weakening currencies in many of these economies exacerbated the situation. This was especially the case for Australia, New Zealand, and the euro-zone countries, where currencies depreciated considerably against the U.S. dollar in 2000. The rise in core inflation, that is, removing products with volatile prices, such as energy and food, and changes in taxes on goods and service from the index computation, has so far been milder than the change in headline inflation. In the outlook, annual inflation rates for most developed economies are expected to drop below 3 per cent by the end of 2001 as a result of weakening demand and softening oil prices. Of course, as oil prices soften, the driving force that made headline inflation diverge from core inflation will peter out as well, leaving the two in closer harmony.

Inflation prospects for developing countries and economies in transition remain stable in general, but some divergent trends among these economies have recently come to the surface. On the one hand, the trend of disinflation in a number of economies where inflation rates had been high in the past few years, such as a number of countries in Latin America and members of the CIS, continued over 2000 and into early 2001, as inflation stabilization remains a key policy objective. On the other hand, many economies in South and East Asia, and in the CEE and Baltic regions have experienced a moderate rise in inflation rates for reasons quite comparable to those that help explain the price drift in many developed economies—basically high oil prices and, in several cases, weak currencies. Some African economies have also experienced upward movement in inflation.

In the outlook, continuation with structural reforms in many developing countries and economies in transition, with the aim in particular of improving efficiency and reaching sounder macroeconomic management, are expected to reduce inflation rates further in those high-inflation countries while keeping inflation from rising elsewhere.

In Japan, deflation has been a major policy concern for the past several years. Mild deflation is expected to continue for some time to come despite the recently adopted shift in monetary policy stance, towards a reflationary bias. Meanwhile, deflation in Hong Kong SAR is expected to reverse by the end of 2001.

There is one caveat to this benign inflation outlook. Weakening demand in developed economies, particularly in the United States, should imply an easing of price pressures. However, if productivity growth were to slow down substantially along with the cut in investment spending on technology, the risk of rising unit labour costs, and thus rising inflation, cannot be ruled out. That is a scenario for stagflation—slow to negligible growth accompanied by worsening inflation.

Employment: a mixed trend

The impact of the current global slowdown on employment will vary across countries and regions, depending on the flexibility of labour markets and economic structures—especially the importance of exporting sectors and of manufacturing.

In developed economies, the tight labour market in the United States has not so far been eased by the sharply slowed economy as increasing employment in services is offsetting job reductions in the manufacturing sector; many of the announced layoffs have yet to be enacted. But also other adjustments have been made that tend to distort the reported employment picture: part-time work, shortening of the workweek, voluntary “holidays,” and sharply lower overtime. However, over the course of 2001, the unemployment rate is expected to rise from the current 4.2 per cent to about 5 per cent, as already announced layoffs materialize. The unemployment rate is also expected to rise in Australia and Canada. By contrast, recent improvements in Western European labour markets are not expected to be reversed. The average unemployment rate in the European Union in 2000 dropped by more than one percentage point to below 9 per cent. It is expected to decline further in 2001, but at a slower pace. The solid growth in employment recently booked in many Western European economies has resulted not only from relatively strong output performance, but also from longer-term structural improvements in labour markets enacted by several of these economies. The outlook for employment in Japan remains gloomy in the short run, as the ongoing corporate restructuring and the fragile growth picture drawn in the outlook are such that they do not suggest any strong improvement in the unemployment rate any time soon.

The employment situation in developing countries and economies in transition varies considerably. In Asia, the unemployment rate continued to fall in line with the recovery in economic growth for most part of 2000. Data for more recent quarters, however, indicate a mild reversal of that trend in a number of Asian economies, due to weakening industrial production and exports. The unemployment rate in several crisis-affected economies, especially Indonesia, continues to surpass the magnitudes prevailing before the outbreak of the crisis. The large number of layoffs in China from the state sector remains one of the most daunting policy concerns. Unemployment rates in most Latin American countries are high, except in Mexico, where the official unemployment rate (urban sector only) has stayed below 2.5 per cent since 1999. While a few Latin American economies such as Brazil, Chile and Venezuela have managed to improve slightly their rate of unemployment in the course of 2000, unemployment rates in such countries as Argentine and Colombia, where they were already at double-digit levels, have recently worsened. The worst situation prevails in Africa, where the large number of unemployed (urban unemployment rates are in the range of 15 to 20 per cent, or worse) and underemployed has been the major cause of poverty and related problems in the region. Unemployment rates in Russia, CEE and other economies in transition on average remain at very high levels. However, there was a marked decline in Russia's unemployment rate in 2000—the first time in many years.

