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Battling the Global Headwinds of Financial Imbalances and Uncertain Geopolitics

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FINANCIAL IMBALANCES CONTINUE TO RESTRAIN the rebound in the global economy. Some of these difficulties, such as the burgeoning of nonperforming loans in Japan, have persisted for more than a decade. Others surfaced when equity bubbles deflated at the onset of the recent global slowdown, funds for many high-tech companies dried up, and financial institutions in Europe and the United States became more cautious in the wake of major defaults. Although debt overhangs have been eased through bankruptcy proceedings and improved profit rates for some, for others debt-service problems have become more severe because of low nominal growth in GDP combined with high spreads. New trouble spots have emerged as well. Against an unfavorable external environment, the debt dynamics of several governments in Latin America have become difficult.

The increasing likelihood of a military conflict in Iraq has cast its shadow over the economic and political landscape in recent months. With oil prices rising and investors waiting uneasily for events to unfold, the recovery in the global economy has likely been delayed further, while downside risks have risen, especially for countries in and around the Middle East. The baseline projections assume a quick resolution to current tensions regarding Iraq, highlighted by the quarterly pattern of the oil price assumed: $32 per barrel in the first quarter of 2003, and $29, $23, and $22 per barrel in the quarters following.

Macroeconomic stimulus measures undertaken in the high-income countries have served to cushion the global economy from an even sharper slowdown, but they have also contributed to further imbalances. By allowing automatic stabilizers to work, adding to discretionary spending, and cutting taxes, the governments of the countries of OECD saw their general balances deteriorate by an average 2.9 percent of GDP between 2000 and 2002.

The U.S. current-account deficit is now approaching 5 percent of GDP, an unprecedented level for this stage of the business cycle. At the same time, financing the deficit has become less straightforward, given the substantial weakening of the dollar over the latter months of 2002.

In this challenging financial environment, the global rebound is lacking sectoral and geographical balance. Global growth is currently projected to accelerate to 2.3 percent in 2003 from 1.7 percent in 2002 (table 2.1), but this would be very anemic for the second year of what should by now be a full-fledged, synchronized global upswing. In many parts of the world, a recovery in fixed investment is turning out to be exceptionally slow.

A worrisome characteristic of the current economic environment is that macroeconomic policies may be running up against their limits and, on balance, those policies in 2003–04 are more likely to be less stimulative—or restrictive—rather than expansive. Upside surprises are plausible, too. As the excesses of the boom of the 1990s are gradually worked out and financial markets stabilize, the fundamentals of the world economy should emerge in fairly sound condition, supporting global growth at rates nearing longer-term trends by 2004–05. Moreover, world growth potential has likely increased due to intensifying trade and financial integration, greater investment in human capital, wider availability of productivity-enhancing technology, and stronger institutional capacity throughout the world.

Table 2.1 The global outlook in summary

(percentage change from previous year, except interest rates and oil price)

						GEP 2003 forecasts	
	2001	2002e	2003f	2004f	2005f	2003	2004
Global conditions							
World trade volume	0.4	3.0	6.2	8.1	8.1	7.0	8.0
Consumer prices							
G-7 countries[a, b]	1.5	1.0	1.4	1.3	1.3	1.2	1.5
United States	2.8	1.6	2.5	2.3	2.1	2.1	2.3
Commodity prices ($ terms)							
Non-oil commodities	−9.1	5.1	8.2	2.3	1.7	5.8	4.4
Oil price (OPEC average)	24.4	24.9	26.0	21.0	20.0	23.0	20.0
Oil price (percent change)	−13.7	2.4	4.3	−19.2	−4.8	−8.0	−13.0
Manufactures unit export value[c]	−2.9	−1.4	5.6	−0.1	1.2	3.0	2.2
Interest rates							
$, 6-month (percent)	3.5	1.8	1.7	3.2	4.2	1.5	3.1
€, 6-month (percent)	4.2	3.3	2.4	2.3	3.1	3.2	3.8
Real GDP growth[d]							
World	**1.2**	**1.7**	**2.3**	**3.2**	**3.1**	**2.5**	**3.1**
Memo item: World (PPP weights)[e]	2.2	2.8	3.2	4.1	4.0	3.4	4.0
High income	**0.8**	**1.4**	**1.9**	**2.9**	**2.6**	**2.1**	**2.7**
OECD countries[f]	0.9	1.4	1.8	2.8	2.6	2.1	2.6
Euro Area	1.5	0.8	1.4	2.6	2.6	1.8	2.6
Japan	0.3	−0.3	0.6	1.6	1.4	0.8	1.3
United States	0.3	2.4	2.5	3.5	3.0	2.6	3.1
Non-OECD countries	−1.1	2.2	3.0	4.3	4.5	3.7	5.3
Developing countries	**2.8**	**3.1**	**4.0**	**4.7**	**4.8**	**3.9**	**4.7**
East Asia and Pacific[f]	5.5	6.7	6.4	6.6	5.9	6.1	6.4
Europe and Central Asia	2.3	4.1	3.7	3.7	4.1	3.4	3.6
Transition Countries	4.5	3.6	3.6	3.5	3.9	3.3	3.5
Latin America and the Caribbean	0.3	−0.9	1.7	3.8	4.5	1.8	3.7
excluding Argentina	1.1	0.8	1.6	3.7	4.7	1.9	3.6
Middle East and North Africa	3.2	2.6	3.7	3.9	3.7	3.5	3.7
Oil exporters	2.2	2.3	3.7	3.6	3.4	3.7	3.6
Diversified economies	4.1	2.5	3.1	4.2	4.2	2.7	3.6
South Asia	4.3	4.9	5.3	5.2	5.3	5.4	5.8
Sub-Saharan Africa	3.2	2.6	3.0	3.6	3.7	3.2	3.9
Memorandum items							
Developing countries							
excluding transition countries	2.6	3.1	4.1	5.0	5.0	4.0	4.9
excluding China and India	1.7	1.7	2.9	3.9	4.3	2.8	3.8

Note: PPP = purchasing power parity; GEP 2003 = *Global Economic Prospects and the Developing Countries,* World Bank, January 2003; *e* = estimate; *f* = forecast.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 1995 GDP weights.
c. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
d. GDP in 1995 constant dollars; 1995 prices and market exchange rates.
e. GDP measured at 1995 PPP weights.
f. Now excludes the Republic of Korea, which has been reclassified as high-income OECD.
Source: World Bank Development Prospects Group, March 2003.

Since the early 1980s, inflation has gradually been reduced in the high-income countries, while developing countries experienced a similar trend during the 1990s. Now, double-digit inflation has become an exception, and several countries are experiencing deflationary conditions. Strict and increasingly independent monetary policy, fiscal restraint, and labor-market reforms were key policies that helped to reduce inflation. A surge in innovation and increased global competition further reinforced the trend. On balance, this has been a beneficial development, as it helped foster a more stable macroeconomic environment while increasing the flexibility of relative prices and real wages. For example, sharp exchange rate devaluations no longer lead automatically to inflationary spirals,

but rather to adjustments in relative prices, making possible a quick economic rebound in the wake of crises.

However, the trend toward deflation poses new challenges. Most important, debt dynamics can easily become destabilized in a deflationary environment. Against this background, monetary authorities should focus as much, if not more now, on avoiding the lower boundaries rather than the upper limits of the forward-looking inflation targets when setting policy.

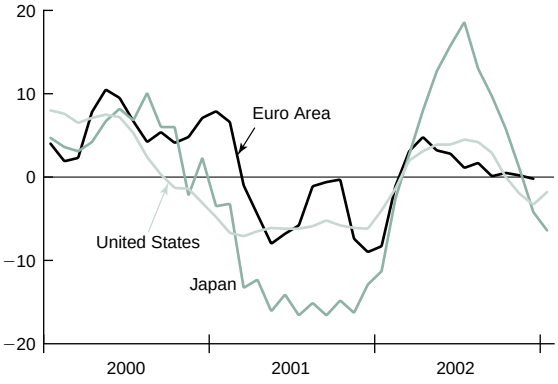
A hesitant recovery in the high-income countries

The recovery among the industrial countries, which commenced in late 2001 in the United States, faltered in mid-2002 (figure 2.1). Quarterly real GDP growth in the major economies slowed from 2 percent in the first half of 2002 to just 1 percent in the fourth quarter.

The early rebound was especially evident in a strong revival of industrial production. On the demand side, a key ingredient to the turn in industrial production was the end of the process of inventory liquidation, which had severely weakened output in 2001. The boost from inventories was limited, however, especially as the underlying weakness of final demand growth in the industrial countries made producers leery of actually rebuilding inventories.

Figure 2.1 Industrial production in the Euro Area, Japan, and the United States, 2000–2002

Percentage change, 3-month/3-month, seasonally adjusted annual rate



Sources: National agencies; Eurostat.

Central to this weakness in final demand growth is that the rebound in the growth of business investment from its slump in 2000–01 came more slowly and less forcefully than is usual. The debt-financed capital spending extremes of the boom years have left many companies across the industrial world with the need to scale back on spending for capital equipment. In some cases, even severe corporate retrenchment has not been sufficient, and 2002 was a year of continued high-profile corporate restructurings and bankruptcies.

During this process, growth in the industrial economies has been sustained by a sizeable stimulus from macroeconomic policies, which has, in turn, provided an important stimulus to certain components of demand, especially consumer spending and housing investment in many English-speaking economies (led by the United States). Not only has the degree of stimulus provided by macroeconomic policies likely passed its peak, but also the reliance on strong growth in U.S. consumer demand prefigures the emergence of new imbalances, as illustrated by the recent acceleration in U.S. household debt growth and the widening of the U.S. current-account deficit.

Against this background, expectations about the pace of the economic recovery in the major industrial economies are grounded in the extent of the corporate-sector adjustment. Precisely because this is a bumpy path, made more difficult by the financial market volatility and geopolitical uncertainties evident over recent months, the recovery in the major OECD blocs is likely to remain quite uneven through the first half of 2003 (table 2.2).

The pace of GDP growth is expected to ease in the United States and Japan from the second half of 2002, while the Euro Area is projected to experience little change in its recent sluggish growth.

Table 2.2 Real GDP growth in the major economies, 2001–2003

(percentage change over previous period at an annual rate)

	2001		2002		2003	
	H1	H2	H1	H2	H1f	H2f
OECD	0.5	−0.5	1.6	2.6	1.0	3.0
Euro Area	1.7	0.1	0.9	1.3	1.2	1.9
Japan	1.0	−3.9	1.0	3.3	0.3	1.2
United States	−0.4	0.1	3.5	2.7	2.2	3.1

Note: H = half, f = forecast.
Source: World Bank staff projections.

