I THE WORLD ECONOMY IN 2003

The world economy has not yet recovered from its slowdown in 2001. Gross world product (GWP) increased by less than 2 per cent in 2002, marking a second consecutive year of growth substantially below potential. China and India, together with a number of economies in transition, were notable exceptions to the sub-par performance that characterized the majority of the world's economies. More generally, as in 2001, a substantial number of developing countries, as well as a few developed countries and economies in transition, experienced a decline in output per capita. Overall, the first few years of the new millennium have been a development disappointment for the majority of developing countries and an absolute setback for a number of them.

A global recovery is now forecast for the second half of 2003, with GWP expected to increase by 2 per cent for the year as a whole, accelerating to slightly above 3 per cent for 2004. The developed countries, most notably the United States of America, are expected to lead the recovery and to provide a stimulus to the rest of the world. However, world trade and international financial flows will continue to be sluggish by the standards of the 1990s, with exports growing by less than 4 per cent in 2003. Moreover, the stimulus provided by the United States will be reduced for many countries if the recent depreciation of the dollar against their currencies persists. Under these circumstances, few developing countries are expected to return to their desirable longer-term rates of growth before the end of 2004. The economies in transition, in contrast, have been relatively resilient in the face of this slowdown and are expected to remain so.

The world economy was beset by heightened geopolitical uncertainties in late 2002 and early 2003. Such factors continue to pose a downside risk to global economic growth, but this risk diminished substantially in the second quarter of 2003. A new non-economic shock — severe acute respiratory syndrome (SARS) — jolted economic activity in some countries in early 2003 but appears to have been largely contained. On the other hand, there remain some well-identified economic risks that could pose a threat to short-term global growth. The most important is linked to the nature of the inevitable adjustment of the United States external deficit, a process that appears to have started with the depreciation of the dollar. A second, related challenge is the possibility of deflation in a growing number of countries. In addressing these immediate threats, policy makers should not neglect the agenda that they have established to address longer-term global development issues.

DELAYED RECOVERY

It was expected that a recovery from the global economic slowdown of 2001 would begin in the United States in the second half of 2002 and gradually accelerate and spread throughout the world economy. There was a tentative recovery in 2002, but it quickly faded, largely because of the geopolitical uncertainties associated with the looming confrontation with Iraq.

The heightened geopolitical uncertainties and perceived risks that arose before the invasion of Iraq permeated the world economy through a number of channels. The fear that conflict might disrupt oil supplies raised the prices of oil far higher than warranted by economic fundamentals; higher oil prices were themselves a global economic shock that dampened aggregate demand and imposed additional price pressures in oil-importing countries. Global political tensions caused most equity markets to plummet, aggravating the global asset price deflation that had been in effect since 2000. In several countries, consumer and business confidence fell to their lowest levels in a decade. Business capital spending declined in many developed economies. Economically, the overall effect of the stand-off with Iraq was reduced activity in late 2002 and early 2003, with the setback being most pronounced in the developed countries (see table I.1). Instead of recovering as anticipated, growth in these countries in the first quarter of 2003 was generally lower than a year earlier.

With the exception of Western Asia, the developing countries and economies in transition were less directly affected by the geopolitical uncertainties surrounding the issue of Iraq. Nevertheless, indirectly, the delayed recovery in the developed countries itself had negative consequences. In some cases, most notably in Latin America, these were aggravated by domestic difficulties. To a greater extent, however, domestic economic circumstances in developing countries and particularly in the economies in transition served as a buffer against the weak external environment. China and India offered the most pronounced examples of this but most of the economies in transition also demonstrated an important degree of domestically led growth. To a lesser extent, sub-Saharan Africa displayed similar signs of resilience, although growth remained modest.

The invasion of Iraq took a heavy toll on human life and economic activity in the region. Nevertheless, the military action was briefer, less costly in human life, less extensive and less disruptive of global economic activity than had been feared, with the result that several of the earlier negative manifestations of the previous geopolitical uncertainty were quickly and measurably reduced. Oil prices retreated and are expected to fall further as global oil production recovers, with beneficial effects on global growth and on inflationary pressure in oil-importing countries. Equity prices rebounded in the post-invasion period, reflecting and contributing to increased optimism regarding economic prospects. There was also a post-conflict recovery in the indices of both consumer and business confidence. Most of the negative consequences of the earlier geopolitical uncertainties are expected to dissipate by the third quarter of 2003.

In addition, a number of the positive factors that were expected to prompt a recovery in 2002 remain in effect. The most important are the continuing stimulative effects of macroeconomic policy. Policy interest rates in the developed countries continue to be low, with some limited room for further loosening in some cases. Most developed countries are also benefiting from fiscal stimuli, with further fiscal

Table I.1.
GROWTH OF WORLD OUTPUT AND TRADE, 1994-2004

Annual percentage change

	1994	1995	1996	1997	1998	1999	2000	2001	2002[a]	2003[b]	2004[b]
World output[c]	3.1	2.8	3.2	3.5	2.2	2.9	4.0	1.2	1.8	2	3
of which:											
Developed economies	2.9	2.4	2.7	3.0	2.5	2.7	3.5	0.9	1.4	1¾	2½
North America	4.1	2.7	3.4	4.4	4.2	4.1	3.8	0.3	2.5	2½	4
Western Europe	2.7	2.3	1.6	2.5	2.8	2.7	3.3	1.5	1.0	1¼	2¼
Asia and Oceania[d]	1.3	2.0	3.5	1.9	-0.7	0.5	3.2	0.6	0.5	1	1
Economies in transition	-7.2	-0.6	-0.1	2.4	-0.8	3.4	6.7	4.4	3.8	4	4
Central and Eastern Europe	4.0	5.7	4.1	3.3	2.6	1.4	3.9	2.7	2.6	3¼	3¾
Baltic States	-4.7	2.2	4.2	8.4	5.8	-0.2	5.5	6.7	6.3	5½	5¾
Commonwealth of Independent States	-13.7	-5.1	-3.6	1.4	-4.0	5.5	9.3	5.7	4.7	4½	4¼
Developing economies	5.6	5.0	5.7	5.4	1.6	3.5	5.8	2.1	3.2	3½	5
Africa	2.5	2.7	5.2	3.0	3.0	2.9	3.1	3.3	2.9	3¼	4
Eastern and Southern Asia	8.4	8.1	7.3	6.0	0.5	6.3	7.1	3.7	5.7	5¼	6
Western Asia	-0.8	4.0	4.6	5.5	4.1	0.7	6.4	-1.2	2.0	1¼	3¾
Latin America and the Caribbean	5.3	1.4	3.7	5.2	2.0	0.4	3.9	0.3	-0.8	2	3¾
World trade	10.5	8.6	5.5	9.2	3.3	5.2	10.5	-0.9	1.8	4	7
Memorandum item:											
World output growth with PPP-based weights[e]	3.5	3.4	3.8	4.1	2.5	3.4	4.7	2.1	2.8	3	4

