Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Global outlook

Prospects for the world economy dimmed towards the end of 2000. After an unprecedented period of expansion, growth in the United States decelerated sharply in the third and fourth quarters of the year in response, inter alia, to a series of interest rate hikes, falling equity prices and rising oil prices. Lower investment spending in the last quarter snuffed out growth altogether at the beginning of 2001, raising concerns that a harder landing than expected might send recessionary shockwaves throughout the world economy. The fact that the slowdown, with its potential consequences, has caught many observers by surprise is a further confirmation that policy makers everywhere are ill-prepared to cope with the changes brought about by the increasing integration of the world economy.[1]

As a result of growing global interdependence both real and financial shocks are transmitted much more rapidly across regions, countries and sectors. At the same time, given the intertwining of the real and financial sides of the economy, such shocks have unexpected consequences. The Asian financial crisis was initially expected to plunge the global economy into recession; instead, it provided a stimulus to the United States economy, prolonging growth there, which in turn supported a rapid recovery in Asia through higher exports (*TDR 1999* and *TDR 2000*). On the other hand, the adverse impact of the Asian crisis on commodity and petroleum prices, which helped keep prices in the United States under control, created balance-of-payments and fiscal difficulties for a number of developing countries. These eventually produced another series of financial shocks, ignited by bond default in the Russian Federation, which triggered a global rush for liquidity that threatened even United States financial markets during the late summer of 1998. The reduction in United States interest rates in response to that threat, followed by substantial injections of liquidity to counter the Y2K computer problem and to support the introduction of the euro, steadied confidence, particularly in the United States, and brought about a global recovery of growth in 1999 and at the beginning of 2000.

However, the global recovery also aggravated domestic and global imbalances in a manner simi-

lar to that of previous major cyclical disruptions and periods of financial instability. As was suggested in *TDR 2000*, an end to the expansion in the United States economy was unavoidable and imminent. Monetary tightening by the Federal Reserve, which began in mid-1999 and had pushed interest rates to 6.5 per cent by May 2000, took longer than expected to affect business and household expenditures, but the squeeze was clearly visible in the last quarter of the year. The current slowdown is expected to reduce the burgeoning current-account deficit, which stands at over 4 per cent of GDP, thereby helping to correct a major global imbalance, but without faster growth elsewhere it will lead to a significant decline in global demand.

Unlike the Asian crisis, the United States downturn is not expected to generate significant expansionary impulses elsewhere in the world economy.

A broad body of opinion expects the slowdown to be brief, although more pronounced than had earlier been predicted; once equity prices, excess capacity and inventories return to normal levels, the economy is expected to see robust growth consistent with the spread and further development of new telecommunications and information technologies. On this view, therefore, global growth should be little affected by what, at worst, would amount to a short recession, followed by recovery in the second half of 2001.

However, the current United States slowdown cannot be described simply in terms of previous experience, when booms were ended by a combination of monetary tightening in response to wage and price pressures and fiscal tightening to reign in public debt. Critics of the view that the introduction of new telecommunications and information technology has produced a structural change in the productive potential of the economy and in its cyclical behaviour point to the large increase in debt and the reduction in savings ratios that have been incurred by households and the business sector in the presence of large fiscal surpluses (Godley, 2000). If the private sector were to attempt to repay its excessive debt and restore its savings rates to historical levels, the shortfall in demand could produce a prolonged recession, since it would far exceed any fiscal stimulus that could be expected from planned tax cuts.[2] In this scenario, no region of the world could expect to escape the effects of a United States downturn.

The crucial question is consequently whether a new locomotive of global growth will emerge to compensate for the at least temporary abandonment of this role by the United States. Unlike the Asian crisis, this downturn is not expected to generate significant expansionary impulses elsewhere in the world economy. Japan's nascent expansion, based on rising net exports and higher corporate profits leading to a recovery in investment, is vulnerable to a slowdown in the United States. Moreover, output growth was already negative in the third quarter of 2000, after a strong performance in the first half. In addition, with interest rates close to zero and a large public-sector deficit, there appears to be little room for a policy stimulus without the help of a major adjustment in exchange rates. Most analysts are looking instead to the EU to help sustain global growth and offset declining import demand in the United States.

