

DRAFT
For Comments only
Not formally edited
Not to be quoted



United Nations
Department of Economic and Social Affairs

Project LINK Meeting

Oslo, Norway
2-6 October 2000

GLOBAL ECONOMIC OUTLOOK

This report was prepared by the Economic Assessment and Outlook Branch of the United Nations Department for Economic and Social Affairs and is intended as background information for participants attending the 2000 fall session of Project LINK in Oslo, Norway.

INTRODUCTION

The second Project LINK meeting of 2000 takes place in Oslo, Norway, 2-6 October 2000, sponsored by Statistics Norway. The agenda of the meeting includes various presentations of the short- and medium-term outlook for the world economy, discussions of current issues of international economic policy, and presentations on topics in econometric modelling techniques and their application for forecasting and policy analysis.

With inputs from the national LINK centres and information from other sources, as of 22 September 2000 the staff of the Economic Assessment and Outlook Branch, Department of Economic and Social Affairs, at the United Nations prepared a pre-meeting world economic forecast, using the LINK econometric modelling system. This report summarizes the main features of that exercise. The outlook projected here is an interim exercise, which will be updated later this year, taking into account the discussions in Oslo and the post-meeting forecasts. *LINK COUNTRY REPORTS*, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the websites at both the United Nations and the University of Toronto.

OVERVIEW

Global economic growth has continued to accelerate in 2000, along with a very marked expansion of international trade, to the strongest performance in more than two decades. Gross world product (GWP) is expected to expand by 4.1 per cent this year – 60 basis points (bps) over the previous LINK forecast executed in April 2000.

The current recovery phase has now been under way for almost two years, following the setbacks incurred as a result of the 1997-1998 international financial crises. The acceleration portion of the upswing seems to be coming to an end, as signs of constraints on further global economic expansion are increasingly surfacing. Among these forces, especially the surge in oil prices and tight labour markets in some countries stand out. As a result, the focus of macroeconomic policies in many countries has been shifting from supporting rapid economic recovery to stabilizing the expansion. But it is a challenge for policy makers worldwide to bring about a smooth transition from accelerating the pace of expansion to consolidating and sustaining economic growth at or near the rates recently observed for the world economy as a whole. In the LINK baseline forecast, the pace of global economic growth is expected to stabilize at a slightly more moderate pace than the 4.1 per cent now anticipated for 2000. But it should remain quite robust at about 3.6 per cent for 2001-2002 (see table 1).

In terms of dynamics, the world economy at present appears to have found a new equilibrium in the face of two major global supply shocks: (1) a positive shock of the still ongoing revolution in information and communication technology (ICT) and (2) a negative shock from high oil prices. The ICT revolution has contributed significantly to the substantial growth in productivity in the United States since the mid-1990s. There have recently been some signs that similar benefits are now beginning to accrue also to some other developed economies in Europe. With appropriate policies, these gains should in time also spread to many developing economies. This widening of the productivity boost from the ICT revolution to a broader range of countries, if it materializes, should provide a substantial lift in the potential growth of the world economy through most of the next decade. However, the high levels of oil prices have been posing an increasing threat for global economic growth. The world economic outlook will therefore depend to a large extent on how policies in the global economy will coalesce into

Table 1. Growth of gross world product and its components, and of world trade

(Annual percentage change)

	October 2000 forecasts ^a			April 2000 forecasts		
	2000	2001	2002	1999 ^b	2000	2001
Gross world product	4.1	3.6	3.6	2.8	3.5	3.5
Developed market economies	3.7	3.1	3.0	2.6	3.0	3.0
Canada	4.6	3.1	3.3	4.5	3.5	3.6
France	3.6	3.1	3.0	2.7	3.6	3.1
Germany	3.0	3.2	2.6	1.5	2.5	2.9
Italy	2.8	2.7	2.9	1.4	2.6	2.7
Japan	1.4	2.2	2.9	0.3	0.9	1.9
United Kingdom	3.2	2.6	2.1	2.1	3.3	2.6
United States	5.2	3.7	3.3	4.2	4.2	3.7
Memo items:						
EU	3.5	3.1	2.8	2.3	3.1	3.0
Euro zone	3.5	3.2	2.9	2.3	3.1	3.0
Developing countries	5.6	5.5	5.7	3.6	5.2	5.5
Latin America and the Caribbean	3.9	4.0	4.8	0.2	3.7	4.2
Argentina	1.6	2.4	3.8	-3.0	2.8	3.5
Brazil	3.9	4.4	5.5	1.0	3.6	4.7
Mexico	5.8	4.5	5.2	4.0	4.8	4.4
Africa	3.6	4.1	4.8	3.0	4.4	4.5
North Africa	4.1	5.9	5.4	4.1	5.5	5.2
Sub-Saharan Africa (excl. South Africa)	4.5	3.8	4.9	3.2	4.4	4.6
Nigeria	3.5	3.5	3.5	3.4	3.4	3.2
South Africa	2.2	2.9	3.4	1.4	3.2	3.0
South and East Asia	6.6	6.0	6.1	5.9	6.2	6.2
India	6.6	6.9	7.2	6.4	6.5	6.8
Indonesia	3.6	5.8	5.6	0.3	4.3	4.6
Korea, Republic of	8.6	6.0	6.2	10.7	8.2	7.3
Malaysia	8.3	7.5	7.3	5.6	7.2	6.9
Philippines	3.6	3.6	4.6	3.3	4.1	4.2
Thailand	5.8	5.4	5.3	4.2	4.8	5.4
China	8.4	8.5	8.0	7.1	7.5	7.6
Western Asia	4.7	4.9	4.1	2.5	3.9	4.7
Oil-exporting countries	5.0	5.2	4.2	2.9	4.2	4.9
Oil-importing countries	2.6	3.3	3.1	0.3	2.0	2.6
Economies in transition	5.3	4.2	5.0	2.9	3.0	3.4
Russia	6.5	3.9	4.8	3.2	2.5	2.5
World export volume	10.4	7.7	6.6	4.9	7.6	7.7
Export prices (all goods)	0.8	2.7	4.2	-0.6	1.7	2.2
Agricultural commodities	0.2	3.8	3.7	-4.9	1.3	2.7
Raw materials and ores	4.5	3.2	2.9	-1.9	6.1	5.3
Oil	59.0	-5.0	4.0	40.0	40.0	-20.0
Manufactures	-2.9	3.6	4.5	-2.4	-0.9	3.9

a Pre-meeting forecasts.

b Actual or revised estimates

economies. This widening of the productivity boost from the ICT revolution to a broader range of countries, if it materializes, should provide a substantial lift in the potential growth of the world economy through most of the next decade. However, the high levels of oil prices have been posing an increasing threat for global economic growth. The world economic outlook will therefore depend to a large extent on how policies in the global economy will coalesce into ensuring that the gains of the ICT revolution materialize while the potency of the threat emerging from any further rise in fuel prices, indeed from maintaining the present high levels of these prices, is reduced.

As identified in the last LINK Global Outlook, the ICT revolution has been a major support in accelerating the pace of the recovery and reaching strong economic expansion throughout major regions in recent years. The trend of rising investment spending on computer equipment and software, the Internet, and telecommunications has continued in the global economy. While so far the bulk of total ICT-related investment has been concentrated in developed economies, where it has been growing at a double-digit rate, more and more developing economies and economies in transition are also speeding up their investments in these activities.

Perhaps more important, the most recent performance measurements provide additional evidence of the continued strong rise in productivity growth in the United States, largely attributable to the ICT revolution. The rise in the trend of productivity growth implies that the economy can now be sustained along a growth trajectory that is more than 100 bps above that observed during the preceding two decades without igniting any significant inflation. A similar acceleration in productivity growth has not yet been measured in official aggregate statistics for other developed economies, largely because the advance with ICT, both its development and application, has been lagging that of the United States by several years. Nevertheless, many economists believe that the gap in the productivity growth between Western European economies and the United States is narrower than the official data would tend to suggest.

If, as reported in some recent studies, the latest revision in statistical methodology of the United States is applied to major Western European economies, such as Germany, evidence that a noticeable rise in productivity growth has already manifested itself there too becomes persuasive. More and more optimistic observers believe that other developed economies, and a number of developing economies, will also soon obtain more solid benefits from the ICT revolution. In other words, a growing number of observers advocate that the further diffusion of the ITC revolution is bound to provide a major watershed in the way in which scarce economic resources can be utilized to maximum benefit. If true, this revolution, as earlier ones, will then support robust global economic expansion for many years to come.

One caveat to the optimism about the ICT revolution is that all kinds of fixed investment tend to be pro-cyclical. This includes ICT-related investment. Its trend might therefore be inherently fluctuating as well when observed over the full cycle, which is yet to be completed. If so, the ICT-related investment itself could entail short-term cyclical turns for the global economy. In effect, the large correction in the value of many ICT stocks in world equity markets since the spring of 2000 has already issued such a warning against excessive optimism.

Meanwhile, views on the negative shock being incurred from high fuel prices have been gathering strength to the point where these risen input costs are seen as posing an imminent threat to sustaining the pace of world economic growth. World oil prices have stayed around \$30 per barrel (pb) for several months, but with some sharp upward thrusts to the mid-thirty range and beyond to about \$38 pb for a few days in September. This has been well above the assumption on which, for example, the LINK spring forecast had been predicated. The impact of these high, and at times surging, fuel prices has been felt in more and more economies, oil-importing countries in particular: deteriorating current-account balances, slowdown in consumer spending, rise in headline inflation, and even social unrest.

