

E c o n o m i c &

S o c i a l A f f a i r s

World Economic Situation and Prospects 2003



United Nations

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CHAPTER I: GLOBAL OUTLOOK

The world economy in 2002 was characterized by several common features shared by a majority of countries to varying degrees: sluggish growth of output, benign inflation (and deflation in some cases), stagnant employment, low interest rates, worsening fiscal balances, low and uneven growth in international trade, reduced international capital flows, lower prices for many non-fuel commodities, and depreciated equity prices.

With some signs of stabilization at the end of 2002, global economic growth is expected to improve in 2003 but the strength, breadth and sustainability of the recovery remain subject to many uncertainties. Risks associated with heightened geopolitical tensions, such as the possibility of higher oil prices and lower business and consumer confidence, are the key threats to global economic recovery in the short run. Moreover, such weaknesses as overcapacity, hesitant business capital spending and hiring of workers, and lower equity prices, may continue to inflict deflationary pressures on the world economy and prolong the period of slow global growth. In addition, the large external imbalances across countries, fragilities in the international financial system, as well as in the domestic corporate sector in some countries, and other structural problems portend substantial vulnerability for the world economy in the medium term.

In such a global economic environment, policy makers are facing prodigious challenges. Macroeconomic policy worldwide has in general been accommodative over the past year and has helped prevent the world economy from falling further into a synchronized global downturn. Nevertheless, the various policy stimuli have proven insufficient to provide a strong and widespread boost to economic activity. The policy framework in a large number of economies has constrained authorities from adopting measures that might have been more effective. In many economies, the policies pursued over the past decade focussed predominantly on fighting inflation; they appear to be less effective, or too rigid, or biased, when used to stimulate growth in the present low inflationary, or even deflationary, circumstances in much of the world. Moreover, the room for manoeuvre and for independent policy action in many developing countries and economies in transition has been increasingly restrained by growing global economic integration. Finally, weak macroeconomic policy coordination, both among countries and between monetary and fiscal policy within many countries, may have compromised the effectiveness of policies to revive global growth.

The present global economic weakness could be aggravated by prevailing uncertainties, to the particular detriment of many of the world's poorest. Bringing about a robust and sustained recovery in world economic growth should therefore be the top priority for macroeconomic policies in most economies in 2003. Over the longer run, further structural reforms continue to be needed so that both national economies and the international trade and financial systems contribute to higher and more balanced growth.

REVIVING GLOBAL ECONOMIC GROWTH

After its sharp slowdown in 2001, the world economy underwent a sluggish and unstable recovery in 2002. Neither the strength nor the breadth of the upturn has been satisfactory. Gross world product (GWP) is estimated to have grown by 1.7 per cent in 2002, only a marginal improvement from the previous year—itself the weakest performance in a decade. World trade barely stabilized following its outright decline in 2001, increasing by only 2 per cent. Only a small number of developing economies managed to increase per capita output by more than 3 per cent in the past two years (see table I.2).¹ Such mediocre global growth implies two consecutive years of decline in per capita income for the world as a whole and marks a setback to fulfilling the overriding Millennium Development Goal of reducing global poverty.² The slow pace of growth is expected to continue for the first half of 2003, with momentum gradually gathering in the second half of the year. GWP is forecast to grow by 2¾ per cent for the year as a whole.

Negative and positive forces for global growth

The frail pace of the global economic recovery has resulted from a confluence of competing forces, with negative factors dominating.

The factors that contributed to the global downturn of 2001 included tepid business capital spending; a protracted consolidation in the global information and communication technologies (ICT) sector; and lower equity prices.³ Additional negative factors have emerged since mid-2002, including rising geopolitical tensions and an associated

surge in the price of oil; an increasing number and an enlarged scale of corporate scandals in major industrial countries, particularly the United States of America; and worsening fiscal and external debt problems in several Latin American countries. As a result, business and consumer confidence, which were strengthening from their low levels in the wake of the terrorist attacks of 11 September 2001, reversed their course during the year. Those new factors, and the havoc wreaked by unusually severe floods and droughts in a number of economies, exacerbated the previous weaknesses in the world economy and almost aborted the tentative global economic recovery at various points in 2002. At the same time, a number of key supportive factors prevented the global economy from deteriorating further, notably monetary- and fiscal-policy stimuli in countries where they were possible, resilient consumer spending and inventory restocking.