Growth in EU last year broke through the 3 per cent barrier for the first time in over a decade (table 1.1), and there is confidence that it will outperform the United States in 2001, given that exports to that country amount to less than 3 per cent of regional output. However, despite the fact that the EU countries have successfully reduced their budget deficits, have kept their current accounts in balance and are showing little sign of inflationary pressures, last year's growth recovery continued to rely on net exports, accounting for as much as half of the increase in output, even in larger economies such as Germany. As net exports are expected to make a smaller contribution in 2001, a sustained expansion in private domestic demand will be needed to meet even the modest growth ambitions expressed at the Lisbon summit. Perhaps not surprisingly, and despite the moderate stimulus that has resulted from structural reforms in the fiscal regimes in a number of countries, there has as yet been no policy commitment to the kind of domestic demand-led growth enjoyed by the United States in recent

Table 1.1

WORLD OUTPUT, 1990–2000

(Percentage change over previous year)

Region/country	*1990–1995[a]*	*1995–2000[a]*	*1990–2000[a]*	*1998*	*1999*	*2000[b]*
World	2.0	3.1	2.6	1.9	2.7	4.0
Developed market-economy countries	1.8	2.9	2.3	2.1	2.6	3.5
of which:						
United States	2.4	4.3	3.4	4.4	4.2	5.1
Japan	1.4	1.1	1.3	-2.5	0.2	1.3
European Union	1.5	2.5	2.0	2.7	2.4	3.3
of which:						
Euro area	1.6	2.4	2.0	2.8	2.4	3.4
Germany	2.0	1.8	1.9	2.1	1.6	3.1
France	1.0	2.4	1.7	3.2	2.9	3.1
Italy	1.3	1.7	1.5	1.5	1.4	2.9
United Kingdom	1.6	2.8	2.2	2.6	2.2	3.1
Transition economies	-6.9	1.9	-2.6	-0.6	2.3	5.6
Developing economies	5.0	4.3	4.6	1.5	3.3	5.5
of which:						
Africa	1.5	3.6	2.5	3.2	2.9	3.5
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
Asia	6.2	5.0	5.6	1.1	4.9	6.6
of which:						
China	12.0	8.3	10.1	7.8	7.1	8.0
Other economies	4.9	4.1	4.5	-0.8	4.2	6.2
Memo item:						
Developing economies, excluding China	4.1	3.7	3.9	0.5	2.7	5.1

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.
a Annual average.
b Estimates.

years. Indeed, even as overall macroeconomic conditions suggest that Europe should at last be ready to test the limits of its potential growth rate – as the United States did in the second half of the 1990s – the European Central Bank (ECB) sees no signs that the euro zone's non-inflationary growth potential has risen above its current estimates of 2.0–2.5 per cent,[3] implying that it also sees no immediate scope for relaxing monetary policy.

This reluctance to make a more concerted policy move to bolster recent performance is a matter of concern, since Europe will, in all likelihood, be more affected by the slowdown in the United States than official views, based on the limited trade ties to the United States, suggest. Euro-zone exports to the rest of the world still account for more than 15 per cent of the area's output, which is considerably higher than for either the United States or Japan, and the reliance on exports over the past year of some of the larger European countries suggests that they could still be hit quite hard by a global slowdown. Furthermore, the integration of global production means that corporate profitability and investment plans can be quickly disrupted by changes in a country

which plays host to a large number of foreign affiliates. This is particularly true for European high-tech firms that have made very large acquisitions in the United States in recent years. Knock-on difficulties in European equity markets created by reduced corporate earnings in United States affiliates could be further aggravated by a lower dollar, making it even more difficult for these countries to offset the decline in their exports to the United States through higher domestic investment expenditures.

Consequently, without a determined change in economic policy, growth in the EU is unlikely to reach 3 per cent in the current year, and it may be much lower. Moreover, given the current propensity to import, its growth rate would have to be higher than that achieved in the United States in recent years if it is to generate an external deficit similar in size to that of the United States and act as a global buyer of last resort for the recovering economies of Asia and Latin America.