Source: Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA).

a Partly estimated.
b Forecasts, based in part on Project LINK, an international collaborative research group for econometric modelling, coordinated jointly by the Development Policy Analysis Division of the United Nations Secretariat, and the University of Toronto.
c Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 1995 prices and exchange rates.
d Japan, Australia and New Zealand.
e Employing an alternative scheme for weighting national growth rates of GDP, based on purchasing power parity (PPP) conversions of national currency GDP into international dollars (see introduction to annex: statistical tables).

relaxation already promised in some countries. Coupled with the wealth effects of a surge in house prices in some developed countries, these two policy stimuli should reinvigorate consumer demand during 2003. Cyclical inventory replenishment will also provide a boost, possibly more substantial than previously anticipated because it has been delayed. Excess capacity in the information and communication technologies (ICT) sector, which was previously a major disincentive to investment, is also being reduced with the passage of time, particularly with the more rapid rate of obsolescence that now characterizes the sector. These underlying cyclical factors, reinforced by the positive developments since the end of the conflict in Iraq, augur well for a recovery in the second half of 2003.

At the same time, a number of factors will dampen the speed of the recovery. In particular, the extension of the period of below-average growth has aggravated some earlier weaknesses. For example, the further increase in unemployment, particularly, the increase in longer-term unemployment, is likely to constrain the growth of consumer demand. Similarly, the hostile international political environment had a particularly adverse effect on some specific sectors, notably international tourism and airlines, which had not recovered from the fallout of the terrorist attacks of 11 September 2001. Some of these sectors are not expected to recover fully for some time; meanwhile, their weakened positions, including bankruptcies, are likely to have negative effects on growth more generally. These negative factors are likely to reduce the acceleration in growth to levels below those usually seen in cyclical upturns.

Among the developed countries, the United States was the most adversely affected by the heightened geopolitical uncertainties and, correspondingly, is benefiting the most from the return to normalcy. As in 2002, therefore, the United States is expected to lead the global economic recovery. No other major economy appears to be in a position to assume this role in the near future. Japan, for example, continues to face difficulties in extricating itself from its slow growth path while Germany appears to have entered a recession in early 2003. Most countries are explicitly looking for improved growth in the United States to act as a catalyst in revitalizing their own economies.

Recovery in the United States is expected to materialize in the second half of 2003 and to provide a stimulus to growth elsewhere. The depreciation of the dollar in early 2003, if sustained, will reinforce this recovery in the United States but will reduce the extent of the stimulus that United States growth provides to the rest of the world. Nevertheless, there will be an acceleration in the growth of world trade, to the benefit of all countries. Many developing countries are also benefiting from improved, albeit still historically low, commodity prices and some have the advantage of lower interest rates in international capital markets.

A widespread recovery is necessary because, while they may launch a recovery, the present positive forces in the developed countries, particularly the United States, are unlikely to be sufficient on their own to sustain a recovery throughout 2004. Business investment has been particularly sluggish over the past two years and will need to revive in order to sustain the momentum. The decline in excess capacity should increase the demand for new capital, while improved equity prices and higher profits as a result of the revival of consumer demand should ease its financing. Although low interest rates have not stimulated business investment to date, they should facilitate increased investment if other conditions improve. However, there is also a need for a more positive international environment, comprising improved international trade and a revival of international capital flows, in order to induce increased business spending.

A better external environment will enable the economies in transition to build upon their recent domestic strength. In the developing countries, improving external demand in the second half of 2003 and 2004 is expected to buttress recovery in Latin America and to provide additional support to steady but limited growth in Africa. Partially because of the effect of SARS in the early part of the year, growth will moderate in Southern and Eastern Asia in 2003 but will rebound in 2004. Similarly, the situation in Iraq will cause a slowdown in Western Asia before the recovery forecast for 2004.

A LACKLUSTRE INTERNATIONAL ECONOMIC ENVIRONMENT

Particularly when contrasted with the 1990s, both world trade and capital flows currently lack dynamism, reflecting and contributing to the overall weakness in the world economy. Having declined in 2001, **world exports** increased by only

2 per cent in 2002 and are expected to grow by less than 4 per cent in 2003, with expansion of some 7 per cent forecast for 2004 (see table I.1). The non-economic shocks to the world economy were detrimental to world merchandise trade, but above all to trade in such services as travel and tourism. In addition to there being a lower rate of growth of trade than in the 1990s, the ratio of the growth of merchandise trade to the growth of output, having tended to increase from about 2 towards 3 as a result of globalization, has reverted to the lower figure.

Having risen for more than a year, oil prices reached a 12-year high in mid-February 2003, but fell following the invasion of Iraq, largely because the disruption to the oil supply from the region was expected to be less serious than previously feared. For 2002 as a whole, the average price was similar to that in 2001 (see table I.2), but is expected to decrease in 2003.

With the slow growth of the global economy and international trade, average **non-fuel commodity prices** continued their downward trend in 2002. Within the total, adverse weather conditions reduced the supply and increased the prices of a number of agricultural commodities. The brief strengthening of global growth early in 2002 had improved the prices of most minerals and metals before setbacks reversed the gains after mid-year. Prices regained upward momentum towards the end of 2002. With the global economic recovery gaining momentum and with the weakening of the dollar, most non-fuel commodity prices are expected to strengthen during 2003 as a whole and in 2004.