Growth is expected to accelerate going into the second half of the year and into 2004, however, as more progress is made to mend corporate balance sheets, and global monetary conditions remain very accommodative.

Tracking corporate-sector adjustment

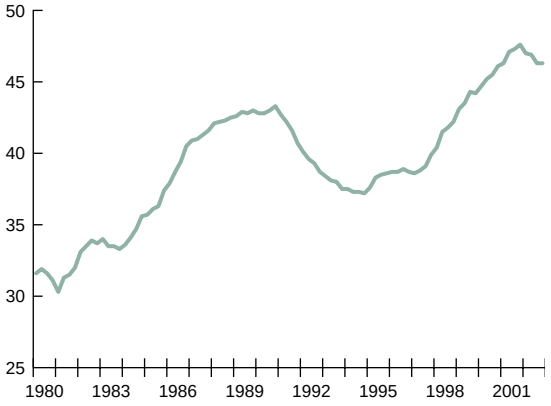
The 1990s ended with a perception of health and performance in the corporate sector that was at the opposite extreme of the end of the 1980s. Then, the corporate models of Japan and Germany were held up as ideals to follow, while the corporate sector of the United States was widely seen as having fallen behind. Ten years on, however, it was the U.S. model that was viewed as best practice, especially as the spread of information technology through the economy accelerated the growth of productivity throughout the economy. Meanwhile, many of Japan's companies remained mired in the banking and debt difficulties created during what, in retrospect, came to be seen as a bubble period in the second half of the 1980s, a time when Europe's companies were held back in their own countries by rigid labor markets and inflexible distribution channels.

Two developments followed. First, capital flows to the U.S. corporate sector surged in the late 1990s, especially after the East Asian and Russian crises, producing a sharp drop in the effective cost of capital in the U.S. corporate sector, especially in (but not limited to) information technology. Second, companies outside the United States increasingly moved to follow or emulate their U.S. counterparts, either by taking outsized bets on growth in their own economies (this was especially true of European telecommunications companies), or by undertaking aggressive acquisition and expansion strategies in the United States itself (thereby helping to further fuel the U.S. equity-market surge).

When global equity markets moved down from the middle of 2000, the effect was profound on businesses across the major economies, not just in the United States. As asset prices fell, it became increasingly difficult for companies to finance capital spending at levels in excess of profits, especially since such financing was entirely dependent on debt issuance. The resultant need to cut capital spending and employment levels created something of a vicious circle, as the economic downturn and growing caution by consumers undermined profits, thus widening the corporate sector's financing gap.

Figure 2.2 U.S. business debt, 1980–2002

Debt as a share of GDP (percent)

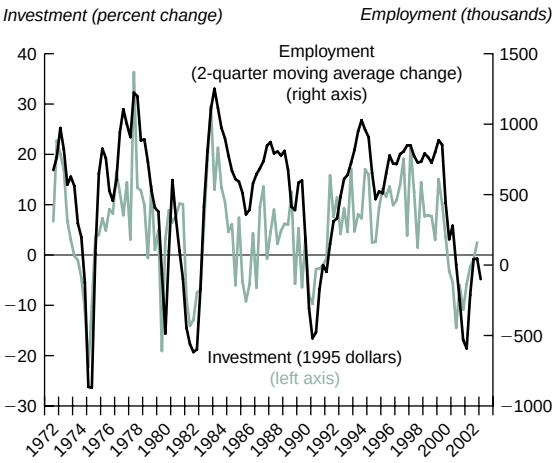


Source: U.S. Federal Reserve.

While these developments are easiest to document in the United States, given comprehensive macro-level data on the corporate sector, it is striking how widespread corporate-sector debt difficulties became in 2001–02. Business debt in the United States skyrocketed by some 25 percentage points of GDP between 1999 and 2002, presenting a formidable overhang to be addressed against a background of sluggish revenue flow (figure 2.2). Globally, telecommunications firms have suffered the consequences of building substantial excess capacity or investing in technologies not yet appropriate for the current market (such as G-3 licenses in Europe). High-tech firms and airlines have faced a collapse in demand, while financial institutions have been weakened by major corporate and sovereign defaults. And persistent weakness in construction and trades in Japan and Germany have saddled banks with nonperforming loans as business insolvencies have escalated.

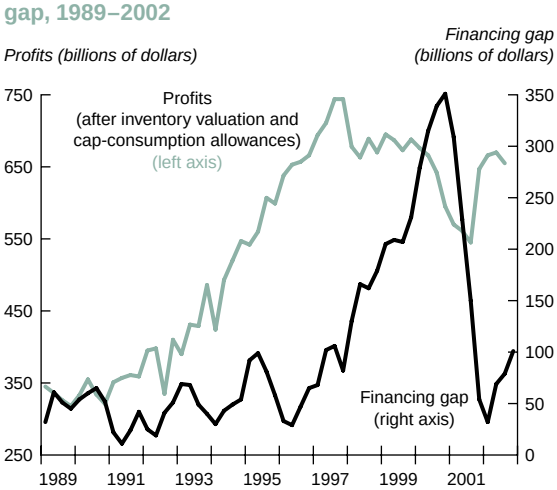
The result has been a subdued private sector, with balance-sheet adjustments across the rich countries entailing a substantial contraction in capital expenditure, normally the force underpinning movement from early recovery to economic expansion. Business investment in the United States has declined at a faster rate than during the recession of the early 1990s, dropping by a cumulative 12 percent since 2000 highs, while adverse effects on employment have been quite similar (figure 2.3). The rate of unemployment has not risen to the highs

Figure 2.3 U.S. business investment and change in nonfarm payrolls, 1972–2002



Sources: U.S. Commerce Department and Bureau of Labor Statistics.

Figure 2.4 U.S. corporate profits and the financing gap, 1989–2002



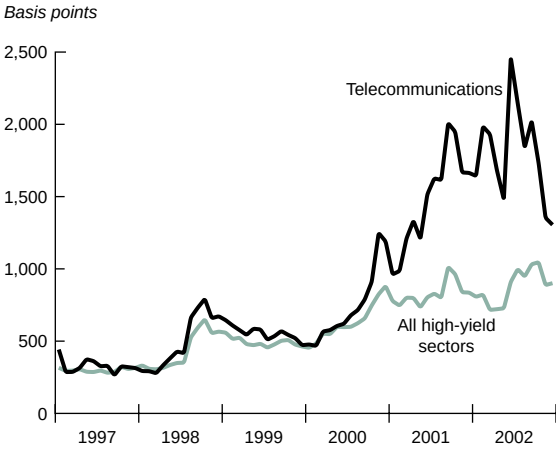
Note: Financing gap denotes capital spending less adjusted profits.
Sources: U.S. Commerce Department and Federal Reserve Board.

seen during the 1990s downturn (some 7.8 percent), due in large measure to slowing growth in the labor force. Japanese private investment has declined more than 10 percent since recent peaks, while the rate of unemployment has risen to a record 5.5 percent. And although European capital spending has contracted by a more moderate 5 percent, employment has borne a larger share of the burden, rising to 10.3 percent in Germany and to 9 percent of the labor force in France and Italy.

On an encouraging note, however, there is some evidence that corporate financial imbalances are being rectified. In the United States, corporate profits staged a recovery through 2002 and were up by 20 percent in the third quarter over a year earlier. A reacceleration in productivity growth and consequent reductions in unit labor costs have contributed, as have lower interest rates on debt. The nonfinancial corporate sector's financing gap (the difference between adjusted income and capital outlays) has narrowed substantially from the late 1990s, a signal that adjustment measures are indeed having positive financial effects (figure 2.4). Moreover, market perceptions of this progress are being reflected in narrowing spreads for the broader high-yield asset class and for the telecommunications sector in particular—which saw a drop of 1,000 basis points over the period since June 2002 (figure 2.5).

Improving signs of corporate profitability and diminished financial strains are not limited to the

Figure 2.5 Benchmark spreads for U.S. high-yield bonds, 1997–2002

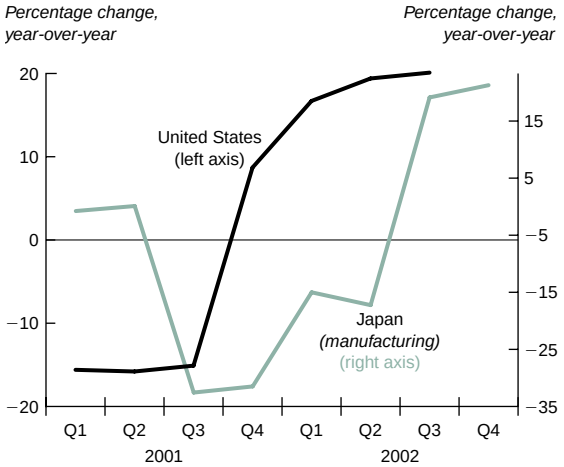


Source: Bloomberg.

United States. In Japan, profit growth has recently resumed following massive decline in 2001 (figure 2.6). The revival in profits in the Japanese economy, however, has been concentrated in the major manufacturing (and export) sectors. A return to profitability is not anticipated for industries and firms serving the domestic market, where consumer spending has been volatile and labor market conditions deteriorating. Banks continue to write off bad loans and, consequently, rack up sizeable losses.

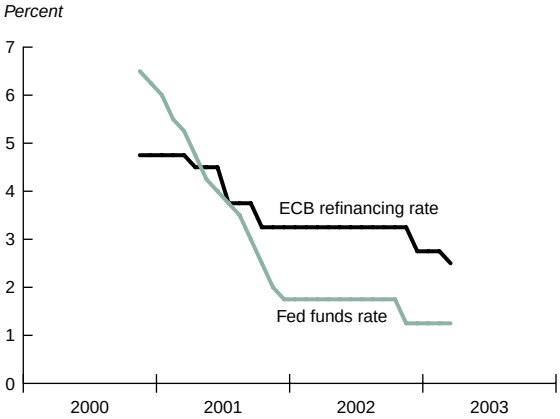
In Europe, corporate profits have yet to turn the corner, however. German company surpluses

Figure 2.6 Corporate profits in Japan and the United States



Note: The United States uses the inventory valuation and capital consumption adjusted national accounts based measure.
Sources: U.S. Department of Commerce; Japan ESRI.

Figure 2.7 Federal Reserve (Fed) and European Central Bank (ECB) target rates, 2000–2003



Sources: Federal Reserve; ECB.

dropped from a gain of 5 percent during 2001, to a decline of almost 4 percent in the first three quarters of 2002. Performance in France has been similar, with profit growth falling from 0.7 percent in 2001 to a decline of 3.5 percent in the first three quarters of 2002. The brightest recent signs have come in corporate debt markets, where the pace of debt downgrades has slowed and yield spreads have narrowed.