Aside from non-economic uncertainties, the core of the current global economic weakness has been the problem of overcapacity, particularly in the developed economies, resulting from excess investment in the late 1990s. This overcapacity has resulted in asset price deflation, notably in the major equity markets, and debt overhang. Many of those excesses have yet to be worked off.⁴ From a global perspective, the excess manufacturing capacity in developed economies reflects not only lacklustre effective demand within these economies, but also mediocre effective demand from the rest of the world, including developing economies. In today's more globalized constellation of production, trade and financing, capacity built in individual economies has become more dependent on aggregate demand worldwide. This holds especially for the high-technology sector with its large scope for economies

Table I.1.

GROWTH OF WORLD OUTPUT AND TRADE, 1993-2003

Annual percentage change											
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 ^a	2003 ^b
World output ^c	1.4	3.0	2.7	3.2	3.5	2.2	3.0	4.0	1.1	1.7	2¾
<i>of which:</i>											
Developed economies	0.9	2.9	2.3	2.7	3.0	2.5	2.8	3.4	0.7	1.3	2¼
Economies in transition	-6.7	-7.2	-0.6	-0.1	2.2	-0.7	3.0	6.3	4.4	3.5	4
Developing economies	5.2	5.6	5.0	5.7	5.4	1.6	3.5	5.8	2.0	2.9	4¼
World trade	4.6	10.5	8.6	5.5	9.2	3.3	5.2	12.3	-0.8	1.9	6¼
World output growth with PPP-based weights ^d	1.6	3.5	3.4	3.9	4.1	2.5	3.4	4.6	2.0	2.6	3½

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

^a Partly estimated.

^b Forecasts.

^c Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 1995 prices and exchange rates.

^d Employing an alternative scheme for weighting national growth rates of GDP, based on purchasing power parity (PPP) conversions of national currency GDP into international dollars (for explanation, see the introduction to the statistical tables in the *World Economic and Social Survey 2002*).

Table I.2.
DEVELOPING COUNTRIES: FREQUENCY OF HIGH AND LOW GROWTH OF PER CAPITA OUTPUT, 2000-2003

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2000	2001	2002 ^a	2003 ^b	2000	2001	2002 ^a	2003 ^b
		Number of countries							
Developing countries	95	24	38	33	18	35	15	14	30
<i>of which:</i>									
Latin America	24	6	13	12	5	7	1	1	3
Africa	38	14	9	9	5	8	8	6	16
Eastern and Southern Asia	18	1	7	3	2	13	4	6	9
Western Asia	15	3	9	9	6	7	2	1	2
<i>Memo items:</i>									
Least developed countries	41	16	12	12	11	9	6	6	12
Sub-Saharan Africa	31	13	9	7	5	5	6	6	13
		Percentage of population							
Developing countries	95	6.4	12.5	9.5	4.6	74.2	55.9	57.1	61.8
<i>of which:</i>									
Latin America	24	11.8	49.4	31.2	15.3	59.7	2.5	1.6	2.0
Africa	38	28.1	12.4	20.8	5.2	16.5	18.4	13.8	35.3
Eastern and Southern Asia	18	0.2	2.5	0.9	0.2	90.6	75.5	78.8	80.6
Western Asia	15	9.1	66.7	40.4	37.7	71.3	29.6	29.1	29.2
<i>Memo items:</i>									
Least developed countries	41	24.3	13.1	17.9	14.1	39.0	22.1	23.2	38.6
Sub-Saharan Africa	31	37.2	17.7	15.8	5.8	9.3	21.9	22.6	45.8

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

^a Partly estimates.

^b Forecasts.

of scale. As part of the effort to reduce the overcapacity in developed economies, it is necessary for policy makers to boost domestic demand; however, it will be even more crucial in the longer run to promote growth in developing countries, where demand for high-technology products and services is potentially large.