There was a substantial movement in the exchange rates among the major currencies in mid-2002 and in the first few months of 2003, most notably a decline in the value of the United States dollar against the euro and, to a lesser extent, other

Table I.2.
INDICATORS OF THE INTERNATIONAL ECONOMIC ENVIRONMENT, 1998-2002

	1998	1999	2000	2001	2002
World prices					
Oil (price per barrel (dollars))[a]	12.7	17.8	28.3	24.4	25.0
Non-fuel commodities (1990 = 100; base year 1985)[b]	96.3	86.9	92.7	93.2	89.2
Manufactured export prices (1990 = 100)[c]	95	91	87	84	86
Trade-weighted exchange rate of US dollar (1997 = 100)[d]	116.5	116.9	119.7	126.1	127.2
Interest rate (US six-month LIBOR[e]) (percentage)[f]	5.6	5.5	6.7	3.7	1.9
Emerging market yield spread (percentage)[g]	11.5	8.2	7.6	7.3	7.7
International financial flows (billions of dollars)					
Net transfer of resources to developing countries	-33.7	-120.9	-179.3	-155.1	-192.5
Official development assistance	52.1	56.4	53.7	52.3	56.6
Foreign direct investment	128.0	133.0	125.6	145.3	110.0

a International Energy Agency, *Oil Market Report*.
b United Nations Conference on Trade and Development (UNCTAD), *Monthly Commodity Price Bulletin*.
c United Nations, *Monthly Bulletin of Statistics*.
d United States Federal Reserve.
e London Interbank Offered Rate.
f International Monetary Fund (IMF), World Economic Outlook Database, April 2003.
g J.P. Morgan Co. (Emerging Markets Bond Index Plus (EMBI+)).

major currencies. If this depreciation of the dollar is sustained, it will have major implications for global economic prospects (see below).

Net official financial flows to developing countries remained substantial in 2002 but this was mostly because of large International Monetary Fund (IMF) loans to a few countries facing financial pressures. More encouragingly, official development assistance (ODA) increased in 2002, not only in absolute terms but also, marginally, as a proportion of the gross national income (GNI) of donor countries. There were also pledges during the year of future increases in ODA, hopefully marking a turnaround in the downward trend that has characterized recent years.

Private international financial flows continued to be lacklustre in 2002 and no major improvement is expected in the short term. Among the developed countries, the global economic slowdown and the bursting of the bubble in equity markets have created a lull in international financial transactions, notably large cross-border mergers and acquisitions between companies.

For developing countries, official and private capital outflows and payments abroad associated with earlier inflows not only exceeded the corresponding receipts for the sixth consecutive year in 2002 but did so by a record amount. This net financial transfer has exacerbated the negative effects for developing countries of the slow growth in the real sectors of the developed countries.

Foreign direct investment (FDI) flows to developing countries initially withstood the global economic slowdown of 2001, possibly because of the lag between investment decisions and implementation. In 2002, however, global economic conditions and the slowdown in privatizations resulted in a fall in FDI flows to developing countries, with the notable exception of China. A major resurgence in these flows seems unlikely in the short term. FDI flows to Eastern European economies, on the other hand, continue to be robust, prompted not only by cost considerations but also by the prospect of their entry into the European Union (EU); these flows are expected to be sustained.

Reflecting their largely pro-cyclical nature as well as the poor geopolitical climate, other private capital flows to developing countries continued to be weak in 2002 and were exceeded by outflows. For those developing countries that are able to participate in international capital markets, the cost of international borrowing has tended to fall as lower interest rates in the developed countries have been coupled with lower “spreads” for borrowing developing countries, particularly since the invasion of Iraq. Private financial flows to developing countries may increase as the global geopolitical environment improves and the world economy gains momentum. However, these same developments are likely to prompt a recovery in financial markets in developed countries, which may reduce the present incentive to channel funds to developing countries.

POLICY RESPONSES TO SLOW GROWTH

The extent of the initial economic slowdown, while severe, was reduced by the counter-cyclical policy measures, including those of an automatic nature, adopted by many countries. There were, however, variations in the extent to which countries were able or willing to adopt expansionary measures, particularly as the period of slow growth lengthened. The continued sluggishness suggests the need for more stimuli, but the policy framework in a large number of economies is constraining many authorities from adopting such measures.

The immediate reaction to the economic slowdown in 2000-2001 was substantial reductions in policy interest rates in developed countries. Although energy and, in some countries, housing prices rose in 2002, inflation was not seen as a major threat in the majority of developed countries and low interest rates were maintained in most countries throughout the year and into early 2003. Some central banks, notably the Federal Reserve of the United States (Fed), reduced interest rates further in this period, bringing them to unusually low levels in many cases. The inflation-targeting rule followed by the European Central Bank (ECB) until early 2003 gave it less room for manoeuvre and delayed its cuts in policy interest rates until March 2003. At the same time, it changed its inflation objective of 2 per cent from a ceiling to a target, allowing greater flexibility in its monetary policy. The possibility of deflation has encouraged a number of central banks to indicate that they would consider the possibility of further monetary easing if necessary. In several countries in Eastern Europe, interest rates were reduced in 2002, primarily to dampen any appreciation of the exchange rate so as to maintain competitiveness.

Most countries have had less scope for expansionary fiscal policies because the size of their fiscal deficits has made them subject to either a self-imposed budgetary rule or a possible adverse reaction from global financial markets or the international financial institutions. A major exception has been the United States where increased central government expenditures and reduced taxation in 2002 combined to produce a sizeable fiscal stimulus and a growing fiscal deficit. In Western Europe, fiscal policy was slightly expansionary in 2002, but France, Germany and Italy are under pressure to consolidate their budgetary positions in order to meet the 3 per cent deficit ceiling embodied in the Stability and Growth Pact. Although it has no such policy rule, the Government of Japan is already in a difficult financial position and any further sizeable fiscal stimulus would aggravate the risk of a further downgrade in its sovereign debt by international rating agencies, further damaging economic confidence.