An orderly transition to a world where the leading economies all pull in the same direction is further complicated by the uncertainty surrounding exchange rate adjustments to current imbalances. The recent strength of the dollar has been due to relatively high United States growth and profit levels, the large inflows of capital seeking to join the information and communication technology (ICT) revolution, positive interest rate differentials and the high liquidity premium attached to dollar assets in the aftermath of the global liquidity crisis that followed the Russian default in 1998. If the United States economy were to slow down sufficiently to induce the Federal Reserve to further relax monetary policy, this would eliminate two factors that underpin the dollar's strength. Moreover, the large-scale acquisition of United States companies during the period of boom in high-tech stocks[4] appears to be running out of steam, as European firms move to consolidate existing operations rather than expand into what is an increasingly uncertain market.[5] However, the likely impact on the dollar is not clearcut since not all merger and acquisition (M&A) activity is financed by cash payments requiring the sale of currency for dollars.[6]

In any event, with widespread expectations of slower growth, falling interest rates and lower profitability of high-tech companies in the United States, the liquidity premium on United States assets remains the major support for the dollar. Recent experience teaches that this is not a reliable foundation. The way global imbalances are corrected and, in particular, the behaviour of the United States current-account deficit, may be crucial in determining whether slower inflows into dollar assets leads to a major weakening of the currency and widespread disruption in global financial markets.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth. The benefits to European growth of a stronger euro, which would allow interest rates to fall, are likely to outweigh the disadvantages of reduced competitiveness and earnings of European companies with affiliates operating in the United States. In addition, a stronger euro would further reduce the dependence of growth on external demand and encourage a more positive role for Europe in sustaining global growth.

The United States slowdown is likely to have a damaging impact on the developing world, particularly if it is not offset by strong growth in other OECD economies, even assuming a measured decline of the dollar. However, the impact on individual countries and regions will depend on the relative importance of their trade and financial linkages with the United States. In Asia, where rising net exports have financed a post-crisis expansion, a weaker dollar, coupled with a sharp United States downturn, will quickly reduce current-account surpluses and could threaten bank and corporate restructuring.[7] Linkages to United States firms are particularly strong in high-tech sectors, such as semiconductors and personal computers, where declining sales and difficulties in financing production translates directly into lower

component imports from Asia. While a substantial depreciation of the dollar would help exports of countries such as China and Malaysia with pegs to that currency, it could create difficulties for the stability of regional exchange rates. It might also trigger currency depreciations across the region, which, together with the fall in semiconductor prices, could result in terms of trade losses and declining demand in countries affected. Japan's recovery would not be helped either by a weaker dollar or by a depreciation of Asian currencies. On the other hand, if the Japanese economy weakens further, the yen/dollar exchange rate might come under pressure. This could lead to similar pressures for depreciation against the dollar across East Asia rather than to a strengthening of regional currencies against the yen.

By contrast, a weaker dollar, accompanied by lower interest rates, could benefit many Latin American countries that have linked their currencies either directly or indirectly to the dollar. With the exception of Mexico and some smaller Caribbean economies, dependence on exports to the United States is lower than in Asia and financial links are more important. Brazil and, in particular, Argentina could stand to gain from a weaker dollar and lower United States interest rates through the effects on the public finances and the services account of the balance of payments. Since the major Latin American economies still have large external financing gaps, they should benefit from lower international interest rates more than they lose from declining exports. However, even in these countries, trade flows would probably decline. Furthermore, if the United States slowdown leads to an overall perception of increased risks and, hence, higher yield spreads for emerging-market borrowers, the final outcome might still involve considerable costs for the region.