The weakness of global demand has exerted downward pressure on the prices of many commodities that form the backbone of the export earnings of many developing economies and has reduced developing countries' inflows of private capital, which have proven once again to be highly pro-cyclical.⁵ As a result, many developing countries with a high external debt burden have experienced pressure on their exchange rates when adhering to a fixed-rate regime or weaker exchange rates if they have adopted floating rates, as well as deteriorating debt-to-GDP ratios. Especially vulnerable have been countries with large current-account and fiscal deficits. The

diminution in capital flows to these countries has resulted in a contraction in economic activity⁶, which in turn has precipitated a deterioration in the fiscal situation, eroded investor confidence, and led to a further shrinkage in capital flows and a rise in the cost of external financing. A number of economies in Latin America were mired in such a vicious cycle in 2002—a situation that continued into 2003.

Another feature of the present situation is that the economic recovery of a large number of countries continues to depend to a large degree on the health of the economy of the United States. There is no other major economy that, at least in the short run, could plausibly assume the role of the United States as the locomotive of global economic growth. However, China is increasingly providing impetus to other countries within its region and to the world economy at large. Over time, other regionally significant countries could play a similar role in their respective regions.

Among the *developed economies*, the United States is forecast to continue to lead the global recovery, but without decisive momentum. In Japan and Western Europe, weak domestic demand means that economic recovery continues to rely chiefly on external demand and will remain fragile. Japan's fiscal and debt difficulties continue to weigh on its economy, while most economies in Western Europe are tightly constrained, on both the fiscal and monetary sides, by their adopted policy frameworks, leaving little scope for expansionary macroeconomic policies. The economies of Australia, Canada and New Zealand have fared better than other developed economies, but some moderation in their growth is expected as well.

Having experienced a deceleration in 2002, fairly robust growth is expected for the group of *economies in transition*. Strengthened domestic demand, resulting from fiscal-policy stimuli and, to some degree, the cumulative benefits of the structural reforms enacted in recent years, are offsetting some of the external weakness. Over the medium term, prospective entry into the European Union (EU) is providing some stimulus, but has relatively little impact on short-term prospects. External deficits and fiscal constraints are major policy concerns for a number of Central and Eastern European (CEE) economies while, in the absence of further restructuring and a substantial increase in investment, growth in the medium term for many economies in the Commonwealth of Independent States (CIS) will be constrained by emerging supply bottlenecks.

Among *developing economies*, the rebound in several Asian economies is expected to continue, but the recent buoyancy remains vulnerable to any relapse in the economic recovery in the major developed economies. The outlook for Latin America remains poor, against a backdrop of outright decline in GDP for the region in 2002. An increasing number of countries in Africa are expected to grow by 4 per cent or higher due mainly to strengthened domestic economic factors, but many economies in the region are still not expected to achieve any tangible growth in per capita income. Despite the rebound in oil prices, the benefit for most oil-exporting developing economies in Western Asia and elsewhere will continue to be limited.

Stagnant employment and benign inflation persist

Accompanying the weak recovery in global output has been the discouraging situation for employment—a key channel linking macroeconomic weaknesses to poverty and other social problems, particularly for the most vulnerable groups in a country.

Except for such economies as Australia, Canada and New Zealand, most developed economies continued to experience a loss of employment in manufacturing sectors in 2002. In the United States, for example, factory

employment is 10 per cent below its peak in 2000; there has been a similar decline in Japan and smaller losses in some EU economies. Recovery in industrial production has not yet been sufficiently strong, or of a sufficiently long duration, to staunch the employment losses incurred in those economies during the downturn. After rising to nearly 6 per cent during 2002 from below 4 per cent in 2000, the unemployment rate in the United States has stagnated (see table A.2). Although the total rate is far below levels observed in the past few decades, the number of long-term unemployed—those unemployed for six months or longer—reached a record in 2002. The unemployment rate in Japan is also rising to a historical high, while the rates for most economies in Western Europe have continued to hover around their 2001 levels. A new feature, associated with the consolidation in the ICT sector, is that the number of unemployed with a high level of skills has risen faster than that for low-skilled labour in a number of developed economies.