Many developing countries and some economies in transition improved their fiscal positions in the 1990s but deficits remain a problem, aggravated since 2001 by reduced government receipts and, in some cases, increased expenditures to offset the economic slowdown. However, there is a broad dichotomy between developing countries with relatively sustainable macroeconomic positions and those with macroeconomic disequilibria and/or other, often external, constraints. China and most economies in East Asia have been able to use monetary and fiscal instruments in the appropriate counter-cyclical manner during the present period of slow growth. In contrast, most economies in Latin America and Africa have had to give priority to addressing their macroeconomic imbalances; this has usually required using their macroeconomic policy instruments in a restrictive, currently pro-cyclical manner, rather than as a means of offsetting the present sluggish conditions. This dichotomy is likely to continue in 2003 and will contribute to a continuation of the divergent growth outcomes, and hence widening income disparities, across regions and countries.

REGIONAL PERFORMANCE AND PROSPECTS

Because they have faster rates of population growth, developing countries need to grow faster than developed countries if they are to achieve a year-to-year improvement in the well-being of their average citizen. If they are to make meaningful progress towards reducing the number of people living in poverty, developing countries have to maintain a high growth rate continuously for an extended period of time. The current period of sub-par growth has compromised both these objectives.

Although growth in the developed countries has been generally deemed unsatisfactory, only four of these countries experienced a decrease in per capita income in 2002 (see table I.3). The economies in transition fared even better, with only two suffering such a setback. In the case of the developing countries, per capita output fell in 33 of the 95 countries monitored (compared with 37 in 2001). These 33 countries accounted for 8 per cent of the world population (compared with 10 per cent in 2001). In 2002, 16 developing countries, accounting for 46 per cent of the world

Table I.3
FREQUENCY OF HIGH AND LOW GROWTH OF PER CAPITA OUTPUT, 2000-2002

	Number of countries monitored	Decline in GDP per capita			Growth of GDP per capita exceeding 3 per cent		
		2000	2001	2002[a]	2000	2001	2002[a]
	Number of countries						
World	145	25	41	39	69	45	40
of which							
Developed economies	24	1	3	4	14	2	3
Economies in transition	26	0	1	2	21	23	21
Developing countries	95	24	37	33	34	20	16
of which							
Africa	38	14	10	10	7	12	7
Eastern and Southern Asia	18	1	7	2	13	4	6
Western Asia	15	3	7	7	7	3	2
Latin America	24	6	13	14	7	1	1
Memorandum items:							
Least developed countries	41	16	12	15	9	12	7
Sub-Saharan Africa	31	13	9	9	5	10	7
	Percentage of world population						
Developed economies	16.6	0.0	4.8	0.1	3.6	0.2	0.3
Economies in transition	17.9	0.0	0.0	0.1	5.8	5.6	5.3
Developing countries	65.5	5.1	10.3	8.0	57.4	45.9	46.4
of which							
Africa	26.2	3.6	2.4	1.9	1.0	4.1	1.5
Eastern and Southern Asia	12.4	0.1	1.3	0.5	48.4	40.4	42.2
Western Asia	10.3	0.4	2.4	1.3	2.9	1.2	2.3
Latin America	16.6	1.0	4.3	4.3	5.1	0.2	0.4
Memorandum items:							
Least developed countries	28.3	2.6	2.1	2.1	4.2	4.4	2.2
Sub-Saharan Africa	21.4	3.1	2.3	1.8	0.7	3.5	1.5

Source: UN/DESA, including population estimates and projections from *World Population Prospects: The 2000 Revision*, vol. I, *Comprehensive Tables* and corrigendum(United Nations publication, Sales No. E.01.XIII.8 and Corr.1).

a Partly estimated.

population, achieved an increase in per capita output exceeding 3 per cent. However, most of the people in this group were accounted for by China and India. If these two countries are excluded, only about one fifth of the 2.5 billion people in the rest of the developing world were living in countries where the increase in GDP per capita exceeded 3 per cent. Of the 41 least developed countries for which data are available, 15 recorded a fall in per capita GDP in 2002. Only seven least developed countries, five less than in 2001, achieved growth in their per capita GDP exceeding 3 per cent more in 2002. These data suggest that, for most countries and people in the developing world, 2002 was another year in which there was little progress in reducing poverty

Developed countries: recovery derailed

The uncertainties associated with the possibility of conflict in Iraq constituted a major factor causing GDP growth in the **United States** to plummet from 5 per cent at the beginning of 2002 to 1.4 per cent in the fourth quarter. With the "war overhang" largely eliminated, the economic outlook has improved and growth is expected to accelerate as 2003 progresses. The household sector was weak during the pre-war period, but should strengthen: consumer confidence has recovered, interest rates are still at historic lows and the housing and residential construction markets remain strong. The depreciation of the dollar will provide a boost to exports and import-substituting activities in the medium term, when the recovery will depend more heavily on an upturn in business spending. Growth in **Canada** slowed as 2002 progressed, largely because of weaker exports. Growth is forecast to fall in 2003, but exports and business investment are expected to lead a recovery in 2004.

The economy of **Japan** grew only 0.2 per cent in 2002, with strong exports being the major factor preventing the economy from falling into recession. The outlook remains sombre: housing investment is sluggish, public investment is expected to be reduced further and the prospects for household consumption are discouraging. With an anticipated replenishment of inventories and some recovery in corporate investment, growth is expected to improve but remain low in 2003 and 2004. However, growth remains highly dependent on exports and is therefore vulnerable with respect to the appreciation of the yen.

Following growth of only 1.0 per cent in 2002, **Western Europe** is expected to recover somewhat in 2003, with a further improvement in 2004. The extended period of below-trend growth has led to higher region-wide unemployment and to a number of States' approaching or exceeding the fiscal deficit ceiling of 3 per cent of GDP called for by the EU Stability and Growth Pact. Together with the appreciation of the euro, these factors will dampen the recovery, but consumption is expected to strengthen slowly and business investment is forecast to rebound.

