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GLOBAL ECONOMIC OUTLOOK

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Prepared by:

Economic Assessment and Outlook Branch
Development Policy Analysis Division
Department of Economic and Social Affairs

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Introduction

This "pre-meeting" global economic forecast was prepared with inputs from national LINK centres and information from other source (both as of 15 April 2002), using the LINK econometric modeling system to produce a global situation. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the web sites of both the United Nations and the University of Toronto.[1]

This report summarizes the main features of this exercise. The forecast presented here will be updated for publication in the World Economic and Social Survey 2002 by taking into account the discussions at the LINK meeting and the post-meeting forecast.

Overview

The world economy is on the mend. After a pervasive global slowdown in 2001, with roughly a dozen economies falling into recession, a recovery is unfolding. While the turning point has been confirmed, the unknowns in the global economic outlook are the strength, the sustainability, and the breadth of the recovery. By taking into account a confluence of various factors, the LINK baseline forecast predicts growth of 1.8 per cent for gross world product (GWP) for 2002, up from 1.2 per cent in 2001(table 1). The momentum of the recovery is expected to continue in 2003, pushing the growth of GWP back to its long-run path of annual growth of about 3 per cent.

Since the beginning of 2002, a spate of statistics has indicated that the upturn of the world economy arrived much earlier than most forecasters expected. In particular, the recovery of the United States from the September 11 terrorist attacks was surprisingly faster than anticipated.[2] Meanwhile, data from other regions, such as Asia and Europe, have all shown either an actual revival of economic activities or at least the antecedents of a recovery. This global recovery is being driven by a number of factors.

Accommodative monetary policy Central banks in many economies have cut interest rates substantially over the past year, injecting an abundance of liquidities to the global economy. Although the global monetary easing is ending, with some central banks already raising rates, the effects from the accommodative monetary stance will continue to support the recovery in the months to come.

Fiscal stimulus Many economies have also adopted various fiscal measures to stimulate effective demand. Fiscal stimuli have been especially strong in the Unites States, where a combination of tax cuts, increases in spending on military and homeland security, and a rise in other expenditures, are estimated to have boosted GDP by more than one percentage point in the fourth quarter of 2001.

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[1] The UN website is: http://www.un.org/esa/analysis/link; the University of Toronto's is: http://www.chass.utoronto.ca/link.

[2] After the September terrorist attack, most forecasts predicted a recovery in the second half of 2002. While a possible recovery as early as Spring 2002 was foreseen by the UN Expert Group Meeting in November 2001, it was a high frequency model by Lawrence Klein and S. Ozmucur that correctly forecast positive GDP growth in the fourth quarter of 2001, rather than a continued decline (as almost all other forecasters were expecting).

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

	April 2002 forecasts a/			November 2001 forecasts b/	
	2001	2002	2003	2001	2002
Gross world product	1.4	1.8	3.2	1.3	1.5
PPP weighted	2.2	2.6	3.6	2.2	2.5
Developed market economies	1.0	1.3	2.8	0.9	0.8
Canada	1.5	2.3	4.5	1.5	1.5
France	2.0	1.6	3.0	2.0	1.5
Germany	0.6	0.9	2.4	0.8	1.0
Italy	1.8	1.3	2.6	1.8	1.3
Japan	-0.4	-1.1	1.7	3.4	3.8
United Kingdom	2.4	2.0	2.8	2.2	2.0
United States	1.2	2.4	3.4	1.0	1.3
Memo items:					
EU	1.6	1.4	2.7	1.6	1.5
Euro zone	1.4	1.3	2.7	1.6	1.5
Economies in transition	4.0	3.1	4.1	4.3	3.8
Russia	5.0	3.5	4.4	5.2	4.0
Developing countries	2.4	3.5	4.9	2.3	3.5
Latin America and the Caribbean	0.3	0.3	3.1	0.5	1.3
Argentina	-4.5	-10.0	1.0	-4.0	-4.5
Brazil	1.5	2.4	3.1	1.5	2.0
Mexico	-0.3	1.7	4.5	0.0	1.5
Africa	2.9	2.7	4.2	3.3	3.5
North Africa	3.3	2.1	4.4	n.a.	n.a.
Sub-Saharan Africa c/	3.1	4.1	4.9	3.3	4.3
Nigeria	3.4	3.1	3.3	3.0	3.0
South Africa	2.0	2.3	3.3	2.6	2.8
South and East Asia	2.2	4.5	5.4	3.5	5.0
India	5.1	5.7	6.4	4.7	5.5
Indonesia	3.3	3.2	5.4	3.0	3.5
Korea, Republic of	3.0	5.8	6.0	2.5	4.0
Malaysia	0.4	4.9	6.3	0.3	2.8
Philippines	3.3	4.2	5.6	3.0	2.3
Thailand	1.6	2.8	3.7	1.4	2.3
China	7.3	7.2	7.0	7.3	7.3
Western Asia	-0.7	2.0	4.7	0.8	3.5
Oil-exporting countries	1.6	1.3	5.2	4.3	4.0
Oil-importing countries	-3.6	2.8	4.1	-4.4	2.8
World export volume	-1.0	2.2	5.8	0.8	2.8
Oil price (Brent, $/pb)	24.4	23.0	24.0	24.5	20.0

a/ Pre-meeting forecasts.
b/ Actual or revised estimates as published in *World Economic Situation and Prospects, 2002.*
c/ Excluding Nigeria and South Africa.