High unemployment and large underemployment remain rooted in the structure of many developing countries and economies in transition. This situation continues to pose a long-term policy challenge and is a key hurdle on the way to substantial poverty reduction. Cyclically rising unemployment rates have also become a problem in some Latin American economies, particularly Argentina, where the crisis has driven open urban unemployment above 20 per cent and the population living in poverty has soared (see box III.1.). A number of Asian economies have managed to lower their unemployment rates somewhat, but the rates are in general still higher than those observed prior to the Asian crisis of 1997-1998. In China, sizeable surplus labour in rural areas, combined with the large number of laid-off workers in the cities, continues to be a key policy concern.

A number of CIS economies are the only ones that have continued to reduce their unemployment rates in recent years, but only from the very high levels recorded in the earlier years of transition; unemployment rates remain high. In other transition economies, such as Poland, unemployment, especially among young people, has surged to very high levels.

In the recovery phase of the business cycle, improvements in the labour market normally lag the rebound of output. As a rule, an economy needs to grow above its potential rate of GDP growth for several months before businesses begin to absorb workers laid off during the downturn. Since GWP is forecast to grow only slowly in the near term, with many economies growing at far less than their potential, unemployment rates are expected—at best—to stagnate in many countries and to continue to worsen in others.

In comparison with the problem of employment, inflation is not a policy concern in a large number of economies.

Inflation edged up in many economies during the first part of 2002, driven by a rise in the prices of food and energy in some countries, weaker currencies in others, and large wage increases in some others. In spite of these developments, and with the exception of only a few countries, inflation remains tame throughout the global economy.

Apart from the possibility of an oil shock resulting from the geopolitical tensions in Western Asia, the inflation outlook continues to be benign for the majority of economies. A few developing economies that have recently experienced large currency devaluations need to bring inflation under control. In several CIS and south-east European economies where annual inflation rates remain around 20 per cent, further progress is anticipated. In the Baltic and CEE economies, inflation has already been reduced to single-digit levels so that further reductions can be only mar-

ginal. At the same time, continued deflationary pressures remain a concern in a number of Asian economies.

UNCERTAINTIES AND RISKS

The baseline forecast is subject to a plethora of uncertainties and encompasses a number of risks. Major caveats include: (1) military action in Western Asia might lead to a disruption in oil supplies, provoking an oil-supply shock to the world economy or exacerbating the effects of the increase in oil prices in late 2002 (see box I.1); (2) a prolonged depression in major equity markets could send the global economy into another downturn, or trap it in a protracted period of growth well below its potential; (3) an abrupt adjustment in the large trade imbalances among the world's economies, notably

Box I.1. Economic consequences of possible military action in Western Asia

In all respects, including from the point of view of the global economy and the region itself, the most beneficial outcome of the political tensions pertaining to Western Asia would be a prompt, definitive and peaceful solution. These tensions are already having a negative impact on global economic growth through the higher price of oil, rising economic uncertainty and the decrease in business and consumer confidence that they have generated. The present forecast includes these various existing "political premia", but does not include the possibility of military action. The political premia, and particularly the costs they entail, would probably increase if the stand-off continues for an extended period, but an escalation into military action would have even more profound negative economic consequences.

If there is military action in Western Asia, it could take a variety of courses and therefore have a wide range of plausible economic consequences of substantially different magnitudes. Opinions are widely split on the impact on the world economy of even a precisely-defined hypothetical military and political outcome. For example, some commentators claim that a brief conflict would reduce the price of oil and some of the uncertainties currently dampening consumer and investor confidence and equity markets and thereby boost economic growth. Dissenters argue, however, that new uncertainties arising from any military action will prolong, or even aggravate, the deterioration in confidence, that disruptions in the supply of oil could persist for some time, sustaining pressures on the price of oil, and that the financial costs of a military operation will crowd out business investment. All these forces would reduce global economic growth. A third possibility is that military and political developments are outside any presently hypothesized scenario, making it even more difficult to speculate on their economic impact.