Historically, the three major oil shocks in the 1970s, 1980s, and the early 1990s all led to a marked slowdown in the pace of global economic growth; some even induced sharp recessions in some developed economies. Many observers have argued that the impact of the current oil shock will be less severe because of the reduced energy intensity of output in many developed economies. By contrast, due to their industrial expansion, chiefly of the energy-intensive kind, in many developing economies over the past decade or so, the adverse effects of the oil shock have become more serious for these economies than they were in the past. While the LINK baseline forecast has been prepared on the assumption that fuel prices will retreat in 2001, thus that the current shock will be mild in intensity and duration, the risk of a worse outcome is by no means nil.

In addition to the above two major shocks from the ICT revolution and fuel prices, several other factors have been affecting the world economic outlook. For example, the strong and rapid economic recovery of many crisis-affected economies, particularly developing Asian ones, has provided another support to the strength of the recent acceleration in the pace of global economic growth. The recovery in these countries was further solidified and broadened in the first half of 2000 to economies that had earlier been lagging in their recovery. Equally, if not more, important has been the comparatively smooth transition in many of these economies from the early phase of the recovery led by policy stimuli and strong export gains to a mature phase of the recovery, where increases in domestic demand, particularly business investment and consumer spending, provide the major strength underlying the pace of economic buoyancy of these economies.

As stressed in the last LINK Global Outlook, this transition is important for avoiding aborting the recovery and for sustaining global growth in the next few years. However, it is a challenge for policy makers in these economies to determine the timing for changing the stimulus macroeconomic policies to a neutral stance, or even to restrictive measures where warranted, for example on account of strong fiscal imbalances. Withdrawing the stimulus policies too soon may impede recovery in employment and private consumption, which usually lag the recovery part of the cycle. Keeping such stimulus policies in place for too long can lead to economic overheating and growing budget deficits, thus putting pressures on inflation. In due course these developments will need to be countered through strong monetary tightening and possibly severe fiscal consolidation, meaning, more pronounced cyclical fluctuation.

Restraining factors in the global economy other than the oil shock include the restrictive monetary policy in most developed economies and the tight labour markets in some countries. All these are moderating global economic growth. Other downside risks for the world economy

include the large and growing external imbalances across major regions, the postponed economic restructuring in many crisis-affected countries, and the most recent large depreciation of several currencies, but especially the euro, in terms of the U.S. dollar. The latter has been deemed unwarranted by underlying economic fundamentals, thus underlining that the present international monetary arrangements are not particularly suitable to maintaining stable exchange rates. Maintaining solid and stable economic growth while resolving structural problems in the world economy continues to pose a major challenge for policy makers worldwide.

WORLD ECONOMIC GROWTH: FROM ACCELERATION TO STABILIZATION

The 60 bps upward revision in GWP growth for 2000, as compared to the last LINK Global Outlook, is warranted by the stronger-than-expected expansion in almost all major regions of the world economy, except Africa. In fact, a large proportion of the revision in the pace of global economic growth is attributable to the significant upward revision for the developed market economies: the rate of growth of gross domestic product (GDP) forecast for 2000 for that group alone has been raised by 70 bps. Strong ICT-related investment, robust consumption spending, and a rebound in exports have been boosting economic prospects for many economies in the group.

The revision for the group of developing countries – 40 bps – is more moderate. This reflects mainly the strength of the pace of recovery in South and East Asia. However, the performance of many African economies is estimated to be much weaker than had earlier been expected – by nearly 80 bps – owing to, among other factors, adverse weather conditions, declining prices of some agricultural commodities, and war and political strife.

The estimate of growth for the group of economies in transition (the Baltic States, the countries of Central and East Europe [CEE], and the members of the Commonwealth of Independent States [CIS]) has also been revised upward by a very substantial amount. The forecast for the group as a whole for 2001-2002 is for continued strong performance, albeit at a lower level than in 2000. Sustaining this pace is partly contingent on a strong upswing in Poland. If the forecast deceleration in growth in Western Europe will be borne out, this strong acceleration in Poland may well turn out to be infeasible.

The annual rate of growth of 3.6 per cent now forecast for 2001-2002 can be considered close to the equilibrium pace for the world economy in the new decade, which is perhaps 3.5 per cent or about 50 to 75 bps above the average growth observed in the 1980s and 1990s, though still below that registered in the 1950s and 1960s. From the perspective of propping up the expansion of supply, given the 1.5 per cent annual growth of labour force, it requires 2 per cent or better annual growth worldwide on average in labour productivity to sustain this pace of global economic expansion.

The recent significant improvement in the trend of productivity growth in the United States, along with the expected catch-up in other developed countries, offers some optimism that the projected more than 2 per cent annual growth in global labour productivity in the world as a whole is within reach. In addition to the ICT-led technological innovation, the capital deepening

through increased investment, and the efficiency gains from further global economic integration, steady improvements in the quality of labour through education and training remain important to buttress such a pace of expansion in average labour productivity for the world economy as a whole.

Developed Economies

In the current global economic expansion, the developed economies, particularly the economy of the United States, continue to function as the engine of global growth. Growth in GDP for this group as a whole is estimated to be 3.7 per cent for 2000, up substantially from the 2.6 per cent recorded in 1999. In the outlook, growth is forecast to stabilize at around 3 per cent for 2001-2002. As mentioned earlier, the common feature of strong ICT-related investment in almost all countries in this group, along with the ongoing economic restructuring in many of these economies, is likely to sustain a robust pace of further economic expansion.

Once again, the economy of the United States has surpassed by a wide margin most forecasts, including the LINK forecast, made earlier this year as its GDP is now estimated to grow by 5.2 per cent for 2000 or 100 bps above the pace foreseen in the preceding LINK Global Outlook. Robust business investment and solid consumer spending, plus a rebound in the demand from the rest of the world, have been supporting this stronger pace of expansion. Meanwhile, the latest data show growth of labour productivity by about 5 per cent for the first half of 2000, up from 3.5 per cent in 1999. This provides additional evidence in support of the view that there has been a rise in the trend of productivity growth largely related to ICT innovation. More and more observers are believing that the potential growth, that is, the pace of expansion at which demand and supply will match without exacerbating the pace of inflation, has been lifted by at least 100 bps above the trend observed during the last two decades, to about 3.5-4 per cent.

However, a moderation in consumer spending, although it continues to grow at a solid pace, was evident in mid-2000. This slowdown resulted from the effects of tightening monetary policy, the surge in energy prices, and less buoyant equity markets that may have reduced some of the positive welfare effects that, in the past several years, resulted from the large appreciation of wealth portfolios, notably wealth held in equity. In the outlook, growth of GDP is forecast to be above 3.5 per cent for 2001-2002, but on a declining trend.

Economic performance for many other developed economies has also been more robust than had earlier been expected. GDP growth for Europe is forecast to be 3.5 per cent in 2000, followed by 3.1 per cent for 2001-2002; the same data apply to the 11 members of the euro area, where both investment and consumer spending have been growing at a fairly robust pace, supported by high levels of business sentiment and consumer confidence. A large increase in exports, partly resulting from the weak euro, has also contributed to growth. However, increasing concern about the upward drift in the pace of inflation, resulting chiefly from the double-hit of soaring fuel prices and the plummeting euro relative to the U.S. dollar, as well as the continued monetary tightening are expected to induce some moderation in the pace of growth for the euro area, at least in some major economies, in 2001-2002.

Among the large economies in the euro area, Germany is considered to be the most likely to experience a rise in productivity growth attributable to the ICT revolution. Whereas a pace of economic growth above 3 per cent is expected to continue for France and Spain, the economy of Italy is seen as remaining relatively laggard, owing in part to the considerable fiscal consolidation pursued in the run-up to the inception of Economic and Monetary Union and to the volume of pent-up structural reforms that await implementation, in the meantime slowing the feasible pace of economic expansion. The rate of economic growth has been even stronger in some smaller euro member economies: for example, the near 9 per cent growth sustained in Ireland for the last few years and the 5 per cent growth in Finland, both in part because these countries have carved out for themselves strong niches in telecommunication technology. Their economic momentum is likely to continue.

Economic growth for European developed economies outside the euro area is estimated to be around 3 per cent for 2000, and this pace is forecast to continue in 2001-2002. For example, In the United Kingdom, consumption demand has been the main driving force of GDP growth at 3.2 per cent. Incidentally, the United Kingdom is the only country from among the major developed economies whose forecast for 2000 has been revised downward, albeit only marginally. The fairly solid pace of growth in the United Kingdom has been supported by the appreciation of real estate and the strength in labour markets, with the claimant rate of unemployment falling below 4 per cent, and still declining. In Norway, the high oil prices have benefited economic growth: its GDP growth is estimated to be 3 per cent for 2000, up from 0.9 per cent in 1999, while the budget surplus has risen substantially. In Greece, GDP is estimated to grow by 3.5 per cent or higher for 2000, followed by an even higher rate for 2001-2002, driven by strong investment as the economy is well on the way to euro convergence.

Japan remains the laggard among the developed economies, but a cyclical recovery has been in progress. After the recovery attempt in 1999 faltered, with GDP expanding in the first half but contracting in the second half, growth for 2000 is estimated to be 1.4 per cent, about 50 bps above the earlier forecast. The recent recovery is still being driven by public investment resulting from the implementation of the stimulus package approved towards the end of 1999. But business investment, especially spending on ICT, has also been pronounced. Private consumption has finally started to show some recovery and exports remain on an upward trend. Business sentiments are improving, and so are corporate profits, along with the rise in industrial production. However, the lingering corporate restructuring needed to restore the soundness of the financial system and reduce structural excess capacity, will continue to impede stronger growth in incomes, hence in private consumption demand over the near term. Also the expected fiscal consolidation to reduce the mounting debt in the years ahead will dampen the feasible pace of growth. As a result, GDP growth is forecast, along an upward trend, to an average of some 2.5 per cent for 2001-2002.