Although these generally positive signals provide some support to the view that the worst is behind the corporate sector in the industrial countries, the renewed weakening in recent months in global equity markets (although not high-yield fixed-income markets) is a reminder of both the fragility of the current situation, as well as the major adjustments still ahead.

Supportive monetary and fiscal policies

Monetary and fiscal policies were quite supportive over the course of 2001–02, limiting the downturn during 2001 and providing an important impetus to growth during the early stages of recovery.

With the effects of monetary policy expected to materialize with some lag, the degree of monetary stimulus now in the pipeline is considerable:

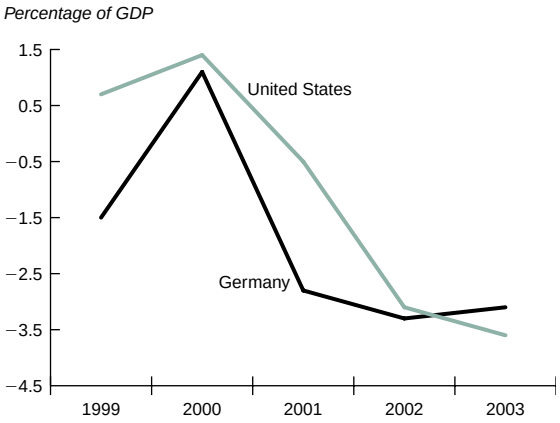
- The Federal Reserve's aggressive 525-basis-point reduction in target interest rates between late 2000 and late 2002 helped to underpin spending on consumer durables, while triggering large-scale mortgage refinancings that supplemented consumers' disposable incomes (figure 2.7).
- Despite having no latitude to trim short-term interest rates, the Bank of Japan has been more aggressive in expanding base money in recent months, which has helped flatten the yield curve. Unfortunately, bank credit to the private sector has continued to contract due to severe structural problems in the banking sector that stifle intermediation.
- The European Central Bank retained a cautious policy stance for much of 2002, which reflected its concerns over inflation. It too eased in December 2002, and again in March 2003, as data underlined the persistent sluggishness of economic activity in the Euro Area.

Looking ahead, the Federal Reserve has little leeway for additional interest rate reductions, and will most likely keep interest rates on hold for the rest of 2003 if growth, as expected, picks up gradually. In contrast, the European Central Bank has more room to ease and is likely to follow market expectations and possibly trim rates slightly further in the first half of 2003. The Bank of Japan is anticipated to step up its already aggressive approach to add liquidity.

Fiscal policies in the OECD shifted toward an expansionary stance in 2001, with both U.S. and European fiscal deficits widening substantially. In part this was due to the operation of automatic stabilizers. In the United States, there were also tax cuts and a sustained rise in government spending on homeland security and defense in the wake of September 11 (figure 2.8). An additional stimulus has more recently been proposed by the administration, so fiscal policy is likely to remain expansionary in the United States in 2003, especially with stepped-up spending on possible military action in Iraq.

Fiscal stimulus has already raised budget deficits significantly in many developed and developing countries around the world. These entail net dissaving and accumulation of financial liabilities by public sectors that eventually spill over to other aspects of the macroeconomic environment and begin to crowd out private-sector activity. Even if deficits are not quickly reversed, the marginal contribution of stimulus to growth will decline. Indeed, it may even turn negative on the fiscal front (box 2.1).

Figure 2.8 U.S. and German fiscal balances, 1999–2003



Source: OECD.

These constraints are already evident in Europe and Japan. In the Euro Area, the Growth and Stability Pact is now constraining fiscal spending, partly because of a failure by members to achieve

Box 2.1 Limits to fiscal stimulus

Average fiscal deficits in the OECD countries deteriorated by 2.9 percent of aggregate GDP between 2000 and 2002, reflecting a 1.5 percentage point of GDP increase in expenditure and 1.4 percentage point of GDP drop in revenue. Model simulations suggest that the impact on GDP was of the same order of magnitude. Indirect effects on private sector spending roughly compensate for the leakage of government spending into imports and the absorption of tax cuts into private savings. Thus fiscal policy may well have averted a sharper slowdown in the short run, but how effective is it as an engine of growth for the medium term?

Fiscal stimulus is unlikely to maintain its positive contribution to growth in the medium term, however. Two factors make fiscal stimulus a poor medium-run engine of growth:

- Even when deficits are kept at high levels, government's *direct contribution to demand growth drops.* To maintain a constant contribution to growth, the deficit has to deteriorate further each year. Instead of deterioration, there are strong pressures (economic, political, and, in some U.S. states and the European Monetary Union, statutory or normative) for more balanced fiscal positions. Under these circumstances, fiscal deficits are best used as a smoothing factor over the business cycle, but not a medium-term engine of growth.
- The positive short-run effects of fiscal stimulus on GDP tend to reverse in the medium run, when higher interest rates start to curb private expenditure and increasing indebtedness discourages foreign investors. The short-run and medium-run effects of a one-time fiscal injection tend to cancel each other out, leaving no impact in the longer term.

A fortiori these arguments apply to developing countries. Financial markets tend to punish fiscal mismanagement in developing countries quickly, making the crowding-out effects larger and more immediate and even forcing many governments into pro-cyclical fiscal policies. Moreover, governments in developing countries generally possess more limited tools and capacities than governments in rich countries. On average, government spending as a percentage of GDP in developing countries is roughly half of the corresponding share in high-income countries, making a substantial growth-stimulus program more complicated.

a more cyclically balanced fiscal stance during the late 1990s. In Japan, government debt has approached a dangerous level after an extended period of fiscal deficits of 6–7 percent of GDP, even with interest rates close to zero. According to OECD estimates, stabilizing gross debt at the relatively high level of 180 percent of GDP will require maintaining a fiscal surplus of 1.25 percent of GDP, nearly 8 percentage points higher than at present.

Rising household debt in the United States

As evidence accumulates that the corporate debt overhang is being gradually reduced, new imbalances are emerging. For example, household debt in the United States has risen to a record 320 percent of GDP as of the end of 2002, a rise of 50 percentage points of GDP since 1998 (figure 2.9). Similar trends, but of lesser magnitude, have emerged in other English-speaking countries of the OECD.

The ballooning of U.S. consumer debt primarily reflects substantial additions to household mortgage debt (some $1.5 trillion since the first quarter of 2000). In addition to financing a significant rise in the housing stock, this net new borrowing has allowed households to cash in some of the equity in their (rising) housing wealth, thus slowing the rise in personal saving rates that resulted from the collapse of household equity wealth.[1]

In the aggregate balance sheet of U.S. consumers, the buildup of personal debt was overshadowed by substantial equity gains up to 2000. More recently, the appreciation of real-estate holdings has helped to lift the value of household assets. But over recent months, equity markets have remained weak, further undermining household wealth. The net effect of these asset changes over 2002 has been a decline of $1.1 trillion—a $2.2 trillion decline in equity valuation set against $1.1 trillion real-estate appreciation. Since its recent peak during the first quarter of 2000, U.S. household net financial worth has dropped by some $7.8 trillion, composed of a $6 trillion decline in the value of financial assets and a $1.8 trillion rise in liabilities. When the appreciation in the value of household tangible assets is included, this net worth decline is reduced to $4.2 trillion, or a 10 percent decline from its peak in 2000.

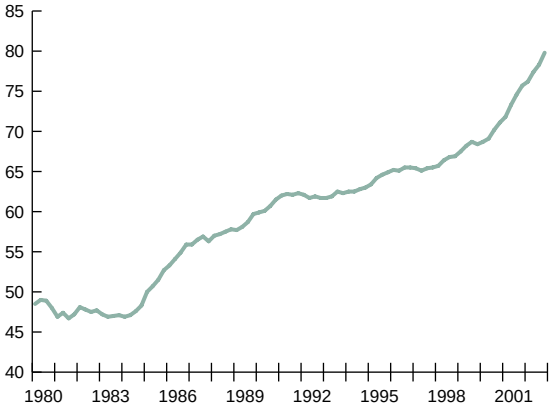
Although the U.S. consumer has been an impressive bulwark against global weakness, these recent developments in the household balance sheet and the labor market suggest that, in the near future, the growth contribution from this source is also likely to be more subdued. While low interest rates may allow consumers to continue to carry relatively high levels of mortgage debt, the appetite of borrowers to take on more debt, and of lenders to extend more, shows signs of fading. Notably, household delinquency rates on higher-risk instruments (so-called subprime lending) are on the rise. To date, household income growth has held up remarkably well, but the likelihood of ongoing corporate retrenchment is liable to restrain growth in labor income. Moreover, readings on consumer confidence, which capture many of these forces in a single indicator, have recently dropped sharply to levels not seen since the early 1990s.

Although less burdened than U.S. households by the legacy of debt, consumers in Japan and Europe have been adversely affected by a substantial deterioration in labor market conditions. As a result, strength in spending earlier in 2002 is now giving way to renewed declines. Particularly in Europe, consumption spending indicators were very weak in the fourth quarter of 2002.

A critical and persistent imbalance for the world economy is the large U.S. current-account

Figure 2.9 U.S. household debt, 1980–2002

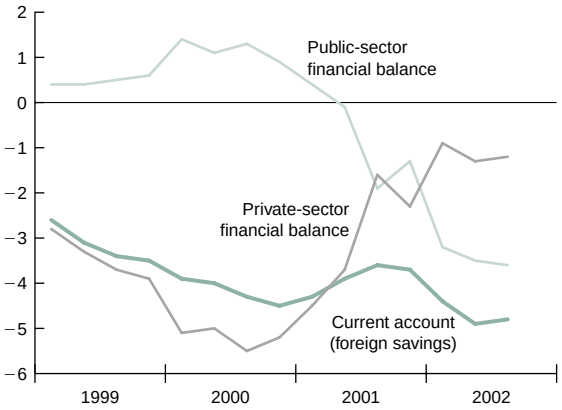
Debt as a share of GDP (percent)



Sources: Federal Reserve; U.S. Commerce Department.

Figure 2.10 U.S. private- and public-sector financial balances and the current account, 1999–2002

Percentage of GDP



Source: Federal Reserve.

deficit. This international counterpart to earlier household and corporate exuberance has not diminished during the recent period of sluggish growth, as would normally happen in a U.S. cyclical downturn, but instead has widened to nearly 5 percent of GDP, as public-sector deficits have risen sharply.

The private-sector financial balance (gross saving less gross investment) improved as a result of the adjustments in the corporate sector noted above and the recent rise in household saving rates (figure 2.10). However, these improvements have been more than offset by the sharp swing in general government financial balance, from a surplus of 1.3 percent of GDP as recently as the third quarter of 2000 to a deficit of 3.6 percent of GDP by the third quarter of 2002. Except for World War II, this swing in the public sector's financial position is the most rapid on record. That it was produced by the working of normal cyclical elasticities and discretionary easing measures underlines the role of the boom and bust in equity prices in the U.S. government's finances (primarily through swings in the ratio of tax revenue to GDP) and in those of the private sector.