In addition to the immediate human casualties, humanitarian crises, destruction of physical capital and overall disruption for the countries directly involved, the major global economic impact of military action in Western Asia would arise primarily as a result of its effects on the supply and price of oil, on consumer and business confidence worldwide and on macroeconomic policies. The magnitude of these effects would be directly related to the scale and duration of any conflict. A temporary rise in the price of oil would adversely affect oil-importing developing countries but would normally have only a limited impact on the world economy as a whole. However, an "oil shock", that is, a markedly higher price sustained for six months or longer, would have a global recessionary effect, not only through welfare losses, but also through further erosion of consumer and business confidence.^a In addition to the losses in the zones of conflict, military action would have a substantial negative impact on economic activity in those countries in Western Asia not directly involved, through reduced trade and capital flows, lower workers' remittances, a fall-off in tourism and other effects of the poor security situation on domestic and international business and consumer confidence. Oil-exporting countries might initially gain from higher oil prices, but experience indicates that those gains are often short-lived, and even negated, by the slowdown in the world economy that ensues if higher oil prices persist.

The possibility of military action in Western Asia is already having a negative effect on the world economy; its realization would be a further brake on global economic growth, in particular on development in Western Asia.

^a For analyses of the effects of higher oil prices, see, for example, *World Economic Situation and Prospects 2001* (United Nations publication, Sales No. E.01.II.C.2), pp. 5-6 and *World Economic and Social Survey 2000* (United Nations publication, Sales No. E.00.II.C.1), box II.2, p. 48.

a sharp reversal of the United States' external deficits, accompanied by a substantial devaluation of the dollar, could trigger financial and real economic shocks in the rest of the world; and (4) financial and fiscal fragility in a number of developing countries could set off further debt crises which, in the present weak economic environment, could have contagion effects.

The sustainability of the external deficits of the United States

A longstanding major downside risk for the world economy continues to be the sustainability of the large trade deficit of the United States and the value of the dollar. The possibility of a marked reversal in the external deficit of the United States, in conjunction with a sharp depreciation of the dollar against major currencies, remains.

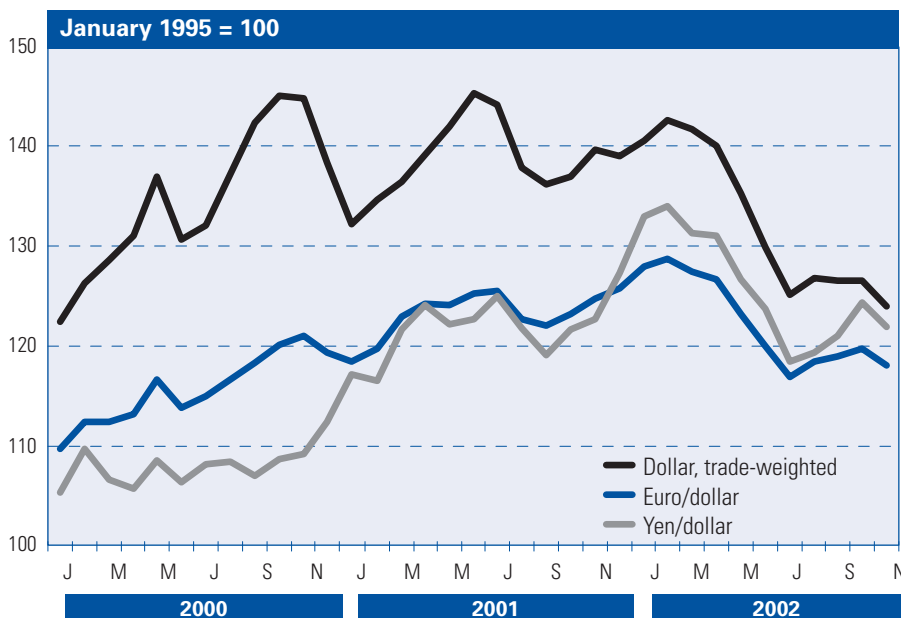
The United States' external deficit presents a dilemma. It is well understood that, the more the deficits expand, the higher is the probability of an abrupt correction later, with consequently ever-larger shocks for both financial markets and the real sectors of the world economy. Nevertheless, strong import demand from the United States is in the interest of global economic recovery in the short run, making a further widening of the country's trade and current-account deficits desirable.