Major assumptions

In preparing the baseline forecast, on which the LINK outlook is predicated, many assumptions had to be made, including on the trend of international prices of commodities, on the prospects of monetary and fiscal policies in individual countries, and on exchange rates, especially the cross rates for major currencies. This section summarizes the major assumptions. More detailed information can be found in the LINK *Outlook Tables* and in the LINK *Country Reports*.

Commodity prices

The downturn in the intensity of global economic activity has been putting downward pressure on international commodity prices since the beginning of 2001, especially on the prices of metals and oil, as industrial production in many economies declined or sharply decelerated. The probability of a replay of the deep deflation in a broad range of commodity prices, such as experienced during 1998-1999, however, is not very high in the outlook.

After a surge of 60 per cent in 2000 to its highest levels in a decade, oil prices are expected to soften in 2001, but only moderately. More specifically, the price of Brent oil is assumed to fluctuate around $25 per barrel for the remaining three quarters of 2001, implying an average decline of 5 per cent over last year's average price. A slight uptick, about 4 per cent, in 2002 is factored into the baseline forecast.

Against the backdrop of weakening global oil demand and strength in non-OPEC supply, OPEC cut production quotas twice in early 2001, totaling 2.5 million barrels per day (bpd). OPEC is expected to adjust supply further to keep prices within the targeted range of $22 pb to

$28 pb. However, several factors could push prices lower than the level assumed in the outlook: a sharper than expected global slowdown with recession in major developed economies, problems of agreed-quota compliance by OPEC members, increase in Iraqi exports; and a rise in non-OPEC production and export capacity. Moreover, oil prices in 2002 could decline further from the estimated 2001-2002 levels, as the still ongoing expansion of investments in oil-producing countries will bring new production capacity on line.

With a moderate rebound in 2000, the prices of metals and industrial raw materials are expected to continue the ongoing decline, with some rebound in the second half of 2001, once economic growth in major developed economies will start to recover. The price index of 31 commodities in the SITC 2 and SITC 4 categories is expected to be flat in 2001, followed by a rebound of 2.2 per cent in 2002. Prices of base metals such as aluminium, copper, nickel and zinc registered a solid recovery in 2000. Especially the price of nickel surged—by 40 per cent. Also these prices have been declining since the beginning of 2001. Although energy-related supply constraints in the production of aluminium and copper may provide some price support, risks are biased towards substantial supply surplus for most base metals, given the broadening weakness of demand, especially in the first half of 2001. The prices of agricultural raw materials such as cotton, wool and rubber also enjoyed a notable recovery in 2000. They are expected to remain flat in 2001, however. It bears stressing that the prices for most metals and raw materials are still well below the levels registered prior to the Asian crisis.

Prices of food and beverages experienced a divergent trend during 2000, as a rebound in the prices of sugar and some grains was accompanied by a sharp decline in the prices of coffee and cocoa. In the outlook, the price index of 11 commodities in the SITC 0 and SITC 1 categories is expected to increase by nearly 3 per cent, because grain prices are likely to rise. The prices of most agricultural products are still on a long-term downward trend and remain far below the levels that prevailed prior to the Asian crisis.

Monetary policy

Monetary policy in many economies has been very active, in the sense that policy makers enacted frequent adjustments in policy interest rates in an attempt to fine-tune the pace of economic activity. This was perhaps in part in consequence of the increasingly complicated environment for national policy-making, given rapid technological and financial innovations, and intensifying global economic integration. As shown in table 3, central banks in many developed economies aggressively tightened monetary policy between mid-1999 and mid-2000 by raising interest rates substantially. As the downturn intensified at the beginning of 2001, however, many central banks, led by the Fed, which cut interest rates by 150 bps in the first quarter, started a new easing cycle.