Under present economic and fiscal assumptions, the U.S. current-account deficit is projected to remain above $500 billion over the next three years, over which time foreigners will acquire more than $1.5 trillion of U.S. assets. How this imbalance, with its large global repercussions (the United States absorbs some 8–9 percent of the world's savings annually), develops over the coming years is a key issue in the outlook, not least because it raises the possibility of a significant further downward move in the dollar (as occurred in the second half of the 1980s). This issue is addressed in more detail in the last part of this chapter.

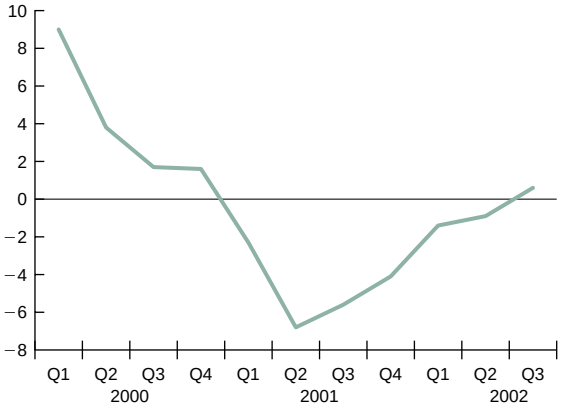
The outlook for growth in high-income countries in 2003 and beyond

Sustainable growth based on a resumption of investment spending in the high-income economies has been slow to materialize. The basic premise of the forecast, however, is that the pieces are now in place for growth to inch up over the next couple of years. There are already signs that the worst may be over on capital spending. For the OECD countries overall, quarterly statistics show a gradual return to positive growth in investment (figure 2.11). The year 2003 is likely to be one in which the pace of growth accelerates progressively as capacity use and profit rates rise and as some of the more immediate uncertainties weighing on consumers and investors, notably the issue of war in Iraq, are resolved.

The threat of a military conflict in Iraq is already acting to temper growth in the first half of 2003, as oil prices spiked by almost $15 per barrel

Figure 2.11 OECD real fixed investment spending, 2000–2002

Percentage change, quarter-over-quarter, seasonally adjusted annual rate



Source: OECD.

between early November and early March and investor sentiment fell anew. The rise in oil prices may well be short-lived and market sentiment may turn around quickly, even in the case of a military conflict, as was the case during the Gulf War in 1991. However, the recovery will be at best muted, and downside risks have increased.

The baseline forecast calls for growth in industrial-country GDP to accelerate from 1.4 percent in 2002 to 1.8 percent in 2003, reaching near-term peak rates of 2.8 percent by 2004 before easing to 2.6 percent in 2005. This contrasts with an average GDP advance of 3 percent during the strong years of the last upswing (1996–2000). OECD-area growth is thus likely to remain well below potential in most countries, pushing up unemployment rates. Although U.S. growth will be constrained by some of the imbalances considered above, it is likely to remain higher than that of its major OECD partners. Constraints on policy implementation in Europe and policy effectiveness in Japan are unlikely to be overcome in the near term, with the result that output growth is likely to be less in these countries.

There are obviously uncertainties in this forecast, but they are not all negative:

- The main upside risks reflect the fact that OECD monetary conditions are currently stimulative everywhere. To date, the results of this stimulus have been narrowly concentrated and slow to spread out across the global economy. As adjustments to previous excesses in both high-income and developing countries are completed, the response to easy money could become more powerful and pervasive.
- Adding to this upside is the high degree of synchronization evident across the major economies over the past few years. For most of this period, synchronization has worked to compound weakness. Once the recovery is underway in earnest, however, it should work to boost the global cycle.
- Finally, a swift resolution of geopolitical uncertainties, especially with regard to Iraq, could give a sharp lift to markets and business confidence, especially if it were combined with a significant decline in the price of oil.

Key downside risks are also evident, however. On top of the risk of protracted geopolitical uncertainty, the risk of an extreme oil price spike has risen more recently. Oil prices have increased well above $30 per barrel, as the risk of military intervention in Iraq rose and the strike in the República Bolivariana de Venezuela reduced supply by 2 million barrels per day (9 percent of OPEC [Organization of Petroleum Exporting Countries] output) through much of the first quarter of 2003.

The other main downside risk to industrial-country growth is that another round of financial turmoil or another phase of weak asset prices lies ahead:

- Despite its decline over recent years, the U.S. equity market remains highly valued when benchmarked against traditional indicators, such as actual earnings.
- Globally, corporate debt levels have been trimmed, but they remain high, and the risk of more "fallen angels"—investment-grade companies finding their debt downgraded to speculative levels by the major rating agencies—is significant.
- Japan's banks remain fragile. While the risk of more acute near-term difficulties seems to have receded, it cannot be excluded altogether.
- A degree of focus has shifted to the condition of Europe's banks, as they have been exposed to both domestic and international credit losses (in both the United States and the developing world, especially Argentina).

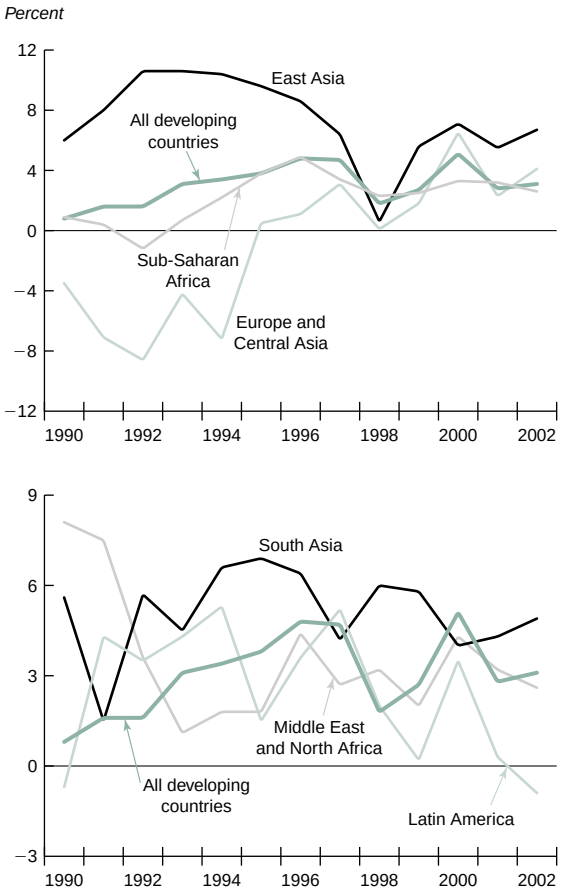
Developing countries: A tortuous return to stronger growth in 2003 and beyond

Output growth for the group of low- and middle-income countries was 3.1 percent in 2002, up by a small 0.3 percentage points from weak 2001 results. Growth was restrained by the lackluster recovery in the industrial countries and by financial and political uncertainties in several large emerging markets. Demand for developing-country exports grew by a small 2.2 percent, while prices for non-oil commodities rose by 5.1 percent. Net debt flows were weak, especially to Latin America, and FDI declined by $28 billion. The price of oil jumped from $19 to $28 per barrel over the course of 2002. For oil importers, this "Iraqi war premium" more than offset gains in agricultural and metals prices.

Over the past 18 months, growth performance has differed substantially across the major regions of the developing world, tied in large measure to the evolution of domestic conditions:

- China continued to make strong advances in output—some 8 percent during 2002—despite relative stagnation in Japan and volatile U.S. demand. In turn, this strong growth has increasingly helped to pull the recovery in East Asia. Together with policy stimulus in other countries, China's performance lifted the region to growth of 6.7 percent in 2002 (figure 2.12).
- At the other end of the growth spectrum, growth in Latin America and the Caribbean was held down by the government debt default and banking collapse in Argentina, uncertainty regarding Brazilian elections, a worsening of conditions in the República Bolivariana de Venezuela, and an associated $31 billion falloff in financial market flows. GDP dropped by 0.9 percent in the year, a sharp 2.4 percent fall in per-capita terms.
- Although slowing growth in the Euro Area cast a pall on those developing countries linked tightly with it, a sharp recovery of activity in Turkey following its 2001 crisis, in tandem with continued gains in the Russian Federation and the Commonwealth of Independent States (CIS) countries linked to higher oil prices, buoyed growth in Europe and Central Asia—producing a 4.1 percent rise.
- Continued strength in domestic demand in India propelled South Asia to gains of 4.9 percent, despite disruptions in regional conditions associated with the war on terrorism.
- Growth languished in Sub-Saharan Africa and the Middle East and North Africa—with the regions both registering growth rates of 2.6 percent.

Figure 2.12 GDP growth for developing countries, 1990–2002



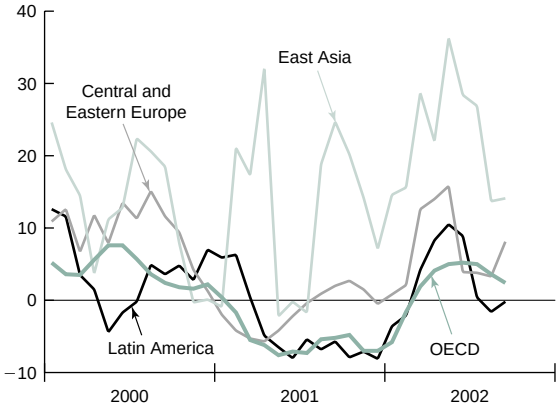
Source: World Bank data and World Bank Development Prospects Group projections.

Variability in performance across regions masks underlying similarities in the developing world. A truly global business cycle has emerged with the advancing integration of developing countries into global production, trade, and financial flows. Economic conditions in rich countries now tend to be mirrored rapidly in developing countries through enhanced trade links, just-in-time logistics, and stronger financial tie-ups with affiliates and suppliers in middle-income countries, especially those in East Asia, Central Europe, and, to a lesser degree, Latin America. Indeed, recent trends in industrial production across these regions show the effects of the general cycle—as well as the cycle of the high-tech sectors in East Asia—distinctly (figure 2.13).