There are myriad ways in which the United States' trade deficit can be reversed. The three basic possibilities are: an abrupt adjustment, driven by a plunge in the value of the

dollar; longer-term structural adjustment in the United States, involving narrowing of the savings-investment gap brought about by an increase in domestic savings (because of a fall in consumer confidence) or a decline in investment (because of a decline in business confidence); and structural adjustment in the world economy, with new growth poles taking over the lead role of the United States and more balance in investment across countries. The most perilous outcome would be an abrupt adjustment. An earlier simulation showed that halving the trade deficit in the United States within two years would lead to a drop in GWP by 1.7 percentage points.⁷ The challenge of ensuring a gradual and orderly adjustment therefore remains. Furthermore, the recent addition of a government deficit to the trade deficit in the United States (that is, the return of "twin deficits") may render the adjustment process more complicated than anticipated previously.

Directly associated with the sustainability of the external deficits of the United States is the exchange rate of the United States dollar vis-à-vis other major currencies, particularly the euro and the yen (see fig. I.1). In mid-2002, the trade-weighted value of the dollar fell about 8 per cent below its peak of January 2002. The decline was broad-based vis-à-vis major currencies, with the euro returning to parity against the dollar for the first time since February 2000. The fall against the yen was sufficient to prompt intervention by the Japanese authorities. Most other Asian currencies strengthened against the dollar. Nevertheless, the fall in the value of the dollar in terms of major currencies reversed only part of its rise during the

Figure I.1.
UNITED STATES DOLLAR EXCHANGE RATES:
JANUARY 2000-NOVEMBER 2002



Sources: J.P. Morgan and European Central Bank, Monthly Bulletin.

second half of the 1990s, when the trade-weighted dollar index increased by more than 20 per cent. Some further decline is therefore forecast, with the euro expected to drift upwards against the dollar but the yen assumed to remain stable.

The dilemma about the external deficits of the United States also applies to the value of the dollar. Depreciation of the dollar should reduce the risk of an abrupt adjustment in global financial markets in the medium term. In the short run, however, as illustrated by the intervention of the Japanese authorities in 2002, the corresponding appreciation of other currencies is likely to have an adverse effect on those countries' exports—currently the most vigorous component of demand for some of the world's largest economies.

Longer-term consequences of the fall in equity prices

The protracted fall in world equity prices since 2000 has inflicted downward pressure on world economic growth and continues to be a downside risk. After the recovery in prices following the 11 September 2001 terrorist attacks petered out in the second quarter of 2002, volatility in and downward pressure on equity prices again became a central feature of all major economies. There were declines in broad indices of share prices in the United States for the third consecutive year in 2002. Such a drawn-out contraction has occurred only twice in stock-market history. Moreover, the cumulative falls have been substantial: one broad index had fallen by 45 per cent in the trough of September 2002 from its peak of 2000, the largest fall since the Great Depression. Moreover, the erosion continued despite the substantial easing of monetary policy.

Equity markets in other countries have also weakened considerably and with a high degree of synchronicity. The core Japanese index has fallen to a 19-year low and all major indices of equity markets in developing countries have reverted to their levels of five years ago.

In the late 1990s and into 2000, equity prices were widely considered to be too high, prompting discussions about the broad economic consequences of their possible decline. A previously reported study⁸ suggested that a 40 per cent drop in equity prices in the United States and Western Europe would lead to a decline of 1.7 percentage points in GWP in two years. This result corresponds closely to what materialized in the global economy in 2001-2002, when the growth in GWP was below its potential rate by about 1.5 to 2 percentage points.

Despite the large correction over the past two years, major equity markets remain overvalued according to such historical benchmarks as price-to-earning ratios and other measures. If equity markets continue to drop, or stay at a low level for a long period, the recovery in global growth towards its potential, as forecast for 2003, is likely to be jeopardized. Moreover, if major equity mar-

kets are trapped in a secular downturn, particularly if this is accompanied by a bursting of "bubbles" in real estate in some countries (as Japan experienced in the past decade), the prospects for the major developed economies in the medium term would be compromised.

Other risks may arise from the financial fragility and debt overhang in a number of economies, particularly developing countries. The latest debt crisis in Argentina has already underlined the severity of the issue. There remains the possibility that other countries could fall into such a situation, particularly if the global economic environment does not improve.