In both **Australia** and **New Zealand**, strong domestic demand offset the weak external sector in 2002, with both economies growing by over 3½ per cent. High business profitability and low debt levels contributed to higher capital spending, while growth in employment and increases in real wages led to strong household spending. Growth in both economies is expected to decelerate, but will remain between 2½ and 3 per cent in 2003 and 2004.

Economies in transition: limited deceleration

Growth in **Central and Eastern Europe** was almost unchanged in 2002, but is expected to strengthen in 2003 and 2004. By the end of 2002, there were already some indications of strengthening industrial production in Central Europe. More generally, growth is expected to be supported by growing domestic demand, continuing FDI inflows and associated investment and by some further relocation of production from EU to the region.

The economies of the **Commonwealth of Independent States** (CIS) continue to be largely sheltered from global economic uncertainties, having recorded strong growth each year since 2000. Robust domestic demand in both the Russian Federation and Ukraine, and rising oil prices and corresponding hydrocarbon investment in the Caspian region, have been the primary causes of this expansion. In Central Asia, many economies continue to surge owing to large oil and gas investments, while smaller economies are benefiting from expansion in their mining and metals sectors. Growth for the region as a whole is projected to be 4½ per cent in 2003, moderating to 4¼ per cent in 2004.

The **Baltic countries** grew by 6.3 per cent in 2002 on the basis of strong domestic demand and their flexibility in responding to robust demand from CIS to offset decreased demand from EU. Growth is expected to moderate in 2003 and 2004, with domestic demand remaining the driving force.

Developing countries: continuing underachievement

Africa's GDP growth is forecast to improve modestly in 2003 and to continue accelerating in 2004. Exports are expected to increase as global economic growth picks up in the second half of 2003. Projected price increases for almost all categories of export commodities will additionally strengthen export revenues and support GDP growth in many countries.

Reduced Organization of the Petroleum Exporting Countries (OPEC) quotas and sluggish international demand dampened North Africa's performance in 2002, but these economies are expected to grow more vigorously in 2003. Sub-Saharan Africa's growth in 2002 was driven largely by domestic factors: most countries benefited from increased agricultural output, lower inflation and significant growth in non-agricultural sectors. The impact of these positive forces is expected to continue in 2003 and 2004. At the same time, the outlook for some subregions remains clouded by the persistence of instability in a few countries.

East Asia's rebound from its sharp slowdown in 2001 started to ease in the second half of 2002. Sluggish external demand persisted in the first quarter of 2003 and expected growth for the year as a whole has been further reduced by the outbreak of SARS. If the epidemic is contained, growth is expected to improve in the second half of the year and into 2004. Import demand from the United States and continuing robust demand from China will support export growth, while broadly accommodative policies, lower oil prices and improving confidence will strengthen domestic demand and boost industrial production, particularly in export-oriented industries.

Growth in **China** accelerated in early 2003. Both domestic demand and the external sector expanded rapidly. Fixed investment in all sectors and regions has been leading domestic demand, although housing continues to expand rapidly. Both exports and imports grew by more than 15 per cent in 2002 and are forecast to increase by nearly 20 per cent in 2003. Despite some perennial challenges, such as large-scale unemployment, widening income gaps, and the fragility of the financial system, GDP growth is expected to remain high in 2003 and 2004.

South Asia's growth increased modestly in 2002 and the region's near-term prospects are positive. Growth is being supported by both domestic demand and exports. Exports in most countries were increasing in the first half of 2003 and are expected to increase further as external demand picks up in the second half of the year. Domestic demand is also expected to strengthen, supported by lower interest rates, rising exports and a better harvest as weather conditions normalize. Stronger growth will emerge by mid-2003 and the outlook for 2004 is for a further increase, with more balance across the region.

Following a decline in 2001, **Western Asia**'s economy grew modestly in 2002 as oil production declined in most oil-exporting countries and the uncertainties associated with the conflict between Israel and Palestine and the situation in Iraq resulted in declines in FDI, tourism revenues and consumer and investment confidence. The invasion of Iraq had negative economic effects on the country and the region. While the damage to oil infrastructure was limited, a return to former levels of oil production and exports may take several months. Regional prospects are expected to improve in 2004 as oilfield development and several petrochemicals projects come on-stream. The reconstruction of Iraq will provide additional stimuli to the region, although growth in the other oil-exporting countries will be modest. Oil-importing economies of the region are not expected to exhibit much dynamism.

After contracting in 2002, **Latin America** is making a limited recovery, although the weak international environment and domestic economic or political problems in a number of countries are a constraint. Growth in the region remains heavily dependent on the volume of foreign capital flows. Although FDI continues to be the major source of external finance, inflows are generally weak while portfolio flows have been volatile.

SHORT-TERM UNCERTAINTIES AND RISKS

The overriding task for policy makers in the short term must be to restore global economic growth to its long-term potential. Although the immediate economic outlook has become more positive than earlier in 2003 and a gradual global recovery is expected to take off in the second half of the year, the short-term outlook is fraught with a number of uncertainties and risks, the balance of which are on the downside.

First and foremost, although some **geopolitical risks** have abated, they have not all evaporated. The invasion of Iraq removed the pre-war uncertainties but future political developments pertaining to Western Asia, as well as to some other regions, remain uncertain. There were further international terrorist acts perpetrated in the second quarter of 2003, suggesting that such activities are likely to continue in future. Experience shows that such acts can have large effects on confidence and hence on short-term growth.

Although **oil prices** have declined since the invasion of Iraq, they remain highly volatile and therefore present both upside and downside risks. In this case, the balance is likely to be on the upside since potential oversupply could cause prices in late 2003 and 2004 to fall further than expected, with beneficial effects on global growth.

SARS reduced growth in a number of Asian developing countries in the first half of 2003. While the outbreak appears to have been largely controlled, a widespread occurrence of this or a similarly devastating disease could adversely affect some regional economies or even the world economy as a whole.