Resilient household spending For many economies there was salient dichotomy in the past cyclical downturn: a sharp decline in business investment spending was accompanied by relatively buoyant consumer spending. Not only did the resilience of the household sector prevent many economies from sliding into a much deeper contraction, but it is also currently providing important support for the recovery.

Softening energy prices A decline in the prices of oil in 2001and in the first two months of 2002 has provided an important impetus for the initial recovery. With the recent surge in prices, this driving force is fading but, as long as the prices stay in the range anticipated in the baseline forecast (see below), the impact on the recovery should be benign.

Strengthening in confidence The confidence of both consumers and businesses worldwide was depressed significantly in the aftermath of the September terrorist attacks. According to various surveys, confidence is rising to its pre-September levels, although it remains below its historical highs in many countries.

Inventory replenishment The global slowdown featured protracted and deep inventory-shedding in many industrial countries. A reversal of the process is expected to provide a strong spur to the recovery of the overall economic growth and to the recovery of industrial production in particular, at least in the short run.

These factors are critical for initiating the recovery, but they may not be enough to sustain the recovery. Some of these factors can provide only short-term support for growth: inventory restocking is highly cyclical; the effects from low oil prices, as mentioned above, are disappearing, or even being reversed; and continued strength in consumer spending itself needs support from improvements in employment levels and in income growth. Therefore, in order for the current recovery to be solidified and sustained, it requires a few other developments: a recovery in corporate profits, an increase in capital spending, and an improvement in labour markets.

Both capital spending and corporate profits have experienced a deep decline over a prolonged period in many economies, particularly in a few major developed economies. So far, there have been only tenuous signs of a bottoming-out in business capital spending. Capital spending is highly correlated with corporate profits, and both are also highly related to equity markets. Most global equity markets have recouped the precipitative sell-offs that occurred in the aftermath of the terrorist attacks, but valuations are still far below the peak levels of early 2000, particularly stocks in the severely depressed information and communication technology (ICT) sector. The protracted consolidation in ICT is near a nadir, as indicated by a rebound in the demand for semiconductors and PC products, but the timing of a new wave in the ICT revolution cannot be discerned. Another boom in ICT spending as strong as in the late 1990s is not foreseen in the baseline forecast, although the ICT revolution is expected to continue and its diffusion to more and more economies in the world will remain a major driving force for the global economy in the longer run.

Sustaining the recovery will also depend on a gradual improvement in the labour market; otherwise, the strength of the household sector will peter out. Unemployment was on the rise in most economies in the past year, but the most recent data indicate a stabilization in the unemployment rates of many economies. Nevertheless, an economy would have to grow above its potential for several months in order to replace the jobs lost in the downturn.

More questions remain regarding the breadth of the recovery. The current global recovery is led by the economy of the United States, which also lead the world economy in the downturn last year. The growing dependency of the global economy on the “single engine” of the United States has become a conspicuous feature of the world economy. Another important feature has been the increased synchronization among the world’s economies, at least in the past downturn. These two features have key implications for the breadth and the sustainability of the global recovery. The questions are whether the synchronization is symmetric; and if synchronization in the upturn could lead to a broad worldwide recovery. A synchronized upturn is likely in the early stage of the recovery (the revival of the United States has already lifted the exports of many Asian economies) but the breadth of the global recovery will depend on a broad improvement in the international environment and on the economic structure and economic policy of individual economies.

A solid improvement in international economic conditions, such as trade flows, commodity prices, capital flows, and external financing conditions, will be crucial for strengthening the prospects of most developing countries and economies in transition. While these conditions are expected to improve during 2002, they will remain challenging for most developing countries: international trade, which declined in 2001 for the first time in decades, is expected to recover only modestly; international prices of many primary commodities are rebounding, but most of these prices will stay in the range of their historical lows; and capital flows to developing economies are expected to increase only marginally.

Another factor that may hamper the breadth of the global recovery is the limited capacity for policy manoeuver in many developing countries and transition economies. Many of these economies are not in a position to use macroeconomic policy effectively to counter-attack external shocks, or to tackle their domestic problems.

For those reasons, there will be some dispersion among the world economies in the outlook for short-run growth. Synchronization, symmetric or not, will not produce convergence in growth among the world economies.

Furthermore, even this scenario of moderate recovery encompasses a number of caveats. First of all, the political and military developments in the Middle East create a prodigious uncertainty. Related to this is the risk of a much higher oil price. Moreover, the remaining large imbalances in many economies, particularly the United States, create the risk of a relapse in the global recovery. Meanwhile, the persistent deflation and the fragility in the banking system of Japan could lead to a financial collapse, with profound consequences for the global economy. In addition, these remain downside risks at the regional and country levels, as indicated by the recent debt crisis in Argentina, and the political instability in Venezuela and a few other countries.