Equally noteworthy is the movement into current-account surplus by the developing world. Developing countries as a group chalked up a surplus of $48 billion during 2002, up from $28 billion in 2001. The change was more than accounted for by developments in Latin America, where devaluations and import compression yielded sharp increases in trade surpluses and a $35 billion change in the region's current-account position—from a deficit of $51 billion to one of

Figure 2.13 Industrial production in select regions, 2000–2002

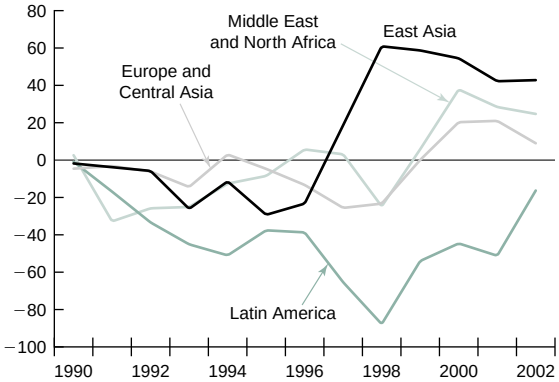
Percentage change, three-month/three-month, seasonally adjusted annual rate



Source: World Bank data.

Figure 2.14 Current-account balances for select regions, 1990–2002

Billions of dollars



Source: World Bank data.

$16 billion (figure 2.14). East Asian surpluses are being sustained at $40–$45 billion levels, while the increase in oil prices is having divergent effects across Europe and Central Asia and the Middle East and North Africa, where the mix of oil exporters and importers leads to mixed regional results.

Growth in developing countries overall is projected to accelerate to 4 percent in 2003 and to 4.7 percent in 2004. This view of steady improvement partly reflects the end of crisis conditions in several countries where output was severely compressed in 2002. But it is also founded on a number of crucial assumptions about the conditions facing developing countries:

- Some disruptions from possible military actions in Iraq (including a temporary rise in the oil price) are built into the forecasts, but no severe, lasting dislocations are assumed.
- Related to this, the expectation is that world trade will expand by 6.2 percent in 2003, a substantial multiple of the 2.3 percent growth in global GDP, as is normal at early stages of recovery. The strength in trade flows also reflects the gearing up of international production networks, further underpinned by dynamic conditions in China, a new World Trade Organization member, and reinvigoration of regional trade in several areas.
- Financial conditions facing developing countries are expected to be a little less austere in 2003 than in 2001–02. Flows of FDI are projected to rebound slightly, while net debt flows from private sources should be modestly positive, albeit still quite anemic.

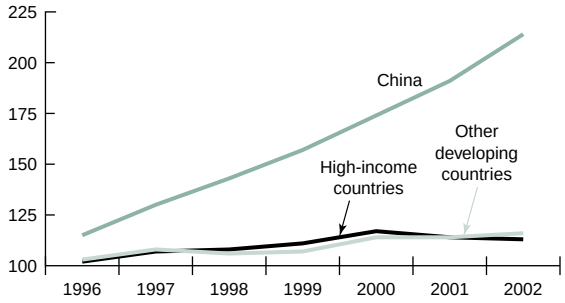
China becomes the engine of East Asia

The economies of East Asia and the Pacific grew by 6.7 percent during 2002, impressive in light of the difficult external environment. Despite a rise in volatility, exports contributed solidly to growth, but domestic demand was also strong, thanks to supportive monetary and fiscal policies. Vulnerability to external shocks has been much reduced since 1997 through sustained current-account surpluses, large-scale buildups of reserves, and corporate- and financial-sector restructuring. Notably, there were no major corporate disruptions during the recent turbulence. Regional trade grew, with Chinese imports from other countries in the region up 8 percent in 2002.

Robust growth is set to continue in the medium term. The forecast anticipates average regional growth of more than 6 percent over the next two years, with China increasingly the dominant player in the regional economy (figure 2.15). Exports will continue to play an important role with regional integration and China's admission to the World Trade Organization. Regional investment spending, which has rebounded impressively following

Figure 2.15 Trends in industrial production, 1996–2002

Index; 1995 = 100



Sources: Datastream; World Bank Development Prospects Group calculations.

the collapses of 1997–98, is also expected to remain strong, contributing to productivity gains and keeping inflation in check. The region's current-account surplus is expected to narrow somewhat over the forecast period, although the region will remain a significant capital exporter. Important exceptions to these relatively rosy near-term prospects are the high-income economies of Hong Kong (China) and Singapore, where performance has recently faltered, and Indonesia, which is still reeling from the Bali bombing.

Four possible tensions hang over this favorable forecast of strong growth, low inflation, and solid external positions:

- The extreme openness of the region leaves it vulnerable to global shocks. While an Iraqi conflict would occur half a world away, any associated sharp, sustained rise in the price of oil would hurt much of the region. For example, a $10 per barrel spike in the price would cost the regions' net energy importers some 0.6 percent of GDP in higher import bills.
- The unpredictability of developments on the Korean peninsula has become a new regional concern, and the memory of the bombing tragedy in Bali is a recent reminder of the problem of terrorism in the region.
- Competition among East Asian exporters for market share in OECD economies will remain fierce, and the question of appropriate exchange-rate levels is likely to emerge as a larger issue, especially given the growing competitiveness and sophistication of Chinese exports.
- There has been a remarkable recovery in the health of much of the region's corporate sector since the dark days of 1998. But levels of corporate leverage in the region remain high, with debts becoming more sustainable now largely because of lower interest rates and a willingness of creditors to roll over debts.[2] It is unlikely in the next couple of years that short-term interest rates in the region will spike up to provoke a new round of corporate distress. Indeed, rates across the region are likely to remain quite low in both nominal and real levels, thus supporting growth. But the corrosive effects of deflation, already painfully evident in Japan, could become more pervasive across the region if measures to promote corporate restructuring are slow.
- Fiscal deficits have risen sharply since 1997 and averaged 3.4 percent of GDP in 2002. The forecast anticipates some narrowing of deficits, as further adjustment is required to ensure longer-term sustainability.

A peace dividend for South Asia

A combination of poor weather, geopolitical insecurity, a subdued external environment, and especially weak European demand put a relative damper on the South Asian economy in 2002. At 4.9 percent, growth was well below the region's potential for a third successive year. On the plus side, there was a reduction of military tensions between India and Pakistan and a ceasefire in the long-running civil war in Sri Lanka. Gains in export momentum during the second half of the year augur well for growth in 2003.

Improving exports and a recovery in agriculture, which accounts for a quarter of the region's output are together expected to boost GDP growth to 5.3 percent over the next years. Increases in export revenue will likely be channeled into higher imports, leading to little overall change in trade positions. Domestic demand should also gather momentum. Private consumption could rise substantially with a recovery in agricultural incomes, especially in India. Investment will remain cautious pending more solid progress in the reform process, while large and persistent fiscal deficits have left little scope for substantial increases in government outlays. Accommodative monetary policies are

expected to provide further support for growth, and price pressures should be reasonably well contained over the forecast period.

The outlook for India dominates South Asia's economic prospects. Manufacturing performance in India is showing signs of an incipient upturn, and the burgeoning Bangalore-based international-services sector has experienced much less disruption in demand than high-tech sectors elsewhere.

Further expansion of trade flows would be helped by a reduction of trade barriers in the region. Progress in the Doha round of WTO negotiations will also be important to investment. Key issues for the region are improved access for agricultural goods, textiles, and clothing in high-income markets, and the result of the trade-related intellectual property talks.

Apart from export revenues, workers' remittances have the potential to grow rapidly in coming years as migration pressure is likely to increase and improvements in transportation and communications will complement this trend (see Chapter 7). In the short-run, however, tensions in the Middle East will likely reduce remittances from temporary workers abroad.

Convergence in Eastern Europe and Central Asia

The advance of 4.1 percent in Europe and Central Asia's GDP in 2002 was dominated by a massive 12.8 percentage point turnaround in Turkey's GDP growth as it recovered from a devastating collapse early in 2001. Among the transition countries of the region, growth slowed by a full percentage point to 3.6 percent in 2002. Considering the weakness in Western Europe, and in the capital spending of European companies, much of which is now destined for the East, the transition group weathered the slowdown fairly well. Rising market share in the Euro Area for the countries poised to join the European Union—including the Czech Republic, Hungary, and Poland—tended to offset sharply lower growth in domestic demand. The CIS countries—notably Azerbaijan, Kazakhstan, and the Russian Federation—benefitted from high and rising oil prices.

Growth in the region is expected to hold near present rates—3.5–4 percent—in the near term, although this average hides divergences from country to country:

- The European Union accession process will shape near-term developments in Central Europe even more strongly than it has to date, as the recent Copenhagen Summit established the criteria and schedule of accession for the group of 10 applicant countries. Although there are bound to be some bumps along the way in the process of integration, prospects for the accession countries are now underpinned by expectations of improved performance stemming from growing export demand as the Euro Area recovers, a revival of FDI, and transfers related to the accession process. These circumstances should help growth accelerate from a disappointing 2.4 percent in 2002 to 2.8 percent in 2003 and 4.5 percent by 2005.
- By contrast, the outlook calls for output growth in the CIS countries to moderate in late 2003–04 from growth of 4.4 percent in 2002 as the oil-price boom winds down. Should Middle East tensions escalate on a sustained basis, however, the Russian oil sector could attract additional foreign investment.
- In Turkey, the forecast assumes relative political stability and continued progress on structural reforms, which will permit a slow improvement in performance. The need to run a tight fiscal policy in order to contain the growth of public debt is likely to limit the scope for growth in domestic demand. Turkey could suffer significantly through a collapse of tourism in the case of a military conflict in Iraq.

The fallout from Argentina in Latin America

Latin America and the Caribbean was the one major region where conditions worsened rather than improved during 2002. For the region as a whole, GDP contracted by 0.9 percent, due mainly to the collapse in economic activity in Argentina (from an already low level) in the early months of 2002. Excluding Argentina, growth in the region was 0.8 percent.

The external environment facing the region was difficult in 2002. Tourism suffered badly in

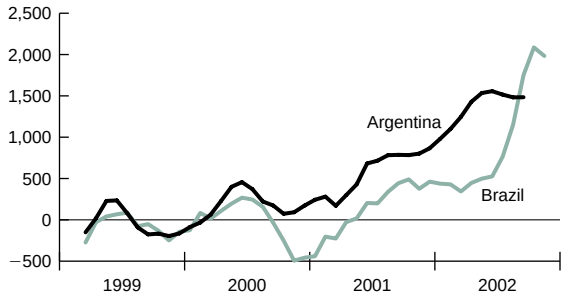
the wake of the September 2001 terrorist attacks. But the main negative was the shift in external finance conditions. While overall flows to developing countries were weaker in 2002, they were especially weak to the heavily indebted economies of Latin America:

- Gross market-based financial flows to the region fell by $31 billion, or 40 percent. (Excluding Argentina, the decline was $26 billion, or 38 percent.) As a result, interest rate spreads on the external debt of most borrowers in the region widened appreciably.
- Despite Argentina's default, the region repaid a net amount of $8 billion in net external debt to private creditors, compared to $9 billion in 2002.[3]
- Net inward FDI fell to $42 billion, from $69 billion in 2001, with declines evident across all countries.