The global recovery continues to depend heavily on having the United States act as a catalyst and driving force and it is therefore vulnerable to the uncertainties and risks faced by the United States economy. The major uncertainties that are unique to the United States economy are the nature and timing of the inevitable adjustment of its **external deficits**. This correction may have started with the fall in the value of the dollar in the first months of 2003, but the depreciation itself poses a number of risks for the global recovery (see box I.1).

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

Furthermore, other risks that apply in varying measure to the economies of many developed countries are — again because of its key role — particularly pertinent to the economy of the United States. There continues to be **overcapacity** in some industrial sectors, either globally or within particular countries. This tendency initially applied most notably to the ICT sector, where overcapacity has since been reduced. However, there is now overcapacity in a number of sectors that have been most acutely affected by the geopolitical developments of the past two years (such as airlines and travel) and a number of other industries (such as automobiles). Such excess capacity will have a dampening effect on the business investment that is necessary to sustain the recovery.

Equity markets are recovering from the negative effects of the Iraq situation and a further substantial or prolonged fall in prices, which was feared earlier, now seems unlikely to materialize. However, a **housing bubble** is widely perceived to exist in a number of developed countries. Rising house prices have been an important element in sustaining strong consumer expenditure, as well as the housing and construction industry itself, in such countries. These rising prices, together with the experience of Japan, suggest that a bursting of the bubble could have sizeable negative effects on these economies.

Deflation has already had profound negative consequences for the Japanese economy; it has also touched a number of other Asian economies and is now viewed by some observers as a possibility in some of the major industrialized economies. The depreciation of the United States dollar reduces the possibility of deflation in the United States but makes it more likely in economies with appreciating currencies, notably the EU countries (particularly Germany). Some Asian economies have experienced brief periods of deflation without widespread detrimental effects but Japan's experience highlights the dangers of allowing deflation to become entrenched. Measures against deflation need — to an even greater extent than an anti-inflationary policy — to be pre-emptive and based on prospects rather than on current developments. Inevitably, such an approach embodies its own set of risks.

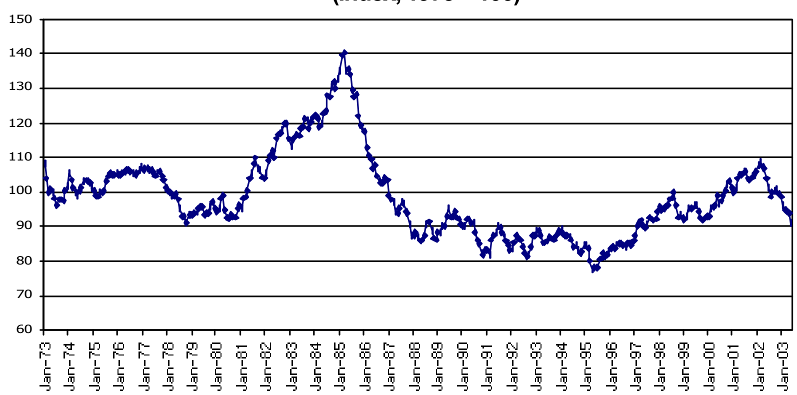
Box I.1

ECONOMIC IMPLICATIONS OF THE DEPRECIATION OF THE UNITED STATES DOLLAR

The value of the United States dollar has declined substantially since the beginning of 2003 relative to a broad range of other currencies, most precipitously against the euro. The trade-weighted index of the dollar vis-à-vis 10 other major currencies has dropped by almost 20 per cent from the peak of 2002 (see figure), although the index is still over 10 per cent higher than in the last trough of 1995. Relative to the euro, the dollar has declined some 30 per cent and is at its lowest level since the introduction of the euro in January 1999.[a]

a If the deutsche mark is used as the proxy for the period prior to the introduction of the euro, the value of the dollar is about 20 per cent higher than the lows of 1995.

Trade-weighted value of the United States dollar (Index, 1973 = 100)



Source: Federal Reserve of the United States.

It has long been understood that movements in exchange rates can overshoot well beyond the range warranted by such economic fundamentals considered to be influential as differentials across countries in inflation rates, in the rates of return on financial assets and in GDP growth rates, and relative balance-of-payments positions among countries. Policy interventions and political stability are also important. In this context, the depreciation of the dollar can be seen as a reversal of its strength in the late 1990s in that a number of forces that favoured the United States currency at that time have now diminished, or even reversed.

Part of the retreat of the dollar around the beginning of 2003 was caused by the concern over the prospect of war in Iraq, but a dominant factor was the long-standing and increasingly heightened concern about the sustainability of the large trade deficit of the United States.[b] Interest rate differentials among major countries may also be at play, as the Federal Reserve of the United States (Fed) has reduced interest rates more aggressively than most other economies have, particularly those in the euro area and the rest of the “dollar bloc” — Australia, Canada and New Zealand. In the late 1990s, when equity prices in the United States were appreciating at an unprecedented pace, giving rise to large capital inflows and driving the demand for the dollar, the role of interest rate differentials was overshadowed, but the influence of those differentials may have re-emerged after equity prices fell. Moreover, GDP growth of the United States has slowed significantly, at least in the short run, reducing the growth differential relative to other economies. Furthermore, the "strong dollar" policy of the United States for the past decade seems to have been jettisoned, at least tacitly. In face of all these developments, the long-anticipated depreciation of the United States dollar is not surprising; nonetheless, the prospects for the dollar remain uncertain, as overshooting can occur in both directions.[c]

b See *World Economic and Social Survey, 2001* (United Nations publication, Sales No. E.01.II.C.1), chap. I, subsect. entitled "Uncertainties and downside risks".

c As indicated by the baseline outlook, GDP growth for the United States is expected to recover at a rate much stronger than that of other major economies, in favour of the dollar.