Recovering global economic growth

Developed economies

The turning point for the economy of the United States emerged much earlier than most economists expected, but uncertainties remain regarding the strength of the recovery. While the near-term pace seems strong, the baseline outlook forecasts only moderate annual growth (2.4 per cent for 2002) to be followed by continued acceleration in 2003, peaking at an annual pace of 3.4 per cent.

Driving the current recovery has been fiscal stimulus, monetary easing, resilient consumer spending, and solid gains in productivity. While the anticipated large inventory replenishment is expected to add another spur to the recovery in industrial production, a sustained recovery for a longer period will depend crucially on a pickup in corporate profits, higher capital spending, and an improvement in the labour market. Since the past economic downturn was relatively shallow by historical standards,[3] it may have not cleansed up all the imbalances accumulated prior to the downturn. Therefore, a number of such weaknesses are likely to drag the momentum of the recovery: the low saving rates of households, the high debt level for private sector, and the large external imbalances. Moreover, some uncertainties may even pose risks for a relapse of the economy, although the probability for a "double dip" in the recovery is considered slim in the baseline forecast.

The outlook for *Western Europe* has recently evolved from one of pessimism to one of cautious optimism, with a uniformly growing evidence auguring a recovery. Compared with the United States, the deceleration in most economies of the region, except Germany, was less severe, but the recovery in these economies is also expected to be more dilatory. Policy stimuli in Western Europe, particularly in euro area, have been less powerful than those in the United States. While inflation worries have restrained central banks from reducing interest rates as aggressively as the Fed did, there was no significant increase in discretionary fiscal spending other than the stimulus from the budgetary function of automatic stabilizer—government fiscal positions in most euro economies are at the deficit threshold of 3 per cent of GDP imposed by the Stability and Growth Pact. One major driving force for the recovery in West Europe is the rebounding global demand, which will provide a boost particularly to manufacturing and generate an impetus to investment spending. While inventory restocking should produce some moderate increase in demand, consumer expenditure is also expected to maintain positive support, though with much weaker momentum than in 2001.

All three largest economies in the euro area suffered a decline in GDP in the fourth quarter of 2001, with Germany experiencing a technical recession. A gradual revival is expected for these economies in 2002, with a growth rate of 0.9, 1.6, and 1.3 per cent for Germany, France, and Italy respectively. Outside the euro area, the United Kingdom avoided an outright contraction, but it registered no growth in the fourth quarter of 2001, the worst performance in a decade. Contrary to many other economies in West Europe, growth in the United Kingdom is

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[3] With an annual growth rate of 1.2 per cent, whether or not the United States had a recession in 2001 is moot. However, the economy did suffer a "growth recession", namely a period of growth much lower than growth and the recession in the manufacturing sector and for corporate profits was unambiguous.

expected to moderate in 2002 to 2.0 per cent from 2.4 per cent in 2001. While the risks for the tentative recovery in Western Europe to falter are not negligible, the baseline outlook predicts an acceleration in the second half of 2002; GDP for the region is expected to grow by 1.4 per cent, followed by 2.7 per cent in 2003.

For *Japan*, a solid recovery is not expected in 2002, with a forecast of another decline in annual GDP of 1.0 per cent, followed by only a mild recovery in 2003. After a drop in GDP of 4.5 per cent in the fourth quarter of 2001, the economy continued to slide in the early part of 2002, although some leading indicators pointed to a possible bottoming-out in the second quarter. Moreover, some nascent signs presage a recovery in exports. While a rebound in exports will provide a cyclical lift to the Japanese economy and will alleviate some of its structural predicaments, a cyclical improvement cannot completely resolve all its structural problems. The fragility in its financial sector, the large volume of non-performing loans, its high government debt, and rising unemployment will continue to impede the growth of domestic demand. Income conditions continue to deteriorate, depressing private consumption. With business investment remaining weak, industrial production is expected to continue to decline until mid-2002. Meanwhile, macroeconomic policies continue to be in quandary, challenged by seemingly conflicting goals.

Elsewhere among the developed economies, Canada is trailing the cycle of the United States closely due to its geographical proximity to and high economic dependency on the latter, and a recovery in the economy is firming. *Australia and New Zealand* have both largely avoided the global slowdown, as strengthened domestic demand has offset some of the impact of the external shocks; however, some moderation in growth in New Zealand is expected in 2002.

Economies in Transition

GDP for most of the Central and Eastern European (CEE) economies, except Poland, is expected to grow at a stable rate of around 3.5 per cent in 2002. During 2001, these economies saw growth waning as major EU economies weakened towards yearend. This weakness extended into the first quarter of 2002. Despite a marked slowdown, most of these economies achieved a double-digit rate of growth in their exports, reflecting a gain in their international competitiveness through both an improvement in the quality of their products and relatively low prices. Meanwhile, domestic demand in many of these economies continued to grow, benefiting from the structural reforms in previous years and policy stimuli. A recovery in the EU is expected to provide important support for these economies, but most such effects are expected in the second half of 2002, with the momentum carrying into 2003. The economic performance of Poland has been singularly weaker than others in the group because of the restrictive policies adopted to rebalance the large macroeconomic gaps accumulated in the past few years. Although interest rates have been reduced, only a modest improvement in the growth of Poland is expected in 2002.