The reduced supply of capital to the region forced a remarkably rapid change in the region's current-account position, brought about partly through another round of sharp currency depreciations vis-à-vis other areas of the world. Tighter domestic financial conditions and, in many cases, tighter fiscal policies reduced domestic absorption, while sizeable real devaluations switched domestic supply to exports and domestic demand away from imports. Brazil's export performance was especially impressive in the light of the weakness in Argentina (figure 2.16). For the region overall, the trade position shifted from balance in 2001 to a surplus of $25 billion in 2002. In turn, the region's current-account deficit narrowed by about $35 billion.

Figure 2.16 Balance-of-trade positions for Argentina and Brazil, 1999–2002

Millions of dollars, three-month moving average, FOB-over-FOB



Note: FOB = free on board.
Source: World Bank data and World Bank Development Prospects Group estimates.

Political uncertainty was both a cause and effect of some of Latin America's problems in 2002. Financial markets in Brazil were weak until the election but recovered quickly once newly elected President Lula made clear his commitment to stick with the IMF program. Argentina's economic difficulties led to considerable political uncertainty. New elections are due in April. Early in 2003, political problems flared up again in the República Bolivariana de Venezuela.

Just how these political tensions play out could easily alter the near-term outlook. The challenges seem greatest in the República Bolivariana de Venezuela, where the economy has already contracted sharply in the early months of 2003, thanks to the disruptions from the general strike. Another wild card is how quickly Argentina recovers from the slump of 2001–02. There is now clear evidence that the economy has moved off its lows and that banks have recovered sufficiently for the payments system to be up and running again. What is unknown is how enduring this phase will be. Should the election produce a strong government that is able to reach an early agreement with the IMF and the country's external creditors, then there would be considerable scope for growth. Such upside surprises have often occurred in recent crises (the Republic of Korea, the Russian Federation, and Turkey), even in circumstances where reforms were, at the time, perceived as being incomplete. As it is, the forecast projects a 13.6 percentage point turnaround in Argentina's growth between 2002 and 2003 (−11 percent to +2.6 percent); that it could easily be greater speaks to the extremes the country has suffered in the past 18 months.

The forecast assumes that challenging external financial markets will remain a headwind against the region for the next couple of years, although the worst of the credit cycle is now behind us. The willingness of private-sector debt investors to increase exposure on a net basis is assumed to be limited, with international lending from banks likely to remain the weakest of all the debt components (see chapter 3). With some key economies facing a significant repayment of emergency funding to official creditors in 2003–05, the region will

likely have to sustain lower current-account deficits into the recovery. Under these conditions, economic activity will accelerate only gradually toward 4 percent growth by 2004–05.

Cross-currents facing the Middle East and North Africa

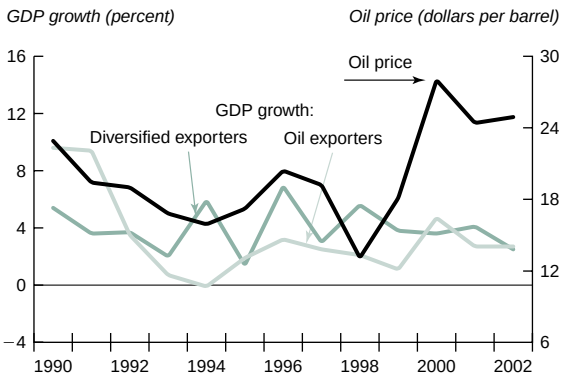
Despite high and rising oil prices, growth in the Middle East and North Africa slowed to 2.6 percent in 2002 from 3.2 percent the year earlier. For oil exporters, largely in the Gulf region, lower OPEC quotas were offset by marginally higher prices, and GDP growth was essentially unchanged.

By contrast, diversified exporters of the region (in the Mahgreb and Mashreq) faced lower prices and demand in the European market, plus a substantial negative shock to tourism linked to the attacks of September 11, 2001. Growth for this group was reduced from 4.3 percent in 2001 to 2.5 percent in 2002 (figure 2.17). Across the quite heterogeneous region, private-sector domestic demand slowed, though public consumption increased and budget deficits widened. The apparent failure of oil-dominant countries to capitalize more on recent windfalls highlights the fact that deeper-seated structural problems have yet to be addressed. Even where reforms have been introduced, the pace has been tentative and the response fairly muted. As in the past, the current oil boom appears to have initiated a fiscal spending cycle, with few broader effects.

For both oil producers and diversified exporters, growth is expected to pick up to 3.5–4 percent over 2003–05 as exports rise and higher incomes stimulate domestic spending. Without structural reforms to raise productivity and promote diversification, however, it will be difficult to sustain growth above that range. Beyond 2003, oil exporters' current-account surpluses will narrow as the oil price slips.

A critical risk is the possibility of military action against Iraq. Neighboring Jordan would be most affected due to its close economic and trade links to Iraq and its proximity, which would affect trade, tourism and investment. Another vulnerable country is the Arab Republic of Egypt, where the balance of payments could deteriorate as tourism and Suez Canal receipts drop.

Figure 2.17 Oil price and GDP growth in the Middle East and North Africa, 1990–2002



Source: World Bank data and World Bank Development Prospects Group estimates.

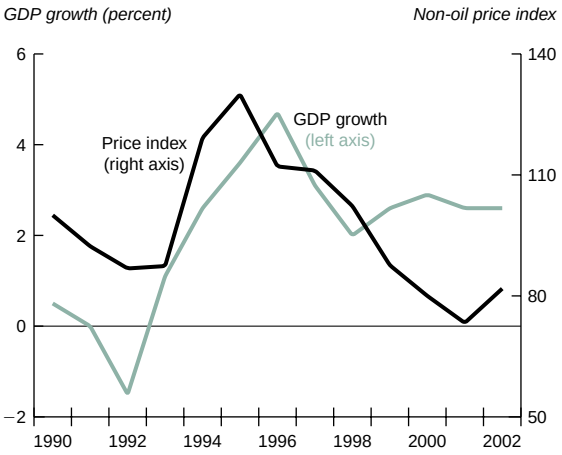
Sub-Saharan Africa: Steady but subdued growth

The growth performance of Sub-Saharan Africa has been less cyclical than that of other parts of the developing world in recent years, a tendency that is likely to continue in the next few years. The overall pace of per-capita growth remains very low, however, doing little to lift incomes in the region to levels consistent with the achievement of the Millennium Development Goals.

The factors holding back growth have shifted over the past couple of years. In 2001, the main drag was the collapse in world trade and steep decline in prices of non-oil commodities. In 2002, some of these external conditions improved, but few gains were made, as domestic conditions remained unfavorable or worsened in many countries (figure 2.18):

- In Nigeria, GDP contracted as a result of political paralysis, while violent and bloody civil strife prevented Côte d'Ivoire from taking advantage of a 15-year high in cocoa prices. Political strife has also been very damaging in Zimbabwe.
- Unfavorable weather conditions in Eastern and Southern Africa put a damper on agricultural production and left as many as 30 million people at risk of starvation.

Figure 2.18 GDP growth of African non-oil exporters and commodity price index specific to Sub-Saharan Africa, 1990–2002



Source: World Bank data and World Bank Development Prospects Group estimates.

- The ongoing problem of HIV/AIDS (human immunodeficiency virus/acquired immune deficiency syndrome) undermines the productive capacity of the region, especially through its debilitating effect on education systems.

Prospects for growth in the region are partly driven by the vagaries of the weather. The forecasted acceleration in growth is conditioned on an assumption of more normal weather patterns, which would give a boost to agricultural output and incomes. Two other important supports to regional growth should be the expected pick-up in external demand, especially once European economies begin to recover in earnest in 2004–05. Nearer term, some gains have already been realized from higher commodity prices—and more are likely in the pipeline. While the level of prices remains low by historic standards, there are indeed signs that the 20-year slide in many commodity prices that has been so painful for much of Sub-Saharan Africa is now coming to an end. The scope for easier policies in the region is limited, but there is a likelihood of some easing in South African monetary policy, especially in the second half of 2003, after a significant tightening in 2002.

Even if commodity markets were to stabilize as expected, the forecast could not call for any significant reversal of recent declines in terms of trade. Furthermore, the region will continue to face deep-seated structural and political problems, including the lack of economic diversification, poor infrastructure and distribution systems, and, most tragically, the HIV/AIDS problem.

The region's ability to finance growth from external sources will remain largely dependent on FDI inflows, and the region's access to international capital markets will remain restricted, except for South Africa. Continued low domestic savings and persistent capital flight will thus hold domestic investment rates to low levels. Accordingly, medium-term prospects for the region are that growth will be limited to around 3.5 percent—somewhat above 1 percent in per-capita terms. Except for a few cases where the policy process is in disarray (Côte d'Ivoire and Zimbabwe), double-digit inflation is rare and should remain so, while moderate fiscal and current-account deficits are projected to narrow.

Outlook for commodity prices

After plummeting to historic lows during the slowdown of 2001, prices for non-oil commodities rose through 2002. Not all these increases have held. As global industrial growth slowed from mid-year, metals prices fell back. Agricultural prices retained more of their gains because of supply problems, especially in coarse grains, aggravated by drought in Australia, Canada, and the United States. The higher price of wheat and close substitutes generated additional export revenue of about $1 billion for Argentina, a large exporter of wheat, maize, and soybeans.

It is common to think of commodity prices in dollar terms. But most commodity prices are determined in world markets, so the price is ultimately set by the balance of global supply and demand.[4] When the dollar weakens, as it has recently, prices tend to rise in dollar terms to stop them falling in yen or euro terms. A moderate decline in the dollar over the next couple of years, as assumed in the forecast, should help boost commodity prices when expressed in dollar terms. Aside from this effect, however, fairly restrained changes in commodity prices (in dollar terms) are expected over the next two years (table 2.1). Prices of nonprecious metals should revive again as global industrial production accelerates through 2003. Higher prices for grains in recent years are apt to stimulate more supply in 2003–05, thus

somewhat checking their upward movement. Critically, the overall global outlook for inflation is likely to remain very subdued (see below), suggesting little underlying demand for commodities as an inflation hedge, as there was in the 1970s and early 1980s.

Oil prices have been pushed up to their highest levels since 1991 by war jitters and the strike in the República Bolivariana de Venezuela. Forecasting the oil price over the next year is obviously very hazardous. Further sharp upward movements are plausible in the near term, especially in the event of military intervention in Iraq. The rest of OPEC would have to produce up to capacity, significantly exceeding the current quota, to compensate for the loss of production in Iraq and the earlier shortfalls from the República Bolivariana de Venezuela. Beyond near-term spikes, however, increasing supply and modest growth in demand suggest that current high prices will moderate into 2004, falling to about $21 per barrel.