Elsewhere in the group of the developed economies, economic performance in Australia, Canada, and New Zealand has been robust in 2000 – about 4.6 per cent for Canada and near 4 per cent for both Australia and New Zealand. Some moderation is expected for all of them in 2001-2002. In Canada, ICT-related investment spending has been booming and exports, mainly to the United States, have also been strong. Meanwhile, labour productivity growth has been rising. With less tight capacities than in the United States, the growth outlook for Canada

remains optimistic, provided there will be no hard landing in the neighbouring economy, which is the country's major trading partner by a wide margin. There will be a noticeable slowdown to the just-above 3 per cent range, basically in consequence of the expected growth deceleration in the United States. But there are more uncertainties in the outlook for Australia and New Zealand: weakening currencies, increasing concern about rising inflation, large external deficits, and tightening monetary policy in both economies, with New Zealand even more vulnerable because of its deteriorating terms of trade.

Developing Economies

Economic growth for the group of developing economies has continued to accelerate in 2000 to an estimated 5.6 per cent, thus returning to the high level of growth observed prior to the 1997-1998 Asian financial crisis. But the economic performance across nations in the group is far from homogenous, with the poorest continuing to trail behind. To realize the projected growth of 5.6 per cent on average for 2001-2002, further improvement in the international economic environment is needed. Persisting with domestic structural reforms in many economies constitutes a formidable task for policy makers and corporate leaders.

Although this year's performance surpasses that for 1999, growth for *Africa* as a whole is estimated to be only 3.6 per cent for 2000, the lowest among the major developing regions and 80 bps lower than the forecast made at the beginning of the year; for sub-Saharan Africa, however, the forecast is slightly above the one in the last LINK Global Outlook. Given the more than 2 per cent growth in population, this pace is insufficient to allow for any significant alleviation of poverty in the region. Moreover, performance across countries in the region has become more diverse. The surge in the international prices of oil and firmer prices of some other commodities, mainly base metals and industrial raw materials, have improved external and fiscal balances and led to solid growth in some countries of the region, especially the oil-exporting countries such as Algeria, Libya, and Nigeria. However, high oil prices and constraints on external financing have severely curbed economic activity in many oil-importing African countries. Meanwhile, declining prices of some agricultural commodities (such as cocoa and coffee) and adverse weather conditions (drought in Ethiopia, Kenya, Morocco, and Tunisia; and floods in some southern African countries) have lowered growth for several countries in the region below what had been anticipated. Further, political instability and civil conflicts have also affected economic performance in a few countries in the region. Among the worst affected, for example, Zimbabwe is expected to have a deep recession with its GDP declining by 6 per cent in 2000. The recession has also had a negative impact on neighbouring South Africa. However, fairly strong domestic demand, especially spending on durables driven by lower interest rates, and improved overall exports have brought moderately more buoyant growth for South Africa than in 1999. But the earlier forecast for 2000 has been revised downward by 100 bps to 2.2 per cent.

The outlook for 2001-2002 remains cautiously optimistic, with GDP growing at 4.1 per cent in 2001 and then accelerating to 4.8 per cent. But this is based on the assumptions of continued implementation of economic reforms, firmer prices of non-oil commodities, softened but stable oil prices, and easier external financing conditions with increases of both private and official capital flows.

Economic growth in *South and East Asia* has been remarkable. Aggregate GDP for this group (excluding China) for 2000 is estimated at 6.6 per cent. The outlook for 2001-2002 continues to be for a robust pace of above 6 per cent. While the crisis-affected economies have sustained strong and rapid recovery, growth in other economies of the region has also been accelerating. Meanwhile, the ICT revolution has yielded increasing benefits in terms of bolstering economic growth for several economies in the region, thanks to strong investments and booming exports in the ICT-related sectors. These economies are the most likely among the developing countries to catch up to the higher productivity path recently enjoyed by leading developed countries.

Among the economies most severely affected by the financial crises, Hong Kong Special Administrative Region (SAR) of China, Malaysia, and the Republic of Korea recorded a double-digit recovery pace in certain quarters in either 1999 or 2000. But recovery has been lacklustre in the Philippines and continues to be fragile in Indonesia; for both the present forecast is lower than the one prepared in spring 2000. Most importantly, the recovery in the region has recently been shifting its underlying strength from inventory adjustment, net exports, and government spending to more self-sustaining business investment and private consumption demand. However, the pace of growth for these economies is expected to moderate in the near term as the recovery matures. The high oil prices are also curbing domestic demand in some of these economies. Sustaining a strong pace of growth in these economies continues to be predicated on their continuing with the needed restructuring in order to reduce the vulnerability of their banking and financial sectors so that sustainable growth can be secured.

The two largest economies in the region, China and India, have continued to expand at strong rates in 2000 – the estimate for China is 8.4 per cent (well above the earlier forecast) and for India 6.6 per cent (just above the earlier forecast). In China, the persistent stimulus policies, continued structural reforms, and improved international trade have finally reversed the deflationary trend predicated on weakening domestic demand. Growth of GDP started to accelerate in the first half of 2000, led by a strong rebound in fixed investment. Meanwhile, corporate profitability has been on the rise, including in state-owned enterprises (SOEs). The near-term outlook has been revised upward, with GDP growing at over 8 per cent on average for 2001-2002. But challenges remain for boosting robust private demand in the face of the ongoing SOE reforms and the expected rise in international competition for China when it becomes a full member of the World Trade Organization (WTO) – possibly later this year. In India, ICT and other export-related industries have been driving strong growth. This is anticipated to continue, leading to a forecast of near 7 per cent average growth for 2001-2002. Elsewhere in South and East Asia, growth for many economies has been on the upturn supported by a generally favourable agricultural output and rising exports.

High oil prices have strongly boosted the pace of economic activity in several oil-exporting economies in *Western Asia*, as both internal and external surpluses rose sharply. GDP for the oil-exporting group is estimated to be 5 per cent in 2000, up from 2.9 per cent in 1999. While the prices of oil in the baseline outlook are assumed to soften somewhat in 2001, the prospects for further expansion in these economies remain strong, with 5.2 per cent growth for 2001 and then a decline to 4.2 per cent in 2002 as lower oil revenues take hold. The revenue from oil exports is expected to boost government spending on infrastructure, education, and

health care, and thus to benefit overall economic growth. The performance for oil-importing countries in the region has been mixed, as GDP is estimated to be only 2.6 per cent for 2000, followed by a forecast of over 3 per cent for 2001-2002. Growth in Israel has accelerated from 2 per cent in 1999 to 5 per cent in 2000, led by strong exports of high-technology goods and tourism; a pace of 4 per cent is forecast for 2001-2002. Meanwhile, the economy of Turkey has recovered sharply from the severe damages of the earthquakes in 1999. GDP growth rebounded to 5.5 per cent in 2000 from a recession of 4.5 per cent in 1999. The forecast for 2001-2002 is for 5 per cent growth on average.

Economic growth for *Latin America and the Caribbean* as a whole in 2000 has been in line with the last LINK forecast, though some differences for individual countries of the group should be flagged up. After stagnating in 1999, growth for the region has recovered to 3.9 per cent in 2000, as Mexico and many economies in Central America and the Caribbean have continued to grow strongly, while countries in South America have been recovering from the recessions or the slowdown in 1999.

The improved external environment has been crucial for many economies in the region. A strong rise in exports, particularly to the United States, has been an important driving force for Mexico, Central America and the Caribbean, while the soaring oil prices have benefited several economies, such as Colombia, Ecuador, Mexico, and in particular, Venezuela, whose GDP rebounded from a deep recession in 1999 to moderate growth of 3 per cent in 2000. Meanwhile, growing foreign investment has helped to finance a rebound in domestic demand. This has been especially relevant for Brazil and Mexico. The reinforcement of prudent macroeconomic policy has also been important in stabilizing the economic recovery for many economies in the region. Argentina has been an exception, however. Its tight fiscal measures and rising unemployment have curbed domestic demand. As a result, its GDP grew at merely 1.5 per cent in 2000, much weaker than earlier expected.

The outlook for the region as a whole remains fairly optimistic, with GDP growth of 4.5 per cent on average for 2001-2002. However, the dependence of the region on external financing, the concentration of output on commodities in some economies, and strong economic linkages of some economies, especially Mexico, Central America and the Caribbean, with the United States continue to make the region vulnerable to international economic shocks.

Economies in Transition

Economic growth in almost all economies in transition of the Baltics, CEE, and the CIS has in general been on the upturn in 2000. These economies have benefited to varying degrees from such favourable external factors as high oil prices, buoyant growth in Western Europe, continued foreign investment, as well as the strong pace of the economic recovery in Russia itself.

GDP growth for the *CIS* is estimated to be 4.0 per cent in 2000, with growth in Russia rebounding strongly to 6.5 per cent. Soaring oil prices and gains from the import-substitution brought about by the devaluations in 1998-1999 have led to strong industrial performance and a

large trade surplus in Russia, with a positive ripple effects fanning out to other CIS economies. Meanwhile the high oil prices and the progress attained in implementing the large-scale oil and gas pipeline networks in the Caspian region have also boosted growth for countries such as Azerbaijan, Georgia, Kazakhstan, and Turkmenistan. But adverse weather conditions have caused severe damage to agricultural production in many economies of the region.

Whereas a favourable external environment and a reversal of the setbacks in agriculture should benefit growth in the years to come. Nevertheless, some moderation on average is expected for the region's growth to a forecast of about 3 per cent in GDP for 2001-2002. Weak private consumption, enormous challenges of restructuring, and financing constraints in many economies of the region will put a lid on the feasible rate of growth in the near future.