The outlook for the group of *Commonwealth of Independent States (CIS)* remains positive. GDP for the group is expected to grow by about 4 per cent in 2002, slightly moderating from the pace of 6 per cent of the previous year. The improved stability and robust growth of the *Russian Federation*, partially because of the benefit it received from the higher prices of oil of the past two years, have been pivotal for other CIS economies. For many of these countries, exports to the Russian Federation continue to be an important growth factor. Meanwhile, strengthening domestic demand has become a more dominant force for economic growth in the group. Increasing real wages and improved consumer confidence have fostered a substantial increase in private consumption in most countries, with the Russian Federation, for example, registering a surge of 8.7 per cent in 2001. The strength in investment, on the other hand, has varied across the CIS, with Kazakhstan, Azerbaijan and Ukraine reporting the strongest rates of growth.

Some CIS countries accelerated their structural reforms in the past year. Most progress was made by the Russian Federation, with substantial tax reform, the new Land and Labour Codes, and improved debt-management. Nevertheless, in most CIS countries the inadequate pace of institutional and structural transition continues to be an impediment to sustainable robust growth. Moreover, oil-exporting CIS countries need to reduce their vulnerability to the vicissitude of oil prices.

Despite their increased economic linkages with the EU, all three *Baltic* economies have managed to avoid being synchronized with the significant downturn in these countries. Weaker demand from the EU has been partially offset by stronger trade with the CIS countries and CEE. More importantly, growing domestic demand in these three economies has become a major dynamic force for the overall economic growth. With the goal of becoming EU members, possibly as early as in 2004, these three economies are continuing their market-oriented reforms, but the pace of privatization is likely to slower in 2002. GDP growth of the group is expected to decelerate slightly, from the pace of 6 per cent in 2001, to about 4 per cent for 2002, partly because the absence of a significant improvement in the EU economies until mid-2002, and partly because of an expected deceleration in other economies in transition.

Developing countries

Africa is expected to register an average growth of 2.7 per cent for 2002. Many African economies that were unfavourably affected by the global slowdown in 2001 are expected to experience a better external economic environment in 2002. Meanwhile, domestic sectors, which played a crucial role in offsetting some of the adverse external impact in 2001, are expected to strengthen further. Nevertheless, overall economic performance will still be far from what is required to achieve the long-run development goals endorsed by the United Nations Millennium Declaration, such as halving abject poverty by 2015. Moreover, there is a large diversity among the economies in the region, as countries vary in their vulnerability to different factors. Therefore, a rebound in the global economy is not expected to be sufficient to lift the growth of every African economy.

A recovery in the international prices of oil and other commodities is expected to alleviate the predicament of many African commodity-exporting countries, which suffered markedly from the severe erosion of commodity prices in 2001. If the prices of oil surge too high, however, the growth of some non-oil-exporting countries in the region will be curbed. In the large and relatively diversified economies of North Africa, the anticipated recovery in the EU will improve their exports, tourism and capital inflows. For Africa in general, tourism receipts, which fell sharply in the aftermath of the terrorist attacks on the United States, are expected to recover further. Many African economies are expected to benefit from other improvements in their external conditions, including more progress in debt relief, additional preferential trade arrangements with developed countries for the exports from the region, such as the European Union's 'Everything but Arms' Initiative and the United States' African Growth and Opportunities Act (AGOA), and an increase in official financial aid, as recently promised by some developed countries.

Domestic factors, such as political stability, macroeconomic policies, and weather conditions, are, however, still the main determinants of the performance of most African economies. The recent moderation of political instability or the cessation of violence in a number of countries--Angola, Central African Republic, Congo, Cote d'Ivoire, the Democratic Republic of the Congo Eritrea, Ethiopia, Guinea and Sierra Leone – is expected to improve their economic prospects. In contrast, the social and political turmoil in Zimbabwe may deepen, with negative consequences for its neighbors as well as the country itself. More generally, improved macroeconomic policies and progress in other social-economic areas (for example, as a result of the Poverty Reduction Strategy processes) are expected to provide more support for growth in the region.

The outlook for most economies in developing East Asia has improved recently. After a year of severe downturn, GDP growth for the group (excluding China) is expected to recover to 4.5 per cent in 2002, from 2.2 per cent of the previous year, and further strengthen to 5.5 per cent in 2003.

For a number of economies in the region, the sharp slowdown, with an outright contraction in a few economies (such as Hong Kong SAR, Malaysia, Singapore and Taiwan Province of China), was mainly due to a protracted and deep consolidation in worldwide ICT demand. The concentration on ICT-related products, and the large trade shares with both the United States and Japan, made these economies suffer the most among all the developing economies in the downturn. In some other economies in the region (such as Indonesia, the Philippines and Thailand), domestic weaknesses, such as political uncertainties, also depressed aggregate demand.