Is global deflation a threat?

Even with interest rates low and oil prices unexpectedly high, there are few signs of inflationary pressure in industrial countries. Consumer price inflation at the end of 2002 was 1.6 percent, a modest 0.6 percentage point higher than in 2001, the trough of the global slowdown. Given the subdued expansion ahead, there is very little prospect of a general resurgence of price pressures. According to OECD estimates, negative output gaps (the difference between actual and potential GDP) have either opened or widened since 2000; with growth expected to remain below potential for the next two years, these negative gaps are not likely to close (figure 2.19). Slack conditions in labor and product markets will leave little opportunity for raising prices. The result is that domestic factors in the major economies point to continued low inflation in Europe and the United States and sustained *deflation* in Japan.

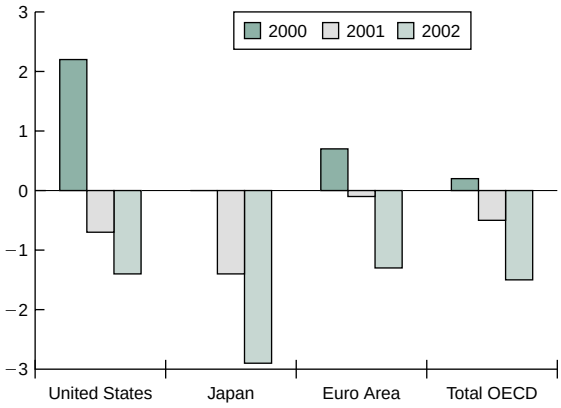
This message of low inflation is echoed in much of the developing world (figure 2.20). China and some of the newly industrialized economies of East Asia are experiencing deflationary trends. This is helping them to maintain or even improve competitiveness in international markets. In China, deflation is driven by fast productivity growth, the shedding of labor from state-owned enterprises and slack in product markets as capacity expands rapidly while consumer credit is still in its infancy.

Although deflation is beneficial for exporters, sustained deflation must be a concern, however, for heavily indebted enterprises and households, especially in financial systems that do not offer borrowers the opportunity to refinance mortgages at lower interest rates.

The most striking aspect about inflation in Latin America is the failure of significant currency depreciations to spark inflation. Through recent waves of devaluations, the rise in prices has generally been well below the decline in the currency

Figure 2.19 Output gaps in OECD centers, 2000–2002

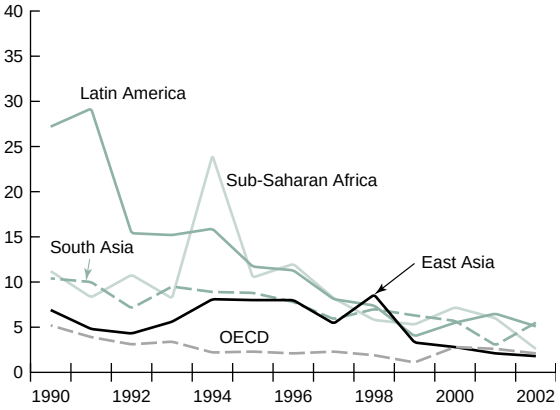
Difference between actual and potential GDP percentage points



Source: OECD.

Figure 2.20 Inflation rate in OECD and developing regions, 1990–2002

Consumption deflators, local currency (median percentage change)



Source: World Bank data and World Bank Development Prospects Group estimates.

Box 2.2 Disinflation is a global phenomenon

Inflation has dropped sharply across all high-income countries from its peak in the 1970s following the collapse of the Bretton Woods system of fixed exchange rates and the first global oil crisis. In the 1990s, however, this development became truly global. By the end of the decade, very few countries (at all income levels) had inflation over 10 percent, as fiscal consolidation and increasing central bank independence limited the creation of inflationary conditions. Monetary authorities developed more sophisticated approaches to monitoring and intervening in financial markets, allowing them to target inflation and interest rates directly rather than attempting to control monetary aggregates. Authorities also learned the value of greater transparency and accountability, communicating their intentions promptly and clearly. Perhaps most important, public support has grown for price stability. Other broad trends that promoted noninflationary adjustment were the growth of more open and competitive output markets and the de-indexing of labor contracts, both of which lowered inflationary expectations. The recent surge in productivity growth has further dampened price pressures.

The result has been markedly lower inflation throughout the world and striking new patterns of price adjustment. Whereas 20 years ago a major devaluation would have triggered an inflationary cycle, real adjustment now takes place quickly. Argentina is a case in point. After the currency board was abandoned at the beginning of January 2002, the peso went into free fall, eventually settling at around 3.6 to the dollar, a decline of around 70 percent (it has since strengthened somewhat). However, prices rose only 35 percent. This occurred in Argentina's extreme deflationary environment, with domestic production collapsing, but a similar story could be told about Brazil or South Africa.

Although disinflation has been a broadly beneficial development, it has a dark side if it leads to deflation or unexpectedly low inflation. These make for a dangerous mix with high debt levels.

Deflation increases debt problems through several channels:

- As deflation suppresses future profits, lower equity prices and higher spreads on corporate debt raise financing costs, deter investment, and make debt problems persistent.
- Households faced with higher costs of debt service curtail discretionary spending, exacerbating the deflationary spiral.
- The financial sector may also be affected, since a decline in equity prices erodes the value of collateral. In countries such as Germany and Japan, where banks take direct equity positions, the fall in equity values also shrinks the banks' capital base.

(box 2.2). Moreover, second-round effects have generally been quite short-lived. For example, inflation rose to no more than 9 percent in Brazil in 2002, despite the 24-percent drop in the real versus the dollar. Consumer price hikes in Argentina were only 35 percent in 2002, despite the currency collapse, government default, and restrictions on bank deposits. Dire warnings of a return to hyperinflation proved too pessimistic (just as they had in Indonesia in 1998 and the Russian Federation in 1999), despite a high degree of policy disorder. In explaining why inflation was less than it was feared to be in Latin America and beyond, two factors stand out:

- The devaluations occurred against a backdrop of weak domestic demand and, in most cases, relatively high levels of unemployment and low levels of capacity utilization. Unlike in the 1980s, Latin American economies have generally devalued at the trough rather than the peak of the cycle.[5]
- Long-standing structural reforms, notably measures to open the economy to trade and competition, have provided strength.

In other parts of the developing world, inflation is also at very low levels—few countries have double-digit inflation rates. Even where this is the case, such as in South Africa, there are clear signs that the condition will be temporary and that a significant decline is in the pipeline.

With inflation low in the OECD and negative output gaps likely to grow in coming quarters, it is reasonable to ask whether widespread deflation is a major risk to the global outlook.

The authorities in Europe and the United States will be able to avoid deflation in the current forecast by sustaining easy monetary policies, which will have the effect of allowing most troubled

debtors to manage their burdens down without strains sufficient to jeopardize the health of the domestic banking system. With the key central banks mindful of the risks and dangers of deflation, the chances of avoiding generalized global deflation look good.

By contrast, Japan is already well beyond the danger point. There, the difficulty is finding a policy recipe to break the cycle of declining prices that increases the burden of corporations' liabilities. As burdens rise, commercial banks becoming saddled with yet more nonperforming loans. The resulting contraction in new lending leads to more economic contraction and price declines.

Policy actions designed to break into this circle of debt and deflation have gained new impetus, but much remains to be done. Cumulative nonperforming-loan disposals have amounted to ¥82 trillion (some $680 billion) since 1992. Economic activity may be adversely affected in the near term as more stringent accounting criteria are applied to banks, and remaining lines of credit to financially encumbered corporations are terminated. Alongside these restructurings, it is desirable that the Bank of Japan should maintain a truly stimulative monetary policy.

A bumpy takeoff in world trade

With the lowering of trade barriers, the intensification of global production networks and the integration of financial markets, international trade cycles have become strikingly synchronous. Volume growth of developing countries' exports and imports over recent years followed closely the pattern of trade flows in high-income countries. After record growth in 2000, trade volumes fell in the first half of 2001 but started rising again from the fourth quarter of 2001. Although the pattern was similar, average trade growth in developing countries was significantly stronger than in high-income countries. This mainly reflected gains in market share by Central European and East Asian exporters and a rapid expansion of regional trade in both parts of the world.

Within this broad, synchronous trade cycle were eye-catching differences across developing regions, especially on the import side. At the high end of the spectrum, East Asian imports grew at an annual rate of 20 percent before the downturn in 2001, fell cumulatively less than 1 percent during the downturn, and returned to a pace of 20 percent growth during the rebound (table 2.3). At the low end of the spectrum, Latin American imports fell almost 10 percent during the downturn and, after a short upswing, started to fall again in the second half of 2002, reflecting severe constraints on external finance. For both high-income countries and developing countries, trade is expected to grow at a fairly moderate pace in 2003, after a brief downturn in the first quarter. The downturn follows the temporary dip in global industrial production in the fourth quarter 2002. On an annual basis global trade growth is anticipated to reach 6.2 percent in 2003, up from the 3-percent results of 2002. The low growth rate for 2002 reflects partly the decline in trade within 2001; the higher growth rate for 2003 in turn reflects partly the acceleration that occurred in 2002. Most developing regions should share in the acceleration of trade growth, with the trend of growing South-South trade continuing. China is expected to grow in importance as an export market, especially for other countries in East Asia.

The relatively uniform rebound in the growth of trade volumes implies little change in trade balances in the near future. There will likely be some price effects on trade balances, especially as the dollar continues to weaken. A weaker dollar should increase dollar-based revenues for exporters of non-oil commodities, with a positive impact on their current-account balances in the short term. At the same time, the depreciation of the dollar—together with fixed-debt servicing on dollar-denominated debt—will appear as a capital gain

Table 2.3 Growth in volume of manufactured imports
(percentage change at annualized rates)

	Q1, 1999–peak in 2000	Cumulative fall in downturn	Growth since the trough of 2001
High-income	11.4	−6.1	7.9
Developing			
East Asia and Pacific	19.6	−0.8	20.2
Middle East and North Africa	8.7	−4.6	2.9
Europe and Central Asia	15.3	−2.4	7.9
Latin America and the Caribbean	12.1	−9.8	−8.4
South Asia	6.6	−7.6	11.5

Source: World Bank staff.

or a rise in real incomes for indebted developing countries, potentially leading to increased import demand. All these effects would be quite modest, however.