CHALLENGES FOR MACROECONOMIC POLICIES

As the sluggishness in the world economy continues, the efficacy of current macroeconomic policies has been increasingly questioned.

Flexibility in monetary policy

Monetary policy in the world economy has remained largely accommodative since the substantial easing in 2001, as the majority of central banks decided to leave interest rates at low levels in 2002. While a few central banks (such as those of Australia, Canada, New Zealand and Sweden) raised interest rates somewhat in the first half of 2002, the Federal Reserve Bank of the United States (Fed) and a number of central banks in developing countries and economies in transition reduced their policy interest rates further. Most central banks are expected to maintain their accommodative stance at the current level until mid-2003. Moreover, in many economies, there remains room for further monetary easing if the recovery falters.

So far, low interest rates seem to have had more salutary effects on households than on businesses. The strong housing market and resilient consumption of durable goods in a large number of economies owe much to low interest rates. However, business capital spending has, on the whole, remained insensitive to the monetary easing, although low interest rates have ameliorated corporate financial conditions. Excess capacity, depressed equity prices, rising risk premia for corporate borrowing owing to heightened uncertainties, the lacklustre outlook for profits and financial scandals have offset—particularly in the major developed economies—the beneficial effect that the monetary stimulus would otherwise have had for the business sector. In addition, fragility in banking and non-banking financial systems, such as the large volume of non-performing loans, in a number of developed and developing economies may have prevented the effects of monetary easing from being fully channelled into the real sector.⁹

At the same time, the rules for inflation-targeting adopted in a number of economies may have prevented some central banks from reducing interest rates low enough to generate adequate stimulus for real economic growth. This policy regime,¹⁰ which has been adopted by an increasing number of countries over the past decade, has worked well in reducing and stabilizing inflation. However, it has not been tested for its efficacy in reflating an economy under circumstances of near-zero inflation, or even deflation, particularly when the deflationary pressures come from the bursting of asset bubbles and supply-side shocks, such as the current cycle in technological innovation. Some observers believe that inflation-targeting may be inherently asymmetric—that is, it may be less effective in dealing with deflationary problems than with inflation and may even generate deflationary pressure. Others believe that more flexibility in setting and implementing the rules could reduce the bias and improve the efficacy of the regime.¹¹

Worsening fiscal positions

Most countries face a dilemma in their fiscal policy. The sluggish economic recovery suggests the need for more fiscal stimuli, but the majority of economies are facing growing difficulties in adopting such measures because the global slowdown has worsened budget balances owing to either a fall in tax revenues, a rise in government expenditures, or both.

Government accounts in most developed countries turned from a surplus in 2000 to a deficit in 2002. In the United States, fiscal stimuli, in the form of a combination of increased spending and tax reductions, have played a major role in driving the economic recovery, contributing an estimated 1.5 to 2 per cent to GDP. Government spending is estimated to have grown by 7 per cent in real terms in 2002. A government budget deficit of about \$150 billion is estimated for 2002 and is projected to be more than \$200 billion in 2003, compared with the surplus of more than \$200 billion in 2000. In Western Europe, automatic stabilizers, in a few cases combined with moderate discretionary stimuli, have helped to support growth but have also resulted in a broad deterioration in budget deficits; the fiscal deficit for the EU-15 increased from 1 per cent of GDP in 2000 to 1.9 per cent in 2002. In the euro zone, a number of countries, particularly the large ones, either have broken or are likely to break the 3 per cent maximum deficit criterion embodied in the Stability and Growth Pact. Abiding by this ceiling will require them to pursue contractionary fiscal policies in the near term. Despite the austere fiscal policy in Japan over the past two years, when spending on public investment declined by about 5 per cent each year, the deficit in the government balance remains about 8 per cent of GDP.

With public debt at 127 per cent of GDP, the highest among developed economies, fiscal policy is expected to remain restrained.

Fiscal deficits and the levels of government debt in many developing countries and economies in transition have worsened substantially. Argentina represented the extreme case when it declared a default on its external debt in late 2001, but some other countries are vulnerable to a possible external debt crisis. In the past year, the only developing economies able to adopt expansionary fiscal policies to counter the slowdown and to stimulate their recoveries have been a few countries in Asia. Most other developing countries and economies in transition are already facing a tight fiscal constraint. The fiscal situation for those economies will remain severe and for some it may even worsen. There is, therefore, no room for additional fiscal stimulus to accelerate growth in those countries.