The recovery in the major developed economies and the apparent end of the global slump in the ICT sector, as indicated by the revival of the prices for semiconductors and PC-related products, are important forces reviving the strength of many East Asian economies. At the same time, domestic policy stimuli adopted by many countries in the region over the past year are expected to provide additional support. Monetary policy in the region has become accommodative and many countries have also introduced other expansionary measures, such as tax cuts, increases in public investment expenditures and pay raises for civil servant. Not all economies in the region, however, are equally poised for a rebound. For example, the Republic of Korea is leading in the recovery, while Hong Kong SAR seems lagging.

The largest developing economy in the region, China, had stable growth of 7.3 per cent in 2001, as the growth in domestic demand, supported by expansionary policies, offset some of the weaknesses in the external sector. Continued policy stimuli, the momentum being generated by its recent accession to the WTO, the staging of the Olympics in 2008 and the acceleration of development in the west of the country, are expected to support another year of growth at 7-8 per cent.

Economic prospects for many countries in *South Asia* are improving. Although most countries in the sub-region have a relatively small external sector, the slowdown in major developed economies in the previous year had a noticeable impact, with a significant slowdown in exports leading to lackluster growth in industrial production. Domestic factors, such as political unrest and poor harvests, also had negative influence. The difficult situation was compounded by the heightened uncertainties in the aftermath of the September terrorist attacks. The war in Afghanistan resulted in some disruption of economic activities in the region, particularly in the neighbouring countries, as a result of a drop in tourism, impediments to transportation, and large numbers of refugees. As of April 2002, more signs indicate an improvement in both external conditions and domestic sectors in many countries of the sub-region. The abatement of military actions and increased international aid are expected to ameliorate the situation.

The outlook varies markedly among the economies in the sub-region. For example, growth in India, Pakistan and Sri Lanka is expected to accelerate, but the economies of Bangladesh and Nepal are expected to weaken further. While political instability continues to hamper growth in a few economies, the performance of many economies in the region continues to depend largely on weather conditions. Monetary policy in most economies is stimulative, but large budget deficits in a number of these countries have severely limited the capacity for fiscal stimuli. For the group as whole, GDP is expected to grow by 5.2 per cent in 2002, up from 4.5 per cent in the previous year, and to strengthen further in 2003.

The economic outlook for *West Asia* has also been complicated by geopolitical and military factors. The escalation of its conflict made it difficult to assess the economic outlook for Israel, which registered a modest decline in GDP in 2001. Without the conflict, the global recovery could have lifted the economy somewhat, but the current situation suggests another year of decline. For *Turkey,* the outlook has improved. After a contraction of 7 per cent in 2001, Turkey's domestic economy is expected to stabilize in the first half of 2002 and recover in the second half, strengthened by the IMF-supported economic stabilization programme. Some improvement is also forecast in the external sector: declining tourism and sluggish exports to EU are expected to revive. Many oil-exporting countries should fare well with firm oil prices, eventhough the average price is expected to be slightly lower in 2002 than in the previous year.

Aggregate GDP for the economies in Latin America and the Caribbean registered virtually no growth in 2001, mainly because of these countries' vulnerability to external shocks. While most economies in the northern part of the region experienced a slowdown in exports and tourism, many economies in the south suffered from weak commodity prices and a shortage of external financing. Political instability also impeded economic growth in a few countries in the region. As the poor external conditions alleviate, the outlook for most economies in the group is improving, but significant diversity among economies remains in terms of prospects, with the possibility that a few of them may continue to deteriorate in the short run.

Among the group, Mexico is expected to recover from a recession year, pulled by the United States. Most Central American and Caribbean economies, whose tourism receipts fell markedly in the aftermath of the terrorist incident, are similarly expected to benefit from the recovery in the United States. The outlook for Brazil is also positive, although some concerns remain: the austere fiscal policy will have to be continued in order to keep debt levels sustainable, and continued capital in flows are needed to stabilize the currency. The recent recovery in the prices of oil and other commodities will provide a lift for some commodity-exporting economies. The outlook for Argentina and Venezuela, however, remain pessimistic. Financial support from the International Monetary Fund (IMF) is crucial for Argentina to stabilize the downward drifting peso, but the anticipated policy adjustments and future debt restructuring are likely to lead to a severe contraction in the real economy: GDP is expected to shrink by 10 per cent in 2002, after consecutive declines in the past three years.

Even though some economies in the region were able to adopt more accommodative monetary policy, the policy stimuli to counter the external shocks and to bolster recovery in the region remain weak, as most economies are fettered by the already flagging fiscal positions and other policy constraints. For the region as whole, GDP is expected to grow by 0.3 per cent in 2002. Excluding Argentina, the regional growth rate is forecast to be 2.1 per cent.

Improving international economic environment for developing countries

The increased synchronization of the world economies in the past global slowdown was mainly a result of the growing global economic integration over the last decade. While this integration has in general benefited many developing countries and transition economies and lifted their economic growth, though not without side effects, it has also increased their dependency on the international economic environment, albeit to varying degrees across countries. The growth of one group of developing countries, such as those in East Asia and North Latin America, has become more dependent on trade, particularly in manufactured goods, with major developed economies, while the growth of many African countries remains highly vulnerable to the international prices of primary commodities. A number of developing and transition economies have benefited from relatively stable foreign direct investment (FDI) flows but, other economies have had to depend on short-term external borrowing. Therefore, even though a moderate improvement in the international economic environment is expected in 2002, many developing and transition economies continue to face challenges in their external sector.