The three *Baltic economies* have also recovered strongly, thanks to the increases in trade with Western Europe and in the transit trade from Russia. The group's GDP is expected to grow by some 4 per cent for 2000, up from the 2 per cent contraction in 1999; the forecast for 2001-2002 is for a continuation of this pace – 4 per cent on average.

GDP growth for the *CEE* group is estimated to be about 4 per cent in 2000, with an acceleration to around 5 per cent forecast for 2001-2002. But the economic performance has been far from homogenous across countries. In Central Europe, economic growth in Hungary and Poland has gained momentum, with both economies expected to register GDP growth in the range of 5.4-6 per cent in 2000; the Czech Republic has pulled out of its three-year long recession with a moderate growth of 2.7 per cent in 2000; but Slovakia grew at a lower than expected rate of 1.6 per cent. Countries of southeastern Europe are still subject to large structural change. The restoration of regional trade and the revival of tourism in the Balkans, after the Kosovo conflict, continue to depend highly on international assistance. Disbursement of such assistance has been significantly lagging behind the expectations engendered by the Stability Pact signed over a year ago. While growth of exports has been strong for CEE, domestic demand remains moderate and agriculture in many economies has been negatively affected by adverse weather conditions, with repercussions on the current-account positions of these countries.

INTERNATIONAL TRADE: STRONG EXPANSION WITH LARGE IMBALANCES

Along with the strong growth in GWP in 2000, international trade has expanded at an even stronger pace. Measured by changes in the volume of global exports, world trade is estimated to have surged by 10.5 per cent in 2000 – double the 4.9 per cent recorded in 1999 and a record pace not observed in decades. This boom in international trade has been widely shared by almost all major regions, as many countries have registered double-digit increases in both exports and imports. Nevertheless, the large trade imbalances among major regions accumulated over recent years, especially since the 1997-1998 international financial crises, have not so far been adjusted; in fact, some of the major imbalances have continued to widen. The outlook for international trade remains solid, although the pace of expansion is expected to moderate along with the anticipated end of acceleration in the sustainable pace of growth of world output. World trade volume is forecast to be at least 7 per cent for 2001-2002.

While the share of international trade of developed economies still dominates total world trade, a noticeable feature in the rise of world trade volume in 2000 has been the strong acceleration in import demand from developing economies and countries with economies in transition. Although most of these economies started their output recovery from the setbacks of the Asian crises in early 1999, the import demand of many remained stagnant until late 1999 and for some, notably several Latin American countries, the import contraction continued throughout the year. In fact, the early recovery in aggregate output in these countries relied overwhelmingly on exports to the developed economies plus policy stimuli, with pressures to reduce current-account imbalances and replenish reserves remaining strong. Since early 2000, when the recovery solidified and spread to domestic demand supports, import demand has been recovering on the strength of the acceleration in domestic investment and private consumption. In spite of this bolstering of imports, replenishment of the foreign reserves of many of these countries has continued as a result of strong export growth and, though still slow, recovery in capital inflows. Both forces facilitated the financing of strong import demand in these economies. For developing economies as a group, import volume is estimated to increase by 14 per cent in 2000, compared with a mere 6 per cent in 1999.

Two developing-country regions – Asia and Latin America – registered the largest acceleration in import demand. Whereas Latin America's import turned from a decline in 1999 to an expansion of 10 per cent in 2000, in developing Asia import demand surged from 3 per cent in 1999 to an estimated 15 per cent in 2000. Seen from a different perspective, the surge in import demand in these economies signals the maturing of their current recovery phase. As a result, a slight slowdown in import demand from these economies is expected for 2001-2002. In contrast to the performance of the Asian and Latin American developing countries, growth of import demand in Africa has been relative moderate along with the rather lacklustre GDP growth and the limited external financing to which these countries had access.

Also import demand from developed economies has accelerated in 2000. The United States continues to lead in import growth, as the strong dollar and robust domestic demand have pushed import demand to rise by more than 10 per cent for another year. Import demand in Japan has also increased remarkably as investment spending rebounded, especially on ICT-related equipment, although the overall economic recovery has not yet solidified. By comparison, the acceleration in import demand in Europe has been moderate, largely because of the weak euro, which has dampened notably the demand of these countries for products from outside the euro area.

The strong surge in global demand has led to robust export performance in almost all main regions, except those whose export supply is concentrated in non-fuel commodities; this includes many African countries. On top of the list is Asia where the dynamism of intraregional and intra-industry trade has revived, as several economies in the region are estimated to have registered growth of export volume by a whopping 20 to 30 per cent in 2000.

The recovery of exports in many economies in transition has also been strong in comparison with 1999, especially for the CEE countries. A notable feature is the increase of their exports to Western Europe as a result of the latter's acceleration of growth in 2000. For example, the Czech Republic, Hungary, Poland and Slovakia have benefited from the increased demand

from Austria, France, and Germany, while countries of southeastern Europe have also benefited from expanding trade ties with Greece and Italy. Foreign-owned companies in economies in transition have played an important role in promoting exports back to the countries where the parent companies are located, resulting in substantial gains in intra-industry trade.

In spite of the full recovery in world trade to the dynamism reached prior to the Asian and Russian currency crises, the large trade imbalances among major regions accumulated over the past several years have not yet shrunk. In fact, the large trade deficit of the United States has continued to balloon during 2000, reaching an estimated \$440 billion – 4.5 per cent of GDP – as compared to some \$340 billion in 1999. During the year, the large trade surpluses of Japan and Western Europe have been reduced slightly, implying an improved trade balances in some developing countries and economies in transition corresponding to the rise in the United States deficit.

The rise in trade imbalances in some countries and the reduction of surpluses in others in 2000 stemmed in part from the factors that have been dominant in driving the global economic expansion in recent years, but also from developments in the course of the year. Especially important has been the surge in fuel prices and their relative stabilization at rather high levels, as compared to the magnitudes prevailing, say, in 1997-1999; some \$60 billion or two thirds of the risen import bill is accounted for by oil alone in the case of the United States. The factors that have driven trade imbalances all along include the familiar ones: large differentials in the pace of growth between the United States and the other developed economies; the strong U.S. dollar in part because of positive interest rate differentials in favour of the United States; and the continued buoyant capital inflows, including into equity markets, in the United States.

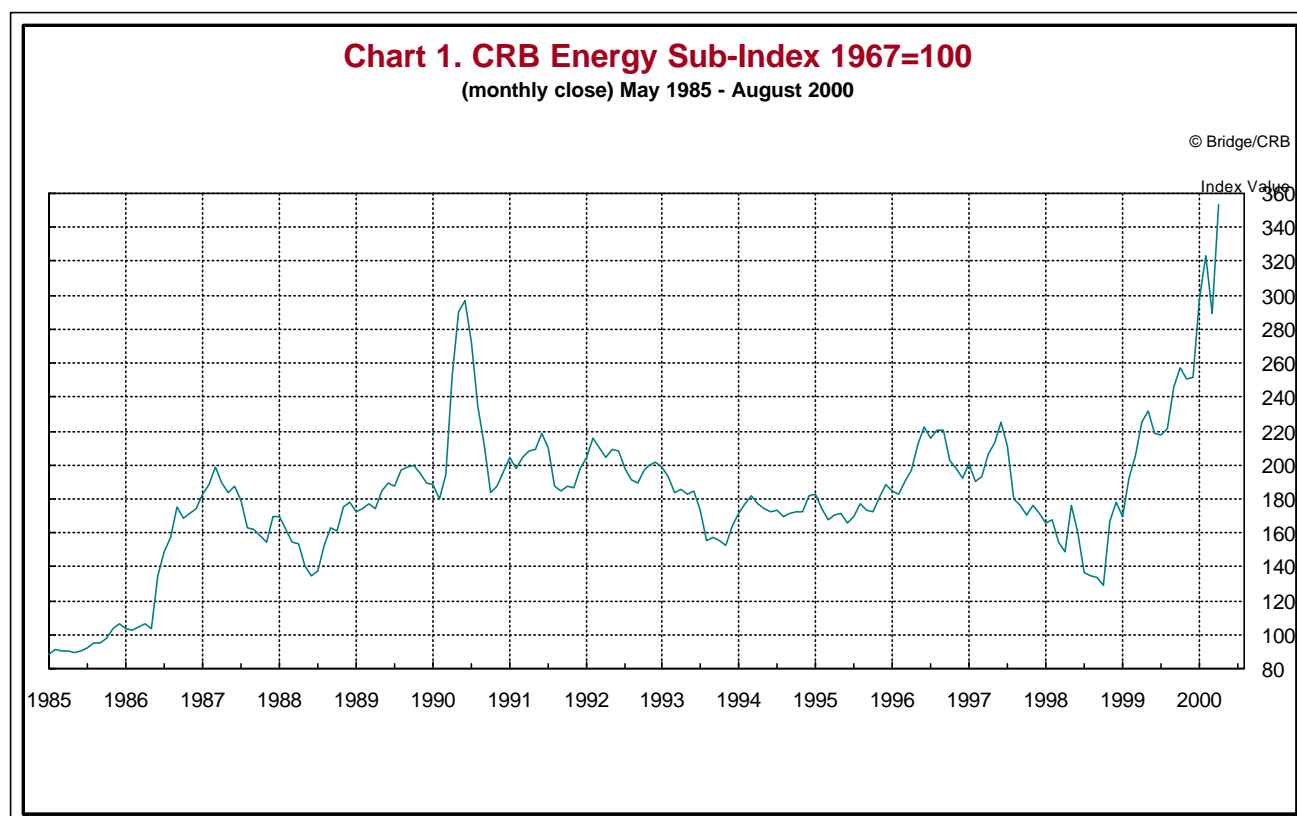
High oil prices in 2000 have led to large changes in trade balances for many economies. Seen from another perspective, they have resulted in large transfers of wealth from oil-importing economies to oil-exporting economies, thus crimping funds that could otherwise have been mobilized for investment or other props for domestic demand in the former, but providing new growth opportunities for the latter. For example, the trade balance for the group of net energy-exporting developing countries is estimated to have increased by \$90 billion in 2000 as compared to 1999 levels. Also Russia and several other CIS countries such as Azerbaijan and Turkmenistan have benefited substantially. A good part of the doubling of Russia's surplus in the first half of 2000 stemmed from the high oil prices; its surplus for 2000 as a whole is estimated at over \$50 billion. The accrued purchasing power of these economies in global markets is expected to bolster international trade in the next several years.