In the outlook, monetary easing is expected to continue in most developed economies. The Fed is assumed to make another cut of 25 bps in the second quarter of 2001 and thereafter to keep interest rates constant until mid-2002. The European Central Bank (ECB) is assumed to follow this move by a cut of 25 bps in the second quarter, the last major central bank to lower

Table 3. Share of exports going to the United States
(In per cent of 1999 U.S. dollar values)

	Change in the last tightening cycle (mid-1999 to end-2000) (bps)	Change in the current easing cycle (January to end-March 2001) (bps)	Current level (End-March 2001) (per cent)
Australia	150	-75	5.5
Canada	125	-75	5.0
Denmark	240	-10	5.3
Euro Zone	225	0	4.75
New Zealand	200	-25	6.25
Norway	150	0	7.0
Sweden	100	0	4.0
Switzerland	175	-25	3.25
United Kingdom	100	-25	5.75
United States	175	-150	5.0

interest rates, and thereafter to hold policy interest rates constant. Central banks in other developed economies are expected to reduce interest rates by varying amounts. The United Kingdom, for example, lowered its policy interest rate by another 25 bps on 5 April. So did Australia with another 50 bps earlier that week. Presumably, further changes may be in the offing.

Recent changes enacted in the policy regime of the Bank of Japan (BoJ) are worth noting. After maintaining a policy of near-zero interest rates for about a year and half, the BoJ raised the targeted overnight rate by 25 bps in August 2000—the first monetary tightening in a decade. Since the beginning of 2001, however, the BoJ rapidly reversed the course of tightening by reducing policy interest rates and introducing a stand-by lending facility ("Lombard-type"), through which it can extend loans at the requests of financial institutions at the official discount rate at pre-specified conditions.

As more signs of a deteriorating economic environment came to the fore in March 2001, the BoJ introduced some unorthodox measures. First, it shifted the target of monetary operations from the overnight interest rate to the central bank's mass of liquid assets available for intervention purposes. The volume of these assets was raised by 25 per cent, from 4 trillion yen to 5 trillion yen. As a result, the overnight rate, which had previously been targeted but is no longer, is expected to decline to zero. Second, although a formal inflation-targeting framework was not adopted, the central bank decided to use the CPI as a major guideline for the duration of the new monetary easing until a stable CPI exceeding zero inflation will have been reached. Finally, it decided it could increase its outright purchases of long-term government bonds to ensure the smooth supply of liquidity.

The monetary policy stance in developing countries and economies in transition varies. Central banks in a large number of these economies (including Chile, Hong Kong SAR, India, Poland, the Republic of Korea and Taiwan Province of China) have started easing as more signs are pointing to weakening growth in these economies. More such action is expected if the current deceleration continues. However, interest rates are still relatively high in many of these economies, notably in Central and Eastern Europe and Latin America, because of inflation pressure; macroeconomic imbalances; and the potential for devaluation of the national currency. These are limiting the central banks' room for manoeuvre to compress interest rates.

Fiscal policy

Fiscal policy in most developed economies is expected to be moderately relaxed in 2001 as a result of tax reductions or increases in government spending, or both. A majority of developed economies, Japan being an exception, registered a budget surplus in 2000. The underlying fiscal policy has recently been revised so that it can now play a more active role in countering the evolving economic slowdown. Several developed economies have already cut taxes or adopted tax reforms in which tax cuts are one component of the package. Other developed countries are planning to follow suit.

Fiscal balances are expected to deteriorate notably in most developed economies during 2001-2002: revenues will decelerate or fall because of the tax cuts and the downturn in general economic activity, and expenditure will rise either because of increases in discretionary spending or as result of predefined automatic stabilizers, or both. Meanwhile, the large government deficit of Japan is expected to continue in 2001-2002 or be somewhat aggravated by a new, if modest fiscal stimulus package.[6]

Fiscal positions for most developing countries and economies in transition are in deficit, although a number of these economies managed to reduce the magnitude of the shortfall in 2000 either by raising revenues, as for oil-exporting economies, or through expenditure adjustments, as for several Latin American countries. The current economic slowdown, however, is expected to worsen the deficit of many of these economies in 2001, leaving policy makers of these countries only limited room for expansionary fiscal policy to counter the evolving growth slowdown. Moreover, large fiscal deficits and high debt-to-GDP ratios in several economies of this group have been posing a threat to macroeconomic stability, as shown spectacularly by the recent financial crises in Argentina and Turkey.