Many developing economies suffered a sharp deceleration in the growth of exports in 2001, with a number of them registering an outright drop, both in value and volume terms. Measured by the volume of merchandise exports, world trade declined in 2001. Leading the downturn was the substantial drop in cross-border trade in ICT products, particularly the reduced imports of these products by the United States and other developed economies. As the economic downturn intensified towards the end of 2001, exacerbated by the disruptions caused by the events of 11 September, the set-back in international trade broadened to non-ICT merchandise and to services, such as tourism and shipment.

A recovery in *world trade* is under way, but its annual growth for 2002 is expected to be only 3 per cent ─a mediocre performance by historical standards[4]. The low growth is, however, also in line with the less homogenous recovery of output among the world's economies. The revival of import demand from the major developed economies is unlikely to gain great momentum until the second half of 2002. For example, imports of the United States, the volume of which dropped by about 3 per cent in 2001, are expected to grow by only 2 per cent in 2002. Imports from Japan and EU are also expected to be lackluster. As a result, exports of many developing economies in Asia and Latin America, which were hit the most in 2001, are not expected to resume their full dynamism soon. Meanwhile, the increased costs of international transportation and insurance due to the terrorist incident will be additional impediments for the recovery of international trade.

The international prices of most primary commodities rebounded noticeably in the spring of 2002, after drifting downward for more than a year, particularly in the period of the aftermath of 11 September. The near-term trend for the prices of most commodities is expected to remain upward in 2002-2003, as their global demand continues to recover. Much of the upturn in these prices will, however, prove to be cyclical, rather than secular, and the prices of a large number of commodities are still around their historical lows. Meanwhile, high volatility will continue to be a salient feature of many commodity prices.

The *prices of oil* have risen by about 30 per cent in the month since March, reaching the middle of the target price range ($22-$28 per barrel (pb)) set by the Organization of Petroleum Exporting Countries (OPEC). The escalation of conflict in the Middle East was the factor creating this pressure on prices and it may or may not last, but improved global demand will provide more fundamental support for the prices. In the outlook, the prices of oil are expected to fluctuate around $23 pb (measured by the price of Brent) in 2002, compared with an average of above $24 pb in 2001. The outlook for the price of oil is subject to other uncertainties, including geopolitical developments. For the time being, the short-run risk is on the upside, highly related to the state of the conflict in the Middle East. But the long-run risks remain towards the downside, as indicated by the prices of contracts for oil delivery in various future periods; these are lower than prices for current-delivery although the difference has become less than it was in 2001.

The *prices of non-oil* commodities are also on the rise, with many of them showing a marked surge in early 2002, such as the increase of more than 20 per cent in the prices of coffee. Despite a broad demand-driven upturn in 2002-2003, developments in the prices of various commodities is likely to remain diverse, depending on specific supply conditions in major producing countries, inventory adjustments, and other factors.

External financing conditions for developing countries and economies in transition are expected to improve only marginally in 2002, with further strengthening in 2003. After a significant decline in 2001, private capital flows to these economies are not expected to recover until the second half of 2002. Since the 1997-1998 Asian financial crisis, private capital flows have stagnated at a level much lower than the pre-crisis peaks; this is especially the case for

[4] Technically, this low annual rate may not fully reflect the otherwise stronger quarterly pace of the recovery: because the slowdown of world trade in 2001 deepened sharply by the yearend, it needs a series of strong quarterly improvements to produce a robust annual growth rate.