An important milestone in promoting the multilateral trading system has been the recent passage by the United States of legislation that accords China the status of “permanent normal trade relations,” which is the equivalent of standard most-favoured nation status. In and of itself, this is a major marker on the way of China's accession to the WTO, perhaps later this year or early next year.

COMMODITY PRICES: DIVERGENT TRENDS

The sharp divergence among the trends of prices for the various groups of primary commodities, as flagged up in the last LINK Global Outlook, has continued in 2000. Putting it in a nutshell, there have been three broad trends for commodity prices: (1) the further surge in prices of oil and their relative stabilization around a high level, as measured by prices observed since the last oil shock in the early 1990s; (2) a moderate rebound in prices of base metals and some other industrial raw materials; and (3) a persistent weakening of prices for agricultural commodities.

Although some knowledgeable participants in LINK meetings, especially since 1999, had warned that prices of oil could surge to \$35 pb, the duration and the magnitude of the upswing in oil prices in 2000 have been even stronger; they certainly have exceeded the assumed magnitudes built into earlier forecasts. After a strong and rapid recovery in 1999 from the 1998 low prices, in part because of the global financial crises, prices of oil fluctuated around \$28 pb for the first half of 2000, and then surged, albeit only for a few days, to \$38 pb in mid-September, the highest level in 10 years, before retreating moderately (chart 1). The last LINK Global Outlook assumed a 40 per cent increase in the annual average price of oil for 2000, but it now looks as if that magnitude should be raised by half to 60 per cent, which is the assumption embodied in the current baseline.



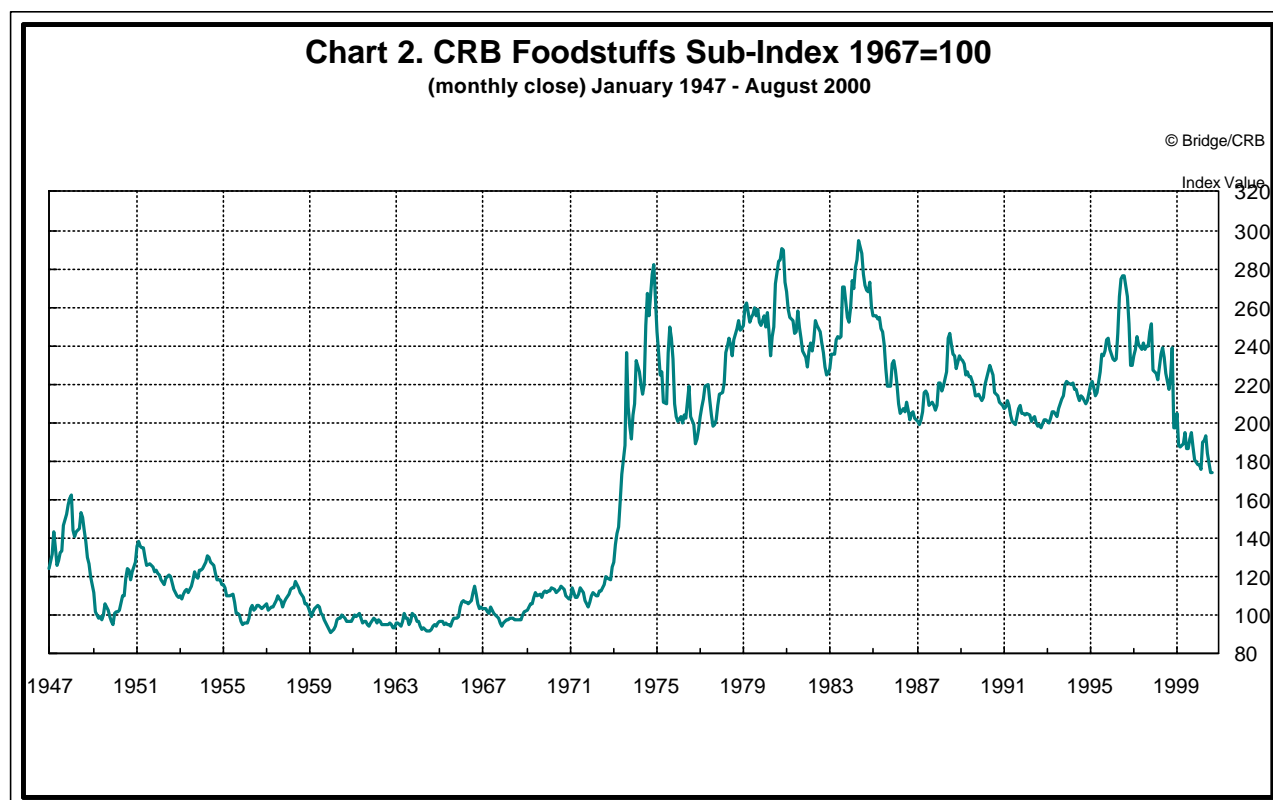
The tensions in oil markets observed during 2000 stem from multiple factors: (1) strong demand driven by the acceleration in the pace of global growth, (2) a conservative and slow supply response from the oil-producing countries, and (3) a mismatch in inventories in terms of timing, location, and composition. All things considered, however, the major culprit of the current surge in oil prices resides in the effects of the 1997-1998 financial crises and their aftermath. The economic recessions engendered by the financial crises first led to a collapse in oil demand, with rapidly plummeting prices. Since adjustments in supply take time, producers struggled for a while with how best to rein in supplies. When demand rebounded, however, suppliers waited for signs of sustainability of the recovery and for incremental cash inflows to finance the expansion of their production capacity and exports. Even at this stage, the number of active oil rigs is estimated to be just two thirds of the average for most of the 1990s, though up 50 per cent from the lows observed as exploration adjusted to the low oil prices of 1997-1998. Some knowledgeable analysts argue that it will take another year before increased drilling adds to market supply.

In September 2000, the Organization of Petroleum Exporting Countries (OPEC) announced the third increase in quotas enacted in the course of 2000. It amounts to about 800,000 barrel per day (bpd). The latest agreement also envisages that further increases will be enacted if high prices persist. However, with the exception of Saudi Arabia, OPEC members are either at near the maximum capacity in the short run. Meanwhile, the United States Government has decided to earmark some of its Strategic Petroleum Reserve to alleviate market pressures; these are swap operations so that part of present demand met by increased supply will be adding to demand later on to replenish the reserve stock. This move immediately lowered the forward prices of oil to about \$30 pb. Other developed countries with strategic reserves are contemplating similar swap operations.

Nevertheless, the key factor underlying the most recent hike in oil prices was neither demand for consumption nor supply as such, but the scramble to rebuild inventories, especially for heating oil in the northern hemisphere. Whereas overall oil inventories have been rising for the last six months, these have not yet translated into rising inventories of heating oil, especially in the United States, which is the largest oil consumer. Taking all of the above factors into account, the current LINK baseline outlook assumes that the prices of oil will stay at \$30 pb until the spring of 2001 and thereafter decrease gradually to high pb by the end of 2001.

Prices of base metals such as aluminium, copper, nickel, tin, and zinc showed some weakness in the first half of 2000, after a moderate recovery over 1999 from the declines to historical lows in some cases in 1997-1998; they have rebounded again since mid-2000. Continued global growth, though at a more moderate level than recently observed, in conjunction with low inventories – as measured by the ratio of stock-to-consumption, aggregate stocks of all base metals have fallen to their lowest levels in decades – will be supportive for these prices. However, the medium-term trend shift in major industrial countries to the production and utilization of more advanced technologies, which are less metal intensive, will dampen the upswing in prices that would appear to be feasible. As a result, the baseline LINK outlook assumes that these prices will remain flat at present levels.

In contrast to the above categories of prices for primary commodities, prices of many agricultural commodities, such as foodstuffs and beverages, have continued to decline in 2000. By September 2000, price levels of many agricultural commodities were at about 50 to 60 per cent of their levels prior to the Asian crises (chart 2). In the outlook, there is no substantial recovery for these prices in the near term.



As a result of the sharply divergent trends among the prices of different commodities, large international financial transfers across countries have taken place. While the net oil-exporting countries have so far benefited from windfall export revenues, the adverse effects of the big swing in the terms of trade may have caused severe welfare losses for the consumers in the oil-importing and agricultural-exporting developing economies. For the developing economies depending for their economic buoyancy primarily on the production and export of a few commodities, a solid hedge strategy can be useful in the short run. In the long run, however, they can ward off their vulnerability to the commodity price cycle only through diversification of their production and exports.