Box I.1 (continued)

The weaker dollar has implications not only for the economy of the United States but for the economic growth of the rest of the world. In principle, the depreciation of the dollar is expected to benefit the United States economy, particularly the manufacturing and exporting sectors, which have been weak for the past two years. Most of the impact on the real economy is likely to be felt only gradually as the pass-through of the depreciation into the changes of relative prices will take time, and the response of real demand and supply to the price changes will take even longer.[d] The weaker dollar is reinforcing the monetary stimulus engendered by the low interest rates policy of the Fed, which is especially auspicious for exports and corporate profits — for the large United States transnational corporations in particular. The impact on the trade deficit will also not be tangible immediately — to the contrary, the deficit may continue to widen in the short run.[e]

On the other hand, the depreciation of the dollar is likely to have a negative impact on financial markets in the United States because it will result in losses for foreign investors who are holding dollar-denominated financial assets. This may lead to a further decline in capital inflows to the United States, and reduced demand for the dollar, begetting a further depreciation of the dollar. If such a vicious circle was formed, financial markets worldwide would be in jeopardy, and so would be adversely affected, to the detriment of economic growth.

The impact on economic growth in the rest of the world will be mixed. The depreciation has weakened import demand and thus the role of the United States as the global locomotive for the economic recovery in many other economies. Major developed economies, particularly those in the euro area, will face more downward pressure on their manufacturing and external sectors. Developing countries whose currencies are pegged to the dollar or have not appreciated much against the dollar, such as China and a few others, will benefit from the dollar depreciation, and their import demand from the United States will not be affected. The prices of many commodities are likely to rise because of the weaker dollar, boosting export revenues for many developing economies, but the real purchasing power of the revenue, or the terms of trade, for these economies may not improve. The weaker dollar will also provide some relief for developing countries with dollar-denominated debts, particularly those that are highly indebted.

The impact of the dollar depreciation on the rest of the world will also depend on the policy response of the economies. For example, with a stronger euro and hence less inflationary pressure, the European Central Bank (ECB) may become more flexible in reducing interest rates in the euro area, and this will stimulate domestic demand. At the same time, a number of developing countries, particularly those where interest rates have been maintained at high levels, now have more room to reduce rates, thereby making them more supportive of growth.

d Various econometric studies, including Project LINK, indicate that it will take about one year to pass about half of the depreciation of the dollar through to relative prices, and depreciation of the dollar by 10 per cent would lead to an increase of about 1 percentage point in the GDP of the United States in the second year.

e This is due to the so-called "J-curve" effects. When the price elasticity of import demand is low, as is the case in the United States, the adjustment in the real demand for imports will be smaller than the increase in the relative price of imports, leading initially to an even higher bill for imports.

DELIVERING ON THE NEW DEVELOPMENT COMMITMENT

For any improvement in growth to be sustained over the medium term, it will be necessary to revitalize international cooperation for development in order to address some underlying challenges to growth in developing countries. Cooperative international development efforts can contribute to repairing the damage inflicted on multilateral cooperation during the past year, as well as constitute an important means of addressing the global inequality that contributes to the underlying geopolitical tensions.

Prior to the emergence of the geopolitical uncertainties that hampered global economic growth in late 2002 and early 2003, the international community had forged, through a sequence of global meetings, an international consensus on development priorities and actions. The Fourth Ministerial Conference of the World Trade Organization, held at Doha in November 2001, the International Conference on Financing for Development, held in Monterrey, Mexico, in March 2002, and the World Summit on Sustainable Development, held in Johannesburg, South Africa, in August-September 2002, collectively defined a new global partnership for development between developed and developing countries. The overriding objective of this partnership is to accelerate development through shared responsibilities and mutual commitment. In each case, the programmes for the implementation of this partnership give attention to both resources and policies.

During the past year, work has continued on the refinement and implementation of these programmes. An important dimension of this work has been an increasing need for coherence among policies and programmes. This is particularly apparent where policies are in direct contradiction, but more generally it requires ensuring not only that all policies and actions are development-friendly but that they are so to the fullest extent possible.

Securing progress on the trade agenda

Inevitably, progress in the implementation of the programmes drawn up at Doha, Monterrey and Johannesburg has been mixed, but it is discouraging that progress on the work programme with the shortest time frame and, in some ways, the largest short-term potential, namely, the “Doha Development Agenda”, has been the most limited. Many of its deadlines for agreement on specific issues have already passed without having been met. Most such issues are of particular concern to developing countries, not only from the point of view of trade but because they relate to a priority developmental concern. Given the slow start, the successful completion of the Doha programme will require a high degree of political determination, including a willingness on the part of the developed countries to undertake the types of adjustment measures that developing countries have long been called upon to make in liberalizing their trade regimes.

The Doha work programme is ambitious both in its scope and in its time-horizon and yet it has been agreed that it should be a “single undertaking” where “nothing is agreed until everything is agreed”. The Doha negotiations are too important to fail so the fact that progress to date has been limited makes the originally ambitious goal even more so. It is essential that meaningful progress be registered at the Fifth Ministerial Conference of the World Trade Organization, to be held in Cancún, Mexico, in September 2003, whose main task will be to undertake a mid-term review of progress in negotiations and other work under the Doha Development Agenda. This will require all Governments to take a more flexible approach to these negotiations and, above all, to see them not as trade negotiations but as part of the new partnership to foster development. They should also be seen in the context of the current need to accelerate global economic growth in the short term. To this end, Governments may wish to focus for the immediate future on a few issues of overriding development concern and, in so doing, to adopt a more open approach.

A priority issue is to enhance the World Trade Organization Declaration on the TRIPS agreement and public health (WT/MIN(01)/DEC/2) adopted at the Fourth

Ministerial Conference on 14 November 2001.[1] The declaration has been an important development breakthrough because it authorizes a developing country to issue a licence to a domestic entity to produce a patent-protected pharmaceutical "predominantly for the supply of the domestic market" (article 31 (f) of the TRIPS agreement). However, countries without the necessary pharmaceutical manufacturing capacity are unable not only to take advantage of this provision but also to import from countries that have been granted such a licence. Such excluded countries are frequently the poorest, the most disease-afflicted and the most in need of low-cost drugs. Governments agreed to resolve this problem in the World Trade Organization but have failed to meet two self-imposed deadlines for doing so (although several developed countries have declared a moratorium on applying the existing restrictions until a solution is found). This problem relates directly to human well-being and so is at the very core of development. A prompt compromise solution, possibly involving a sequenced approach, would provide a much-needed boost to the Doha negotiations, as well as testify to the validity of the new partnership for development not only between the developed and the developing countries but also between the public and the private sectors.