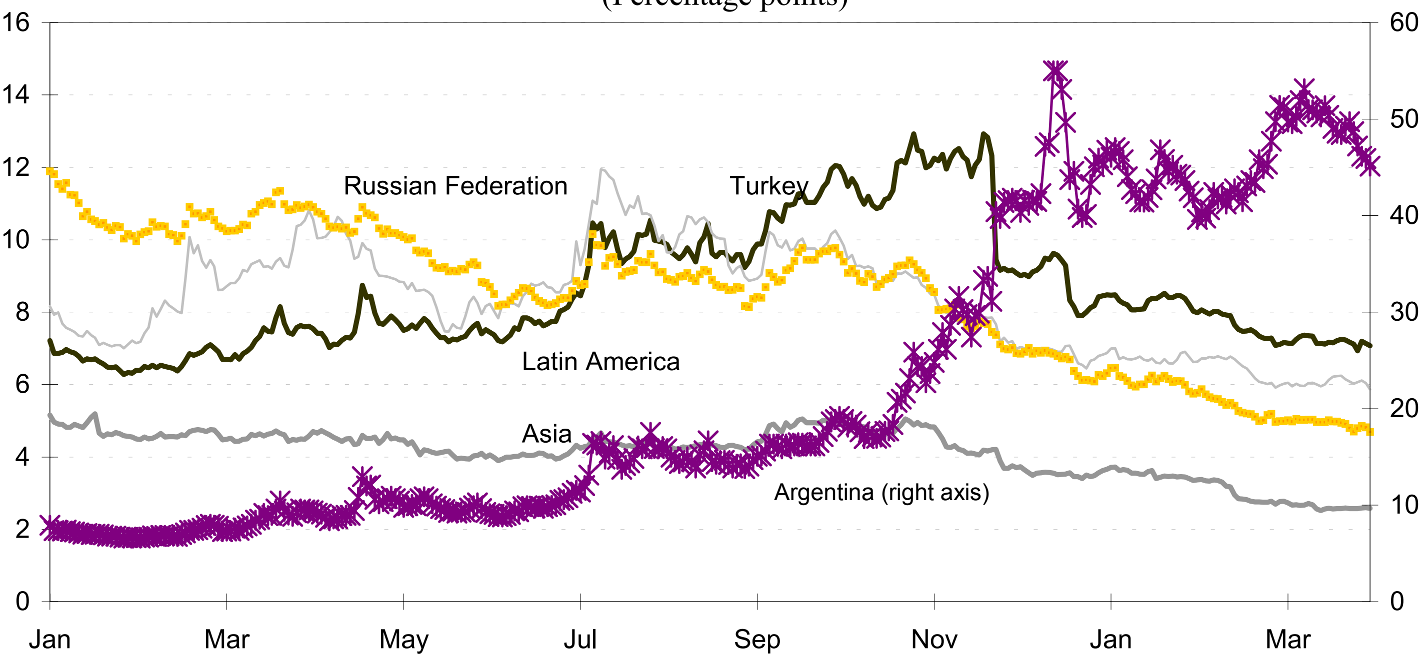
portfolio investment and bank loans. Foreign direct investment (FDI) had remained relatively stable for the past few years and is expected to remain the main external source of finance for developing countries and economies in transition.

The cost of external financing for developing and transition economies has been moving downward since the beginning of 2002, as the rise in the spreads of bond yields for these economies in the wake of the September terrorist incident has faded (Figure 1). Argentina has been an exception, as the unsettled debt crisis in the country continues to push up the spreads on its sovereign bonds.

The outlook for official capital flows to developing countries has improved slightly, as several developed countries have recently promised to increase their official development aid (ODA). Meanwhile, a member of low-income developing countries are beginning to benefit from debt-servicing relief under the Enhanced Heavily Indebted Poor Country (HIPC) Debt Initiative; the widespread recognition that the relief currently being provide is insufficient may result in further resources being made available for this purpose over the medium-term.

Figure 1. Yield Spreads on Emerging Market Bonds, 2 January 2001 to 17 April 2002

(Percentage points)



Source: Data of JPMorgan Co., New York.

Benign inflation outlook versus dilatory revival in labour markets

Inflation has been moving upward recently in many economies, but the inflation outlook for the global economy remains benign, posing no imminent policy concern in most economies.

With a rebound in the prices of primary commodities, particularly energy prices, inflation rates in a number of developed economies of North America and Western Europe edged up in early 2002. Growing upward pressure on wages has also contributed to the rise in inflation in several European economies. The rise in the headline inflation rate has been accompanied by a far weaker core inflation rate in the United States, indicating that firms have minimal power to pass through increased costs to end-users. In contrast, core inflation in many European economies has been moving up together with the headline inflation and now exceeds the 2 per cent target ceiling set by the central banks in these economies. Inflation in many developed economies has been steady at historical lows over the past few years, thanks to increased international competition, vigilant monetary policy, and other factors. Since these factors persist, a rise in inflation in the short run is not expected to escalate. In Japan, deflation remains a major policy concern.

The inflation outlook for most developing countries and economies in transition remains favourable. The recent disinflationary trend in a majority of developing countries and economies in transition is likely to continue; however, inflation rates remain at a double-digit level in a number of these economies, suggesting that more progress is needed in macroeconomic management and in economic restructuring. Meanwhile, due to recent financial crises and/or large currency depreciations, a few developing countries, such as Argentine, Turkey, and South Africa, are facing a significant rise in inflation.

Unemployment has been on the rise worldwide since mid-2001. Although some economies have already shown signs of a stabilization in unemployment rates, a solid improvement in labour markets is expected only in late of 2002. A large number of the workers laid-off labour during the contraction can be absorbed only if the pace of recovery is sustained above the potential growth rate. While economic recovery is expected to reduce unemployment cyclically in many economies, structural unemployment problems will remain. Particularly in many low-income economies, high unemployment and large underemployment ─a direct cause of poverty─ will remain a global concern in the long run.

Macroeconomic policies

Various policy stimuli adopted by many economies in the past year played an important role in mitigating the global slowdown and initiating the recovery. Maintaining an accommodative policy environment is equally important for strengthening the recovery in the future.

Policy interest rates in most developed economies were lowered substantially during 2001 (see table 2), with the corresponding real interest rates reaching zero, or close to it, in some of them. A large part of the reduction in interest rates was in response to the intensified global economic deterioration and heightened uncertainties resulting from the events of 11 September.