EXTERNAL FINANCING FOR EMERGING MARKET ECONOMIES: STILL RECOVERING

As expected, external financing conditions for emerging market economies have been on a modest mend so far this year, but the recovery pace has been slow. While there has been a slight increase of gross private capital flows to these economies as compared with 1999, the overall net inflows to these economies may well register a decline in 2000. This is attributable to the large net outflows on account of commercial bank lending resulting from repayments to

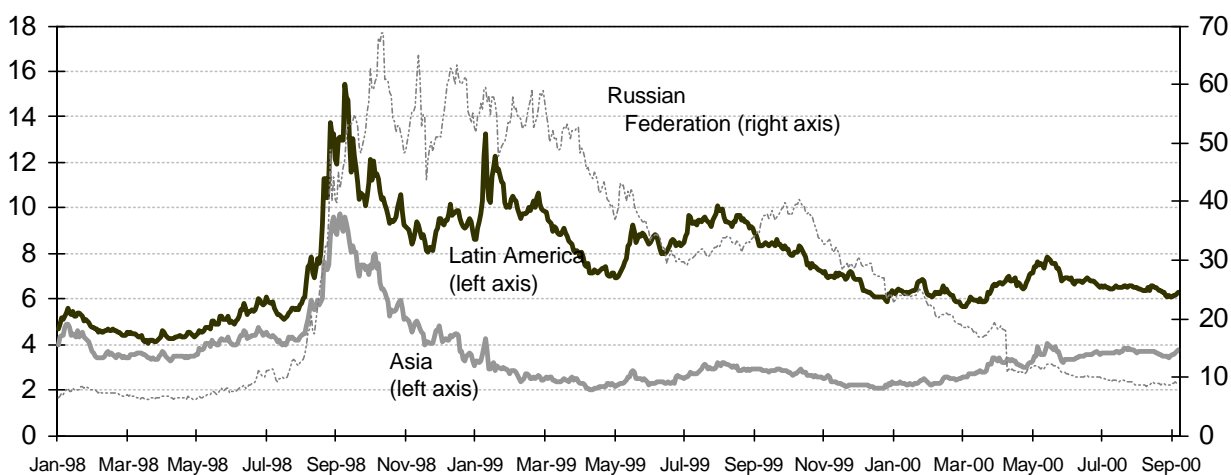
international banks. On balance, these have more than offset net increases in inflows of foreign direct investment (FDI) and portfolio investment. The net flows are expected to rise in 2001-2002, but the level will remain far below the peaks observed prior to the Asian crises.

The general profile of the outlook for capital flows to emerging market economies, in terms of the composition of different flows and the distribution across regions of emerging market economies, at this stage does not significantly differ from the picture drawn in the last LINK Global Outlook. Yet, it is worth highlighting some notable features of developments in the course of the year.

First, the continued tightening of monetary policy in developed economies during 2000 and the large gyrations in the equity markets of these countries since spring 2000 have complicated the external financing conditions for emerging market economies. Since late 1999, central banks in many developed economies have raised interest rates at an aggressive pace (see the section on monetary policy below). Coincidentally, as shown by chart 3, the yield spreads on bonds for emerging market economies in Asian and Latin America have widened during the same period. Meanwhile, as equity markets in many developed economies experienced large fluctuations in spring 2000, with notably a marked downward correction in the value of many technology stocks, the yield spreads have also trended upwards, albeit with wide fluctuations.

While the exact impact of changes in monetary policy and equity market volatility on the conditions for external financing of emerging market economies deserves a more detailed analysis, the correlations observed above are unmistakable. As monetary tightening in developed economies reduces liquidity, the cost of raising funds in international capital markets for emerging market economies rises. On the other hand, increased volatility in major equity

**Chart 3. Yield Spreads on Emerging Market Bonds,
2 January 1998 to 13 September 2000**
(Percentage points)



Source: Data of JPMorgan Co., New York.

markets in the world economy induces investors to become more risk averse, thus requiring a higher risk premium on capital flows for emerging market economies they are prepared to undertake.

Second, at a given international environment, macroeconomic fundamentals in individual emerging market economies are one crucial factor for explaining the differentials in yield spreads for these borrowing economies. After the Asian financial crisis, the spreads dropped the most and the fastest for economies experiencing stronger economic recovery with more prudent macroeconomic management. At the same time, the outcome of macroeconomic policies, such as fiscal positions, in these economies, has also been highly correlated with movements in yield spreads, as shown by the differential spreads of the sovereign issues among Latin American countries.

Third, short-term capital flows to emerging market economies declined substantially after the 1997-1998 financial crises, while FDI remained stable. To the extent that the latter flows are more supportive of growth efforts in these economies, this development implies an improvement in the quality of capital inflows to these economies; but in quantitative terms an improvement has yet to come to the fore.

Finally, recent data show that some of the capital inflows to emerging market economies, especially portfolio investments to Asia, have been closely oriented to ICT activities in these economies. A positive side of this phenomenon is that increased external financing can speed up the pace at which the ICT revolution spreads to emerging market economies, thus narrowing the technology gap. But it may also imply higher volatility.

In general, in the outlook underlying the baseline forecast, external financing for emerging market economies will remain as constrained as recently observed. Their impact on supporting more robust growth will have to await a recovery in the volume of capital inflows.

INFLATION: RISING BUT BASICALLY UNDER CONTROL

The benign inflation outlook as reported in the last LINK Global Outlook on the whole remains valid. The headline inflation rates in many developed economies have all shown a noticeable rise in 2000, by about 100 bps over levels registered for 1999, mainly because of the soaring oil prices. However, the inflation trend in many developing countries and economies in transition has remained downward. If high oil prices will abate somewhat in 2001, as argued earlier, the positive factors that have been holding global inflation in check in recent years will continue to prevail, the overall outlook for the near term is for inflation in the global economy to continue to be under control.

Pressure on the pace of inflation has built up gradually in the course of 2000 in a number of developed economies, as inflation rates moved up from 2 to 3 per cent, which is near or above the inflation target set by the central banks in many of these economies. While the soaring oil prices have been the main cause for the rise, strong growth and weakening currencies in many of these economies have exacerbated the situation. This has been particularly significant for

countries in the euro area, Australia, and New Zealand, whose currencies depreciated considerably against the U.S. dollar in 2000. Nevertheless, when the direct impact of the volatile prices of energy and foodstuffs (and also taking into account other factor such as changes in taxes on goods and services) is eliminated, the rise in the core inflation rate has been much milder than that in the headline inflation rate, implying no significant pass-through of soaring oil prices to other sectors of the economy to date. If the high oil prices moderate in 2001, so will the headline inflation rates.

In addition, several other positive factors are likely to keep inflation in these economies, and indeed in terms of global trends, from escalating. First, the current upward movement in inflation rates in developed economies occurred after a decade-long effort at disinflation, which had reduced inflation rates to record lows. Therefore, the inflation expectations of economic agents in these economies should remain low. Second, the rise in productivity in the United States and signs that more countries will be benefiting from similar gains in productivity in the next several years will keep a lid on the rise in unit labour costs that can be accommodated; rising unit labour costs are usually the key driving force behind the acceleration of inflation. Third, central banks in most developed economies have been tightening monetary policy at a vigilant pace and fiscal positions in most of these economies (except notably Japan) have been improving. This augurs well for a benign macroeconomic environment in configuring the inflation outlook. Finally, increasing international competition continues to put pressure on the pricing power for firms. This limits their ability to pass through increased costs and forces firms to rationalize further production, distribution, and marketing.

Inflation prospects for developing countries and economies in transition remain tame in general. In effect, the trend of disinflation in a number of economies, where inflation rates had been high in the past few years, has continued. The list includes Russia, Turkey, Ukraine, Latin American countries, and several other economies in transition. A number of South- and East-Asian economies have experienced a mild rise in inflation for similar reasons as in many developed economies, namely high oil prices and weak currencies. In the outlook, the continued structural reforms in many developing countries and economies in transition should result in improved efficiency and sounder macroeconomic management. If sustained, these should reduce inflation further notably in countries where inflation is still rather high and prevent inflation from rising elsewhere.

The mild deflation still expected for a few economies in 2000, such as Hong Kong SAR and Japan should end in 2001. In fact, China is expected to end the two-year long decline in general prices in 2000, as growth of domestic demand has finally rebounded thanks to stimulus policies.

EMPLOYMENT: IMPROVEMENT CONTINUING

While the recent acceleration in global output did reduce unemployment rates in many economies from the peak levels reached in the wake of the 1997-1998 international financial crises, unemployment rates continue to remain very high in many developing countries and economies in transition, and also in many developed economies in Europe. A cyclical economic recovery can

only improve employment to a certain degree. It cannot, however, resolve the structural problems that beset the labour markets of countries with high rates of unemployment. Experience in a diverse set of economies demonstrates that a long period of uninterrupted robust growth, in combination with persistent labour-market reforms and broader structural changes throughout economic sectors, is required to lower high rates of unemployment by a significant margin.

Among the developed economies, labour markets have been strong particularly in the United Kingdom and the United States. The latter's rate of unemployment has been hovering around the record low of 4 per cent for more than one year, whereas the claimant count unemployment rate for the United Kingdom has been even lower, though standardized labour force surveys suggest a rate above 5 per cent. The outlook reckons with continued tight labour markets in these economies. In the other developed countries of Europe, a significant improvement in labour markets has recently come to the fore. For example, the average unemployment rate in the euro area dropped by 100 bps to near 9 per cent in 2000 from the two-digit level observed since the early 1990s.

Further improvement is expected in conjunction with the fairly robust growth in the outlook. More important than the upturn in the cycle, however, will be the determination and persistence with labour-market reform on the part of policy makers, especially in the major countries with particularly high rates of unemployment, to resolve some structural problems at the root of the unemployment situation. Also in Japan, a mild improvement has finally begun to show up, such as in the rising ratio of job offers to applicants and the stabilization of the unemployment rate. However, the ongoing corporate restructuring and the moderate growth in the outlook do not suggest that Japan will soon experience any strong improvement in its employment situation.

The trend of unemployment rates and the ongoing changes in employment in developing countries and economies in transition varies.