International policy coordination

The common weaknesses in the global economy have raised questions about the need for international macroeconomic policy coordination. There were concerted macroeconomic policy actions among the major developed economies during the 1980s, but such efforts have since faded. This is partly because the divergent economic performances among these countries in the 1990s called for differentiated policies attuned to the conditions in individual countries and partly because these economies did not encounter any large common shocks until the late 1990s. With the synchronized downturn of the current global business cycle and many common weaknesses among major developed economies, the possibility of reviving concerted international policy actions merits consideration.

One study suggests that coordinated interest rate cuts and fiscal stimuli by the seven major developed economies would increase growth rates in those countries by an additional 0.7 percentage point in 2003 and 0.8 percentage point in 2004.¹² Such actions by the major developed economies would also be beneficial for developing countries and economies in transition. The benefits would include stronger growth in exports, greater capital inflows and a global environment that is generally more supportive of growth and less susceptible to financial crises.

The proposed actions, however, involve various risks and costs. Such a general stimulus is potentially inflationary; fiscal stimulus would mean higher budget deficits in the short run; and many of the global imbalances may either be exacerbated or, at a minimum, not improved by such actions. However, a surge in inflation seems unlikely at present and short-term fiscal measures designed to revive world economic growth need not be at odds with medium- and long-term fiscal responsibility. Moreover,

countries with high fiscal deficits could rely more heavily on monetary measures, while those that face limitations in cutting interest rates could exercise more flexibility in stimulative spending. Finally, an aggravation of the present imbalances would be less likely with concerted action than with unilateral action. Overall, the benefits of concerted action to jump-start the global economy at this time would outweigh the costs and improve the prospects for achieving the Millennium Development Goals.

Notes

- ¹ As a rule of thumb, a developing economy would have to increase per capita output by an annual rate of at least 3 per cent in order to make any progress in reducing poverty in the country.
- ² The United Nations Millennium Declaration set a number of development goals, including halving by 2015 the proportion of the world's people whose income is less than one dollar a day (see United Nations Millennium Declaration, General Assembly resolution 55/2 adopted on 8 September 2000).
- ³ See Part one of *World Economic and Social Survey 2002* (United Nations publication, Sales No. E.02.II.C.1).
- ⁴ For example, telecommunications is the most beleaguered sector in the present phase of the global economic cycle and, even after two years of consolidation, its

capacity utilization at the end of 2002 was estimated to be only 35 per cent in the United States and many European countries (see *Business Week*, 7 October 2002, pp. 66-74). At the extreme, capacity utilization of the fibre-optics infrastructure built in the late 1990s is reported to be only 3 per cent (*New York Times*, 3 October 2002, p. A26).

- ⁵ See chapter II below.
- ⁶ With the recent decline, total net capital flows to developing countries have returned to the level of a decade ago, but the ratio of net capital flows to GDP is now much lower than in the early 1990s. For an analysis of a decade of capital flows to developing countries, see Institute of International Finance, *Capital flows to emerging market economies* (Washington, D.C.: Institute of International Finance, September 2002), p. 4.
- ⁷ See *World Economic and Social Survey 2001* (United Nations publication, Sales No. E.01.II.C.1), p. 23.
- ⁸ See *World Economic and Social Survey 1999* (United Nations publication, Sales No. E.99.II.C.1), pp. 12-13.
- ⁹ The prime example is the economy of Japan, where the policy of a zero interest rate has resulted in double-digit growth in base money, but has left broad money growing at a very low rate.
- ¹⁰ For more discussion on the pros and cons of inflation-targeting, see *World Economic and Social Survey 2000* (United Nations publication, Sales No. E.00.II.C.1), pp. 15-16.
- ¹¹ For example, the Reserve Bank of New Zealand increased its flexibility in late 2002 by excluding zero inflation from the target band (changing it from 0-3 per cent to 1-3 per cent) and by extending the length of the targeting period.
- ¹² See www.globalinsight.com for details.