Table 2. Changes in policy interest rates

	Level at April 15, 2002 (per cent)	Change from Dec 2000 (basis points)
Developed Countries		
United States	1.75	-475
Canada	2.25	-350
Japan	0.00	-25
Euro	3.25	-150
United Kingdom	4.00	-200
Sweden	4.00	0
Denmark	3.55	-185
Norway	6.50	-50
Switzerland	1.75	-175
Australia	4.25	-200
New Zealand	5.00	-150
Economies in Transition		
Czech Republic	4.25	-100
Hungary	8.50	-325
Poland	10.00	-900
Developing Countries		
Brazil	18.50	275
Mexico	7.42	-975
Chile	4.75	-325
China	5.31	-54
Hong Kong SAR	3.25	-475
Indonesia	16.76	234
India	6.50	-150
Philippines	7.00	-650
Republic of Korea	4.00	-125
Thailand	2.00	50
Taiwan Province of China	2.13	-250
South Africa	11.50	-50

Source: JP Morgan

As a recovery is under way in many developed economies, the phase of easing monetary policy in these economies is over. A few central banks such as those in Canada, New Zealand, and Sweden have already started to raise interest rates. A gradual tightening is expected in more developed economies in the second half of 2002 and also in 2003. According to the policy statements recently released by various central banks in major developed economies, monetary policy is expected to remain accommodative in 2002, even taking into account a few anticipated measures in interest rates. The persistent rise in core inflation in a number of European economies, however, may cause a few central banks to tighten faster than expected, leading to the risk of choking the recovery.

Developed economies have also adopted different fiscal stimuli, with some applying tax cuts and other increased expenditure. The fiscal stance has been most significant in the United States; the fiscal stimuli in the EU have mainly come from the functioning of automatic stabilizers with the room for a further fiscal stimulus being limited by the rules governing fiscal deficits. Fiscal policy has turned restrictive in Japan due to its measures to shore up government finance.

Almost all economies have witnessed deterioration in government balances in the past year and no significant improvement is expected in 2002.

In developing countries and transition economies, policy actions to stimulate a recovery have been far less homogeneous, as the scope for policy manoeuver in many of these economies is constrained by other factors. Fiscal policy has been limited in a large number of developing countries because budget deficits are already large—either because of diminishing revenue from lower commodity prices (in many African countries), or because of continued accumulations from the setbacks of the 1997-1998 financial crises (Asia and Latin America). Commitment to fiscal consolidation, either forced by pressures from global capital markets or required by agreements with the International Financial Institutions (IFIs), has also precluded stimulatory measures in some countries. On the other hand, monetary policy in several developing countries and transition economies has been exclusively directed to target either the exchange rate or inflation, leaving no room for counter-cyclical easing. A small number of developing countries and transition economies have been able to adopt both monetary easing and fiscal stimuli simultaneously, but a majority of them have been able to adopt either a stimulatory fiscal policy combined with tight monetary policy, or a monetary easing accompanied by fiscal austerity. Even if monetary easing is over in the major developed economies, a number of developing countries and transition economies are still in a position to continue reducing interest rates: interest rates in some of these economies are much higher than those in the major developed countries.

Uncertainties and forecasting risks

Notwithstanding an improvement in the global economic prospects, many uncertainties and downside risks remain.

First of all, as illustrated by the terrorist incident of last year, the world economy is facing some new uncertainties. In the baseline outlook, the most recent escalation of the conflict in the Middle East is assumed to be contained; if the situation goes awry, there would inevitably be an adverse impact on the economies in the region and on the global economy as a whole.

Directly related to the uncertainties in the Middle East is the prices of oil. When the Middle East conflict increased in early April, Iraq decided to suspend its oil exports for a month with the possibility of a further extension if the conflict were not resolved. Oil prices immediately climbed by more than 15 per cent in a week; prices eased back to around $24 pb after major Arab oil producing countries stated that they would not apply an oil embargo. Based on fundamental factors in supply and demand, the baseline forecast assumes a price of $23 pb, but the probability of a surge in oil prices cannot be completely dismissed. As past studies indicate, a $10 pb increase in the price of oil for an average period of a year would lower world GDP by 1 percentage point. More importantly, if the prices stay above $35 for more than 6 months, a recession in major industrial countries is likely.

On the economic front, the high dependency of the global economy on the recovery of the United States involves risks. The relatively shallow downturn in the United States did not eliminate all the imbalances accumulated in the economy over the previous cycle. For example, equity prices, which underwent a substantial correction, are still above historical benchmarks by a large margin. Household saving rates are still at an extremely low level and private sector debt is at historical highs. All these, together with a seemingly growing bubble in real estate, may pose downside risks for the recovery in the United States, and thus to the global recovery. Internationally, only a small portion of the large external deficits of the United States has been reduced so far, and the deficits are likely to grow during the recovery, implying that there is a higher risk of a more abrupt adjustment in the future.

Elsewhere in the world economy, the financial and banking predicament in Japan and its deflationary spiral involve risks not only for many Asian developing economies, but also for the global financial system. Meanwhile, the debt crisis in Argentina and interroven economic and political instability in a number of countries all pose challenges for the world economy.