In Asia, the unemployment rate has continued to fall in line with the recovery in economic growth. Because of the lag between the rise in demand for labour as output recovers, in several crisis-affected economies the rates of unemployment remain well above their pre-crisis levels. Moreover, the pace at which unemployment rates had earlier been shrinking has recently stagnated; in some countries it has even been slightly reversed. The main reason is labour shedding due to the further restructuring of corporate sectors. In China, the large layoffs from the SOEs under restructuring policies remains one of the most serious policy concerns. Some progress has been made in improving the efficiency of SOEs, in part at the expense of further layoffs.

Poor economic growth and low levels of public and private investment have combined to limit employment growth throughout Africa. Civil service retrenchment as a key aspect of reform policies and the slow pace of private sector growth have also contributed to rising unemployment in a number of countries. Average unemployment rates in North African countries, however, showed a modest reduction in 2000, and this development is expected to gather strength next year. However, unemployment remains high because of, among other things, structural weaknesses in many sectors and rapid labour force growth. The unemployment rate in Zimbabwe rose to over 50 per cent as a result of the economic contraction. In South Africa,

continuing job losses in the non-agricultural formal sector in the first half of 2000 was only partly mitigated by increased employment in an expanding informal sector. As a result, the unemployment rate in South Africa remains high and no significant improvement is in sight in the short run.

Unemployment rates in most Latin American countries are high, but have recently been declining. In fact, the regional aggregate unemployment rate dropped below the year-earlier level in mid-2000, for the first time since the Asian crisis. Mexico is the exception in the region's picture as its (urban) unemployment rate has stayed below 2.5 per cent since 1999, with continuing tightening of labour markets. Meanwhile, some job-creation programmes have been announced in several Latin American countries.

Unemployment rates in most economies in transition continue to be very high. In some countries they have continued to rise due to corporate restructuring. However, there has been a marked decline in Russian unemployment in 2000 to about 10 per cent, the first time in many years. Also Ukraine has shown a significant reduction in registered unemployment. But there is no sign for any appreciable improvement in most other CIS economies. In fact, in many there continues to be large excess employment in the only partially restructured enterprises. While unemployment is also falling in Estonia and Latvia from the highs reached in 1999, it remains above the level prior to the Russian financial crisis. The employment situation in most CEE economies is not promising for the near term. Hungary has recently reported a slight improvement in unemployment, elsewhere it remains a daunting policy issue. For example, high levels of unemployment (14 to 20 per cent) continue in Bulgaria, Poland, and Slovakia and there are presently no signs of a rapid abatement in the near term.

GLOBAL MONETARY POLICY ASSUMPTIONS

Central banks in many developed economies have continued with monetary tightening in 2000, in some cases rather aggressively (see table 2). As signs of moderation in the pace of global economic growth began to show up in mid-2000, the tightening pace since then has slowed, with some central banks holding their interest rates steady.

In the outlook, limited further tightening is assumed in 2001 for major developed economies. More specifically, the Federal Reserve of the United States, which has kept interest rates unchanged since mid-2000, is expected to raise interest rates by 25 bps in the first half of 2001. The European Central Bank (ECB), which has been under double pressure from the high oil prices and the weakening euro, is assumed to increase interest rates by 25 bps in the fourth quarter of 2000 and by another 25 bps in the first quarter of 2001. The Bank of Japan, which terminated the zero-interest rate policy by raising its policy rates 25 bps in August 2000 – the first tightening in a decade – is likely to raise its rates another 25 bps in the first half of 2001. According to recently announced monetary-policy stances, many other central banks in developed economies are contemplating further tightening. However, the current tightening cycle is likely to end in 2001 for many developed economies, when the expected moderation in the pace of global growth to a more sustainable level will manifest itself, with policy interest rates thereafter remaining at long-term neutral levels in these economies.

Table 2. Policy Interest Rates in Developed Economies

	Increase since mid-1999 (Basis points)	Current level (September 2000, percentage)
Australia	150	6.25
Canada	125	5.75
Denmark	185	4.70
Euro area	200	4.50
New Zealand	200	6.50
Norway	25	8.25
Sweden	85	3.75
Switzerland	175	3.50
United Kingdom	100	6.00
United States	175	6.50
Japan	25	0.25

Monetary policy in developing countries and economies in transition has become more divergent after a fairly shared tendency towards easing interest rates in 1999. In countries where interest rates remain high and the strength of the economic recovery is still tentative, such as several Latin American countries (not including Mexico), further easing is expected to continue. But for countries where growth has been strong to the point that the cycle has reached or is about to reach its maturing phase, such as in some Asian economies, interest rates are expected to be raised. In fact, a few developing economies – including Hong Kong SAR, Mexico, and the Republic of Korea – have already started their monetary tightening.

GLOBAL FISCAL POLICY ASSUMPTIONS

Fiscal positions in most developed economies, as well as in a number of developing countries and economies in transition, have continued to strengthen for a variety of reasons other than the shared cyclical improvement due to buoyant growth. While some relaxation in fiscal policy is expected in the outlook for many developed economies, for many developing economies, by contrast, the outlook reckons with fiscal consolidation as spending stances are likely to become more restrictive in the near term.

Budget balances in developed economies have continued to improve in 2000. Except for the large fiscal deficit in Japan and some small deficits in a few developed European economies, most countries are expected to register budget surplus. In the outlook, fiscal policy in most of these countries is expected to be mildly expansionary as various tax cuts and some incremental spending plans have been proposed or already approved in several countries. In Japan, as the implementation of the 1999-2000 stimulus package approaches its end while the economy is still on a tentative recovery, there has recently been some policy discussion of formulating another package. However, the baseline does not assume that such a package will be emerging, basically

because of the already very large fiscal deficit – some 7 to 8 per cent of GDP – and the high level of the public debt – near 110 per cent of GDP.

Fiscal positions in developing countries and economies in transition are in general not as favourable as those of developed economies. Budgets in most of these economies are in deficit, whose magnitude in several countries such as Colombia, Thailand, and Turkey is very large. However, the majority of developing countries and economies in transition have been able to reduce their deficits in 2000. Some managed this fiscal consolidation because of strong growth, with automatic stabilizers reducing deficits. Others such as Nigeria and Venezuela benefited from the significant windfall revenues due to the high oil prices. None the less, more than a score of countries in these groups are expected to register larger deficits in 2000. Some such as China owe this outcome to continued stimulus fiscal policy, while others have seen an erosion in their fiscal positions.

In the outlook, fiscal-policy assumptions for these economies vary from country to country, but mild restraining or less stimulating should be the general trends so that many will succeed with fiscal consolidation in the near future.

EXCHANGE RATES: STABILITY NEEDED

Exchange rates of most currencies against the U.S. dollar were fairly stable during the first half of 2000, leading to the expectation that the dollar, which had been appreciating with respect to most other currencies since the Asian financial crises, would soon be softening. The large current-account deficit of the United States and expectations of a possible soft-landing of the economy were anticipated to help to bring about such a shift.

However, events in the third quarter went against the trends of the first half of the year. As the soaring oil prices increasingly threatened the buoyancy of economic growth in many economies and the ability of controlling inflation in Europe and some other countries by monetary means without jeopardizing the growth momentum, a mini currency crisis erupted in September, resulting in an appreciable erosion in the value of several currencies, including the euro and the currencies of Australia, New Zealand, and a few other Asian countries. When the euro slumped to around \$0.85 from \$1.16 at its debut in January 1999, a joint intervention in currency markets was engineered by several major central banks, including notably the Federal Reserve of the United States.

While this recent rescue has stabilized the euro to date, the episode has alerted some observers into recalling the start of the Asia crisis three years ago as that too was triggered by a currency crisis. The episode also underlines, hopefully as just a timely warning for undertaking further action, that the current international monetary system is still vulnerable and incapable of stabilizing exchange rates principally on economic fundamentals.

While the forecasts of a euro recovery against the U.S. dollar in the last couple of LINK exercises have been proven wrong, the current LINK outlook continues to call for a rebound of the euro, considering several fundamentals factors. First, inflation differentials in the outlook

between the United States and the euro area will be in favour of the euro. Second, the large and growing external deficit in the United States is not sustainable. Finally, corporate restructuring has gathered pace in Western Europe and various reforms and deregulations, including in labour markets and pension arrangements, have been ongoing. In time, these measures should raise the competitiveness of Europe.

In view of the above fundamentals, in the link baseline the euro is expected to stabilize in the fourth quarter and then start to appreciate at the beginning of 2001 to reach \$1.14 by the end of 2002. However, uncertainties exist for a continued weak euro. Factors such as the gap in interest and growth rates between the United States and the euro area as well as perceptions in financial markets that the ECB lacks some credibility, which is hard to factor into any forecast, may continue to work against any appreciable appreciation of the euro against the U.S. dollar. There is considerable evidence that the erosion of the euro against the U.S. dollar has been driven by continued outflows of longer-term capital from Europe, attracted by high expected yields in the United States, and is not due to short-term speculation in financial markets. Monetary policy by itself can do little to discourage such outflows. Instead, a reversal of fundamentals, lowering expected yields in the United States relative to those in the euro area, will be required to support any appreciable improvement in the euro.

The exchange rate between the yen and the U.S. dollar has remained fairly steady around 105 yen/dollar for most of 2000. The baseline assumes a rate of 107 for the coming two years. Given the large gap in GDP growth and the wide interest rate differentials between the two economies, it is hard to justify an appreciation of the yen in the short term by invoking economic fundamentals.