Exchange rates

The current downturn in global economic growth has also been accompanied by a sizeable realignment of parities among major currencies. After a fairly stable period in the first half of 2000, volatility in foreign exchange markets has increased markedly since the third quarter of 2000. As soaring oil prices raised the threat of a slowdown in the sustainable level of economic activity in many economies and of worsening inflation in Europe, given the euro zone's dependence on oil imports and the then expectation that Europe's economic activity would be affected worse than that of the United States, and in some other countries, a mini currency crisis erupted in September. It entailed a marked devaluation of several currencies, including the euro, the Australian dollar, the New Zealand dollar, and a few other Asian currencies. The euro slumped to below \$0.85 as compared to \$1.16 at the currency's debut in January 1999.

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[6] A new stimulus package was unveiled on 6 April 2001, too late to be incorporated in the forecast and narrative.

Volatility has continued during the first quarter of 2001, with depreciations of more currencies of developing countries and economies in transition. Turkey was forced to float its currency. As the global economic slowdown continues, volatility is expected to remain a feature of foreign exchange markets in 2001, with devaluation pressure mounting on a number of currencies. Whether the recent polarization of exchange rate regimes in developing countries and economies in transition, towards either free floating or strictly fixed, will survive, given the large external shocks currently crystallizing from the global slowdown, remains to be seen. Those still adhering to intermediate regimes are likely to face downward pressures on their exchange rates.

Recent events have shown that neither fixed nor floating regimes can prevent monetary instability, whether a foreign exchange crisis or a domestic bank or debt crisis. Even the future of Argentina's currency board may prospectively have to be repealed for the current stabilization efforts to succeed in bolstering growth.

Regarding the exchange rates between the three major currencies, the long anticipated recovery of the euro against the U.S. dollar finally began to take hold in December of 2000 and January 2001, as the magnitude of the dramatic downturn in the United States economy began to crop up in monitoring statistics. However, the euro's appreciation did not last, and its dollar value has since dropped again below $0.9. Nevertheless, given the prevailing fundamentals of the outlook, the current LINK forecast continues to call for a rebound of the euro. There are several reasons behind this assumptions.

First, the recent slowdown of the United States economy has become more pronounced so that the growth differentials will reverse, thus supporting a stronger euro. Second, interest rate differentials between the U.S. dollar and the euro are expected to turn around in favour of the euro, which should lift the latter's U.S. dollar value. Third, inflation differentials in the outlook between the United States and the euro area favour the euro, though this is likely to be more a longer-term factor. Fourth, similarly, the large and growing external deficits of the United States are not sustainable and will need to be reversed, meaning that capital outflows from Europe will decelerate or perhaps even reverse. Finally, the recent rate of the euro in terms of the U.S. dollar, relying on fundamentals, would seem to have overshot perhaps in view of the lack of confidence in the euro and its supporting institutions at the still early stage of the single currency's existence and management. As a track record with the euro's monetary policy and performance is being built up, the currency's value should firm and come more in line with the underlying economic fundamentals.

Therefore, in the baseline, the euro is expected to appreciate gradually against the U.S. dollar to reach parity by the end of 2002. However, it bears to stress, relying on recent exercises aimed at forecasting short-term fluctuations in exchange rates, that predicting the path of such variations over time has not been very successful. It remains a fiendishly difficult task—more speculation than an art, and hardly a science. Inasmuch as the euro's recent weakness appears to stem to a considerable degree from lack of confidence in the currency and less than robust credibility on the part of the ECB and European monetary policy more generally, the cited fundamentals may well fail to sway market makers.

The yen has been weakening *vis-à-vis* the U.S. dollar since late 2000. It recently reached 126 yen/dollar, the lowest rate in two years. The baseline assumes an average rate of 125 for the rest of 2001.