Assessing the global flow of funds

Using the pattern of global current-account balances as a starting point, the global flow of funds can be summarized as follows:

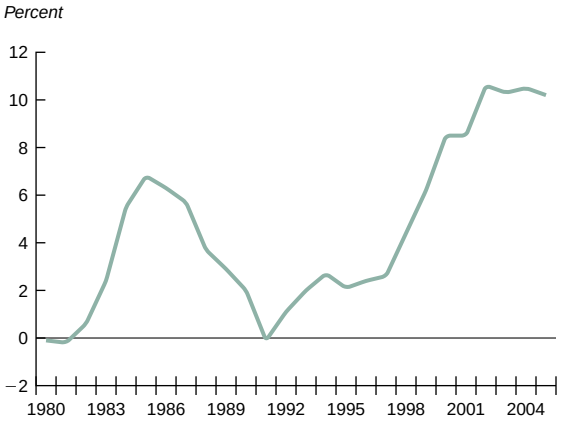
- Developing countries export capital to high-income countries.
- Asia and Europe export capital to the Americas.
- These data need to be treated with some care, as the overall global current-account discrepancy was about $130 billion in 2002, implying that far more payments than receipts are being recorded.

The forecast projects that the U.S. current-account deficit, which widened to nearly 5 percent of GDP during 2002, will remain near that level in the short run. This large deficit began to be accumulated in the late 1990s as U.S. economic growth surged and the dollar firmed. This development was not unanticipated, as current-account deficits are associated to a large extent with business fluctuations and the dynamics of investment. What made the U.S. experience exceptional was that the deficit hardly narrowed during the downturn in 2001 and sharply widened further immediately afterward. By 2000, the peak year of the last business cycle, the U.S. current-account deficit reached 4.2 percent of GDP, or 8 percent of the combined savings of the rest of the world (figure 2.21). By contrast, the peak of the last current-account cycle in the United States during the mid 1980s saw the deficit reach 3.4 percent of GDP, or 6 percent of world savings.

It is difficult to identify the full complement of financiers of the U.S. deficit because the global current-account deficit has ballooned, complicating the picture (table 2.4). In the early phase of the run-up of the U.S. deficit, the main flow of capital came from Asia, where the crisis of 1997–98 led to a sharp turn in capital flows. This flow has fallen from its peak, but not by much. During 2001–02, U.S. shortfalls increasingly came to be financed by higher European inflows to equity and fixed-income markets. More recently, official creditors have been the source of an increasing amount of the funding, as central banks (especially in Asia) have resisted upward pressure in their currencies against the dollar. Japan's international reserve holdings currently stand at around $450 billion and China's at $270 billion. These countries are at the high end of the scale, but the breadth and amount of central bank reserve accumulation over the past couple of years is striking (see chapter 1).[6]

There is, of course, no reason why countries should not maintain current-account deficits or surpluses for an extended period. Since 1980, the

Figure 2.21 U.S. net borrowing as a share of rest-of-world savings, 1980–2004



Source: World Bank data.

Table 2.4 Current-account balances
(billions of dollars)

	2001	2002e	2003f
World[a]	−140	−133	−229
High-income	−170	−181	−255
United States	−393	−498	−550
EU (15)	18	80	69
Japan	89	116	115
Developing countries	28	48	26
East Asia and Pacific	43	43	41
Europe and Central Asia	18	9	7
Latin America and the Caribbean	−54	−16	−20
Middle East and North Africa	29	25	10
South Asia	−3	−8	−6
Sab-Saharan Africa	−5	−4	−5

Note: *e* = estimate, *f* = forecast.
a. Global current-account discrepancy.
Source: World Bank staff.

Table 2.5 Long-run trends in current account balances, 1980–2002
(percentage of GDP)

	1980–82	1983–85	1986–88	1989–91	1992–94	1995–97	1998–2000	2001	2002	Stan. dev.	Correlation with U.S.
United States	0.0	−2.2	−3.0	−1.0	−1.2	−1.5	−3.2	−3.9	−4.8	1.52	n.a.
Euro Area	−0.9	0.4	0.7	−0.6	−0.3	1.0	0.1	0.5	1.3	0.63	−0.53
Japan	0.0	2.7	3.4	1.8	2.9	1.9	2.7	2.1	2.9	1.00	−0.64
Other OECD	−2.5	−0.5	−1.8	−2.0	−2.1	0.0	−0.3	1.5	1.0	1.44	−0.80
East Asia and Pacific	−1.8	−2.1	0.6	−0.7	−1.2	−1.3	4.7	2.6	2.5	2.39	−0.77
Europe and Central Asia	−0.6	−0.1	0.1	−0.2	−0.6	−0.8	−1.6	1.9	0.8	0.52	0.36
Latin America and the Caribbean	−4.8	−0.6	−1.6	−0.8	−3.0	−2.6	−3.4	−2.9	−1.0	1.34	−0.32
Middle East and North Africa	7.3	−4.6	−3.8	−3.3	−5.2	−0.1	0.7	5.0	4.5	4.57	−0.15
South Asia	−1.9	−1.6	−2.2	−2.3	−1.4	−2.0	−1.0	−0.5	−1.1	0.84	−0.77
Sab-Saharan Africa	−5.1	−2.1	−1.5	−0.7	−1.9	−2.1	−2.1	−1.7	−1.4	1.21	−0.23

Note: n.a. = not applicable, Stan. dev. = standard deviation.
Sources: IMF, *Balance of Payments Yearbook;* World Bank staff.

current-account balances (expressed as a share of GDP) of Japan, the European Union, Europe and Central Asia, and South Asia have been relatively stable (as shown in table 2.5 by the standard deviation in their current-account imbalances). By contrast, the current-account imbalances of East Asia and Pacific and the Middle East and North Africa have been quite volatile. In the latter case, this is no doubt due to the volatility in oil prices.

The significant and negative correlations between the current-account balances of most regions and those of the United States suggest that variations in the U.S. need for savings have been met by much of the rest of the world. In the late 1990s, the rise in the U.S. current-account deficit had a counterpart in increased surpluses in Latin America, East Asia, the Middle East, other OECD countries, and, to a lesser extent, in the European Union.

Several factors were likely at play in the widening of the U.S. deficit—and in its financing. Rapid productivity growth in the United States in the 1990s translated into higher demand for imports, as U.S. consumers spent what they perceived to be permanently higher incomes. This was further reinforced by a rise in the real effective exchange rate, which also encouraged imports. At the same time, sharply higher U.S. investment spending and the run-up in equity prices offered international investors exceptional opportunities. And the United States was perceived as a safe haven during financial turbulence in 1997–98 and 2002.

During a cyclical downturn, such as that in 2001–02, the U.S. current-account deficit would normally be expected to narrow. Although this occurred to some extent, the amount was small. The reason lies partly in the global, synchronized nature of the last downturn, in which U.S. partner demand dropped sharply. Also important was the sharp rise in U.S. public-sector dissaving—a result of fiscal expansion.

At present, there is little evidence to suggest that international investors are unwilling to continue financing the U.S. deficit at close to current levels. A weaker dollar vis-à-vis the euro and the currencies of East Asia (especially the yen and yuan) would restore a better balance. But there are several impediments to engineering such a change. Consistent macroeconomic policies would be required to encourage domestic demand in Europe, Japan, and China to replace net exports as a source of growth. It is unlikely that policymakers will elect to effect such change—and unclear that they would be able to do so even if willing.

The dilemma thus facing policymakers across the global economy, especially those in heavily indebted developing countries, is that a U.S. current-account deficit of about $500 billion is absorbing a very high proportion of global saving. But the means of adjusting this imbalance—reduced U.S. import demand, appreciation against the dollar (and the attendant deflation risks that it might bring), and stepped-up efforts to promote domestic demand—are all either undesirable or unachieveable objectives (see box 2.3 for a discussion of the impact of a weaker dollar on developing countries).

But as long as the existing constellation of exchange-rate relationships persists, a constellation that helps foster large U.S. current-account deficits,

Box 2.3 Developing countries and the dollar

Since the summer of 2001, the dollar has lost more than 25 percent of its value against the euro. This erosion affects trade relations and investment positions between the United States and Europe most directly, but it has an important effect on developing countries as well. For developing countries, a change in the value of the dollar may lead to substantial changes in terms of trade, competitiveness, and debt service:

- Exporters of non-oil commodities tend to reap terms-of-trade gains from a weakening dollar. Large segments of supply and demand in many non-oil commodities markets depend on income flows denominated in other currencies. Prices in those markets tend to be determined in currencies other than the dollar. Econometric estimates show that roughly 50 percent of dollar depreciation is translated into a rise in dollar prices of non-oil commodities. And as prices of oil and industrial products are to a larger extent determined in dollars, a weakening of the dollar is likely to generate terms-of-trade gains for non-oil commodity exporters.
- A falling dollar implies a loss of competitiveness for exporters to the United States, or exporters who compete with others whose costs depend on dollar prices. Although fewer developing countries have their exchange rates pegged to the dollar than 10 years ago, different exchange-rate systems still have an impact on competitiveness. An obvious example is the link of the Chinese yuan to the dollar, which gives Chinese exporters a clear advantage vis-à-vis other exporters from the region when the dollar is weak.
- About 60 percent of long-term external debt in developing countries is denominated in dollars. This share may be even higher if one takes into account exchange-rate swaps that developing countries use to limit exposure to fluctuations in the value of other currencies. A weakening of the dollar immediately lowers developing countries' debt service as measured in local currencies.

These mechanisms imply that a weaker dollar is beneficial for non-oil exporters and highly indebted countries—mainly in Latin America and Sub-Saharan Africa—but may adversely affect exporters of industrial and high-tech products in East Asia.

two unfortunate side-effects will develop. First, foreigners will increase their already huge holdings of U.S. assets, many of which are held in liquid form. Second, real resources will continue to be committed to maintaining this pattern of real exchange rates, leading to a possible overinvestment in the tradeable goods sectors in countries and regions where the real exchange rate is being held down by foreign-exchange intervention.

Notes

1. The rate of personal savings from disposable income was 0.8 percent in the fourth quarter of 2001, the lowest level on record. By the fourth quarter of 2002, it had risen to 4.2 percent.

2. See chapter 5. There is also now, if anything, excess demand for dollar-denominated debt issued by East Asian borrowers, leading to the emergence of an "Asia premium" (see chapter 3).

3. This does not include about $8 billion of interest arrears that Argentina built up to private external creditors in 2002. Technically, this should be counted as a short-term net debt inflow.

4. There are a few commodities for which this is not true, since they cannot be easily shipped from one market to another. A good example is natural gas.

5. One exception was Mexico in late 1994. Partly as a result, the inflation pass-through in 1995 was relatively high.

6. Not all of these reserves are held as dollars. Indeed, many central banks are now in the process of diversifying their holdings, especially by acquiring more euros, which may be one factor that has boosted the euro against the dollar over the past year.