The baseline outlook for the exchange rates of developing countries and economies in transition is that they remain stable, with a slight depreciation for those managed within a floating regime. Countries with rigidly fixed exchange-rate regimes have in general been successful in maintaining their peg, whereas those with some flexibility in their peg have come under some pressure; but the number of developing countries and economies in transition with such mixed regimes has declined considerably. In the outlook, continuation with the prevailing peg has been assumed for all countries with a fixed exchange rate.

UNCERTAINTIES AND RISKS OF THE FORECAST

There are a number of uncertainties with corresponding downside risks, global or country-specific, associated with the fairly optimistic baseline outlook presented here. One crucial uncertainty at the global level is the course that oil prices will take in the next several years. A major downside risk is the persistence of high oil prices for longer than anticipated in the outlook. Not only would it cause more welfare losses to consumers in the net oil-importing countries, thus reducing income and output growth in the world economy beyond those presently in the baseline forecast. It might also trigger instability such as via a currency crisis or a sudden drop in confidence that would lead to a collapse in world equity markets. The result would be a much larger slowdown first in the large energy-consuming economies, such as the United States, with subsequent ripple effects throughout the rest of the world.

This big downside risk can be analyzed in detail by making some alternative assumptions on the estimate of the highest oil price level in the worst-case scenario and the duration during which such high prices would be supported. Once these in place, the direct impact of this high price level on income, consumption, growth, trade, inflation, and other macroeconomic magnitudes among the different economies can be estimated. Furthermore, an estimate of the possible impact of such developments on the confidence of different economic agents in the world could be assessed. Moreover, the impact of such changes in confidence on the state of the world economy, through channels such as financial markets (equity, bonds, and foreign exchange) could be detailed. Finally, these various effects could be aggregated to yield an estimate of their total impact on world economic growth.

While a quantitative study based on model simulation of the above steps can shed some light on the magnitude of the downside risk, design and implementation of it is time-consuming. The exercise could therefore not be undertaken in time to make it part of this presentation. But it could be envisaged for later in the year with its results reported either in the Fall LINK Report or the next issue of *World Economic Situation and Prospects*, due by late 2000.

The direct impact of a high oil prices will differ from country to country. In general oil-exporters will be the gainers and the net oil-importers will be the losers. But the welfare loss from the income effects for consumers will depend on the share of oil consumption as well as the secondary effects of mobilizing the higher oil revenues for increased imports or lending to financial markets. As shown by chart 4, over the last three decades, global consumption of oil has been changing across regions. Whereas oil consumption for developed economies has been maintained at a relatively stable level (see charts 4 and 5), though it still amounts to a fairly large share, oil consumption of developing countries and economies in transition has grown

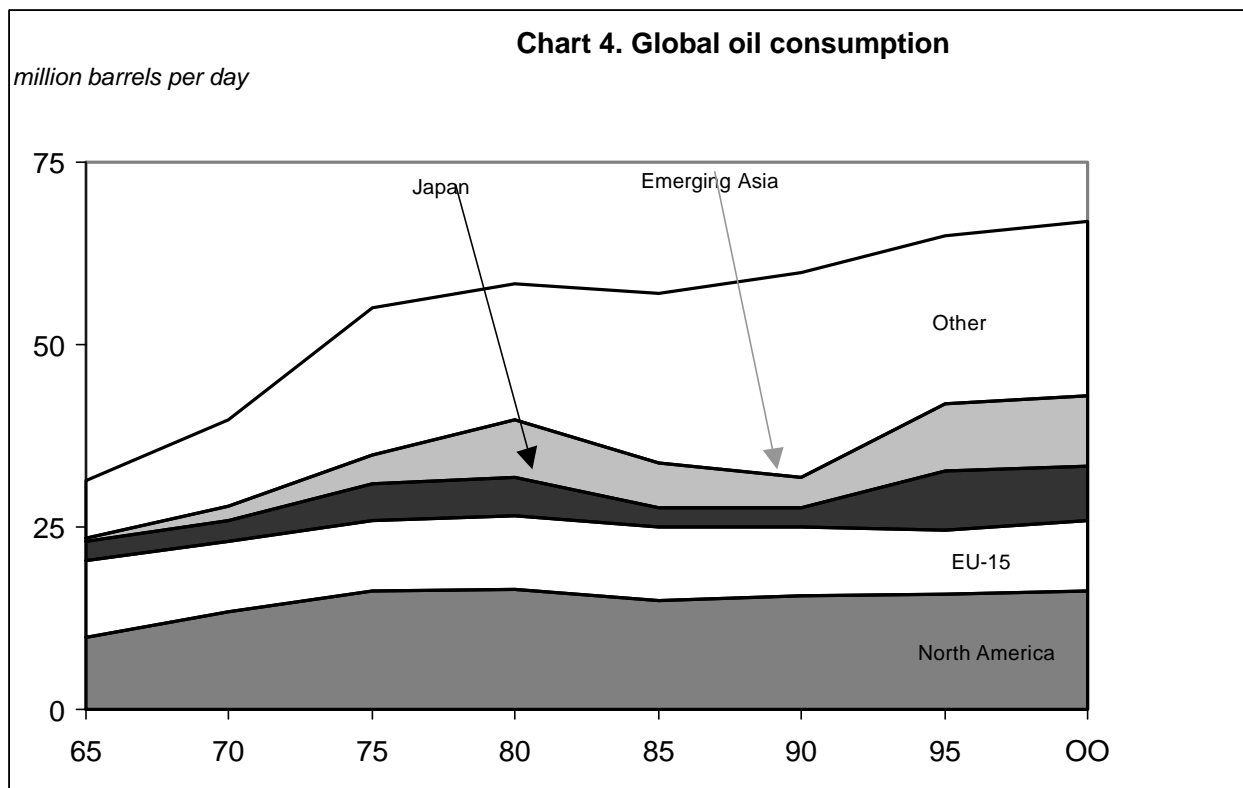
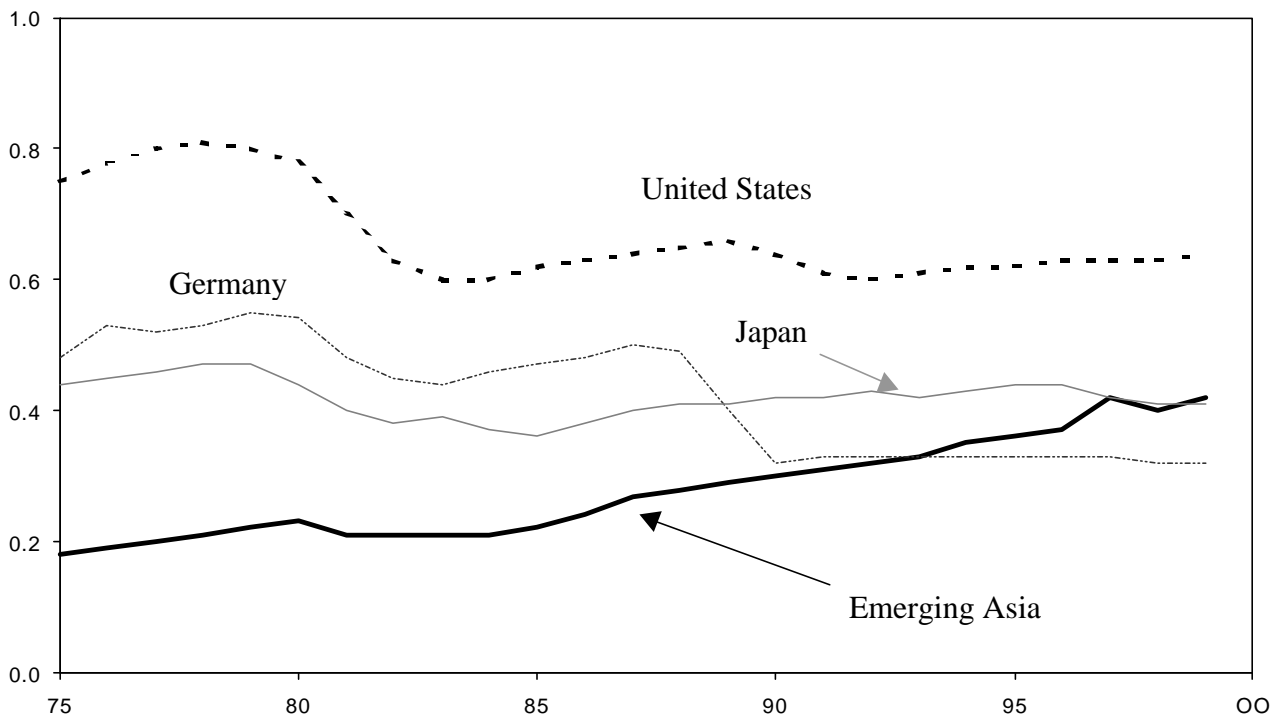


Chart 5. Oil consumption per capita

barrels per day



significantly. However, in per capita terms, as shown by chart 5, the United States is still the largest consumer, while Asian developing economies have significantly raised their per capita consumption of oil. Therefore, the biggest direct impact would in all probability still be on the economy of the United States.

The indirect impact, if higher oil prices were to cause a severe deterioration in confidence, could be larger than the direct income effects, especially if turmoil in financial markets were to be triggered.

There are other downside risks, such as a cyclical downturn in global ICT-related investment activity because of short-run overcapacity as indicated, for example, by large fluctuations in prices of semiconductor products over time; a euro crisis; or a collapse of equity markets in the United States, which may lead to substantial slowdown in global growth, as reiterated several times in several recent issues of LINK Global Outlook.

On the other hand, upside risks also exist: stronger and faster than expected global diffusion of ICT to boost much higher productivity growth in many other economies than those cited earlier (mainly Germany and the United States among the developed countries and the vanguard South- and East-Asian economies) would permit stronger non-inflationary growth in the world economy than is now in the outlook.