Assumptions for the exchange rates of other currencies can be found in the *LINK Aggregate Tables.*

Uncertainties and risks of the forecast

The LINK baseline forecast implies a fairly fast economic recovery in the United States, allowing global growth to return to its long-run pace of 3 per cent in 2002. However, there are substantial uncertainties and several downside risks that might lead to the unfolding of a worse scenario than underlies the baseline forecast. The biggest risk for the global economic outlook would be a deeper and longer downturn in the United States, and a larger spillover to the rest of the world through sharp adjustments in the current account deficit of the United States.

The large trade and current account deficits of the United States, which reached $450 billion in 2000 or 4.5 per cent of GDP, have aggravated concerns about their sustainability and the consequences of any drastic reversal. Recent studies reported that a typical current account reversal in developed economies has tended to start when the current account deficit reaches about 5 per cent of GDP and that the nature of the reversal is a combination of slowing aggregate economic growth and a significant depreciation of the exchange rate.

The sustainability of the prevailing levels of trade and current account deficits in the United States depends, to a large extent, on the ability of domestic policy makers and economic agents to continue borrowing abroad. The total foreign debt owed by United States agents, as measured by the country's net foreign investment position, stands at about 20 per cent of GDP, which is still well below the ratio of 40 to 50 per cent, or even more, that several developed economies reached in the 1990s. However, export intensity and foreign debt point to a potentially more worrisome feature. Since the share of output of the United States that is in effect traded is around 25 per cent of GDP, the foreign debt already constitutes about 80 per cent of the tradable GDP in the United States. This suggests that the external deficits will need to be compressed rather sooner than later.

At issue, then, is how these large deficits will be reduced. Will it be accomplished mainly through cuts in domestic absorption, notably investment, or through a rise in domestic savings, since the current account deficit mirrors the difference between saving and investment? Will the adjustment be an abrupt reversal or a smooth process?

A few model simulations have been carried out to study different paths of the deficit reversal. Among them, a gloomy variant assumes that the adjustment will be accomplished mainly by correcting the private sector's saving-investment imbalance through reductions in domestic absorption in the United States.

The main results of the simulation are shown in table 4. The trade deficit of the United States is reduced by more than $200 billion (about half the total deficit) from the baseline over two years. The deficit reduction would mainly be induced by depressed import demand, which declines by $224 billion as a result of a drop in consumption by 5.7 per cent in combination with a decrease in private investment by 14 per cent (deviations from the baseline).

Table 4. Results of a simulation of a sharp reversal of the United States trade deficit
(Deviations from the baseline)

Countries and regions	Change over two years
United States	
Trade balance (billion $)	+$206
Imports (billion $)	- $224
GDP (%)	- 4.6
Consumption (per cent	- 5.7
Private investment (per cent)	- 14
Exchange rate (per cent)	- 15
Unemployment rate (percentage points)	+ 2
Inflation rate (percentage points)	-2.7
World trade (billion $)	- $307
World trade (per cent)	- 4
Trade balances (billion $)	
Canada	- $39
EU	- $47
Japan	- $31
Developing economies	- $75
Latin America	- $30
South and East Asia	- $25
World GDP (per cent)	- 1.7
Developed economies	- 1.8
Developing economies	- 1.6

The results imply that the larger part of rebalancing the U.S. private-sector saving-investment gap would be accomplished by cutting investment and the smaller part by raising the saving rate. This would probably be the worst case that most economists are prepared to entertain as plausible: reducing investment would not only mean a decline in domestic demand in the current period but a smaller capital stock in the longer run, thus lower income growth in the future. The table shows that the scenario implies a loss of GDP by about 4.6 per cent over two years. It also shows that the impact on other macroeconomic measures for the United States economy would be palpable.

Through international linkages, the deflationary impact on the global economy would also be significant: total world trade (exports) would be reduced by more than $300 billion, or 4 per cent, from the baseline. Mirroring the reduced external deficit of the United States would be the deterioration of trade balances in many economies. For example, the trade surplus of the European Union and Japan would be reduced by $47 billion and $31 billion, respectively. The adverse effects on many developing economies would also be considerable. While developing countries as a group would experience a $75 billion drop in their trade balance, the larger impact would be on countries in South-East Asia and Latin America. Measured relative to GDP, the cost for the global economy of this scenario is a decline of about 1.7 per cent from the baseline over two years, or $600 billion.