A second major concern is agricultural trade, in particular the subsidies and other support that developed countries provide to their agricultural sector. Developing countries have long been encouraged to eliminate subsidies in order to remove distortions in their economies and to improve their fiscal balances but the developed countries continue to maintain massive agricultural subsidies for, as well as high tariffs on, many agricultural products. Because of the central role of the agricultural sector in many developing countries, these measures are directly to the detriment of developing countries, offsetting or even undoing the benefits of other forms of cooperation with those same countries. They are therefore in direct contradiction to the principles of partnership and coherence that form the backbone of the new development compact. Developed countries should therefore begin to reduce agricultural subsidies without delay and make time-bound commitments to eliminating them without a quid pro quo in other Doha negotiations. A starting point would be the elimination of all export subsidies and the discontinuance of the "dumping" of agricultural products in developing countries; this would have an immediate salutary effect on the agriculture sector in developing countries — and hence on the livelihoods of millions, including many of the poorest.

The question of "special and differential treatment" for developing countries assumes particular significance in a round of negotiations that aims at making the global trading system more development-friendly. It is generally agreed that countries at lower levels of development should be subject to less stringent trading rules than more developed countries, but there is little agreement on how this principle should be made operational. As a result, the negotiations on special and differential treatment have also failed to meet a succession of deadlines.

The least developed countries constitute one group that is particularly deserving of special treatment. This is recognized in World Trade Organization negotiations, as well as in some bilateral and regional concessions. In particular, the EU "Everything but Arms" initiative allows duty-free access to all non-arms imports from least developed countries except so-called sensitive products — bananas, sugar and rice; duties on these products are to be eliminated by 2009. As a first step towards enhanced differential treatment for developing countries, all developed countries should adopt the "Everything but Arms" principle and such commitments

1 For the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS agreement), see *Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, done at Marrakesh on 15 April 1994* (GATT secretariat publication, Sales No. GATT/1994-7), annex 1C.

should be bound within the World Trade Organization. In addition, some of the more advanced developing countries should apply the same principles to the less advantaged members of the group. Finally, every effort should be made to advance the date for the elimination of duties on sensitive products, even if this is done on a case-by-case basis.

Addressing external debt

The past few years have highlighted the fact that, more than 20 years after the debt crisis erupted in Latin America, many developing countries continue to face difficulties servicing their external debt. A long-term solution to this problem would be for developing countries to rely as far as possible on non-debt-creating flows. This already appears to be taking place with the reduced willingness of capital markets to lend to many developing countries. In the meantime, the magnitude of the Argentine crisis underscores the need for more effective international arrangements to deal with private sector debt crises associated with existing obligations. The ongoing discussions on means to avoid and resolve financial crises in middle-income countries should be continued.

It is also necessary to resolve the immediate difficulties of the heavily indebted poor countries (HIPCs). There are 15 HIPCs, such as those emerging from conflict situations, whose cases have not yet been considered and whose eligibility needs to be assessed as soon as conditions permit. Of those already reviewed, only 3 more of the 26 countries that had reached the “decision point” in the enhanced HIPC Initiative moved on to the “completion point” between April 2002 and April 2003, bringing the total to 8. Further measures need to be taken to ensure that all eligible countries reach the completion point as expeditiously as possible. For those that have already done so, the amount of relief that is required to achieve debt sustainability as originally envisaged has turned out to be higher than anticipated in several cases; this is often because growth and/or export earnings have been lower than expected, owing frequently to a fall in commodity prices. It is necessary to ensure that the HIPC programme reduces a country’s debt to a level that remains sustainable even when it is adversely affected by events beyond its control. Most importantly, the quantity of debt relief provided is already being threatened by the insufficient funding for the HIPC Trust Fund and by the fact that not all creditors are providing relief. Renewed efforts are required to mobilize the resources necessary to implement the Initiative fully.

Reviving concessional financial flows

There was an encouraging increase in ODA in 2002 and there are commitments to further increases by a number of donors in the next few years. Reflecting the recognition that even these improvements would fall short of what is widely perceived to be required, a proposal was launched in 2003 by the United Kingdom of Great Britain and Northern Ireland for an international finance facility which would aim at doubling the flow of ODA in the next few years. Although a number of donors have had questions about the proposal, it reflects official donor recognition of the need for a substantial increase in ODA flows. There was also progress towards improving the effectiveness of aid flows by the members of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) through the simplification and harmonization of procedures.

These favourable developments were counteracted by an increased politicization of aid flows. There is a growing tendency in the donor community to concentrate assistance on recipient countries that comply with donors' current perceptions of "sound policies", including "good governance". It is a truism that sound policies and good governance foster development, but defining these terms is less straightforward. Conceptually, it is difficult to reconcile this approach with the widespread recognition that conditionality is ineffective, that "one size doesn't fit all" and that "ownership" is central to successful development. A modicum of modesty might be more appropriate in the light of the donor community's limited successes to date.

The global geopolitical situation is also having a bearing on aid flows. The United States, the largest donor, recorded a sudden and substantial increase in ODA flows in 2002, but this was largely a response to the terrorist attacks of 11 September 2001. It is anticipated that the reconstruction of Iraq will also result in a substantial increase in ODA flows over the next few years. The donor community has made several efforts over recent years to ensure that ODA is appropriately defined and measured, for example, by excluding high-income recipients. Inasmuch as ODA inevitably serves geopolitical purposes to some extent funds used for purely geopolitical or commercial objectives should be separately identified so as to ensure that they are not disbursed at the cost of providing development assistance to the many countries that need it to confront long-term development challenges.