B. Developed economies

1. *The slowdown in the United States economy*

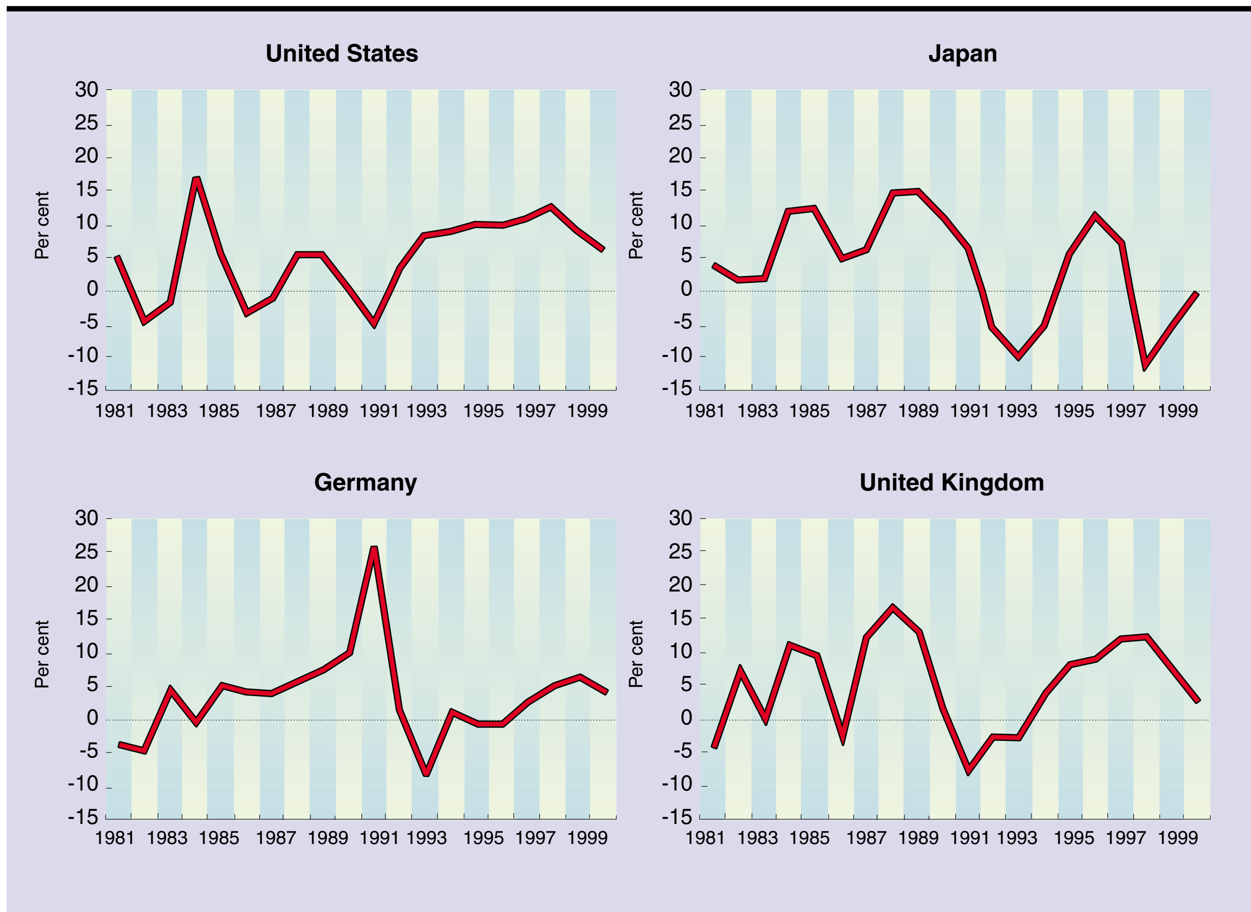
The recent expansion in the United States has been driven by domestic demand and supported by a Schumpeterian process of creative destruction that increased investments in new technologies and raised productivity performance. A series of international events kept the lid on prices, even as the economy grew at around 5 per cent and unemployment dropped below 4 per cent. Although the increase in petroleum prices in 2000 pushed the rate of increase in the consumer price index close to 4 per cent for the first three quarters of 2000, underlying price pressures remain benign.

However, with growth over the past two years exceeding most estimates, the Federal Reserve raised the Federal Funds rate in several steps to 6.5 per cent in mid-2000.[8] While the strong economic activity appeared resistant to tighter monetary conditions until mid-2000, the slowdown in the third and fourth quarters of 2000 was much more pronounced than expected and growth stalled in the first quarter of 2001, suggesting that the risk of recession is by no means negligible. With hindsight, it seems clear that the last increase in the Federal Funds rate of 50 basis points was unnecessary, as was perhaps also the previous increase from 5.75 per cent to 6 per cent, given the lagging effect of changes in monetary policy. In response to falling equity prices and sharply lower

Chart 1.1

INVESTMENT CYCLES IN MAJOR INDUSTRIAL COUNTRIES, 1981–2000

(Real gross fixed capital formation of the business sector, per cent change over previous year)



Source: OECD, *Economic Outlook*, various issues.

indicators of consumer confidence, the Federal Funds rate was reduced by 50 basis points twice during January 2001.

Two mutually reinforcing developments accounted for the faster than expected slowdown: the decline in investment spending on information technologies; and the sharp drop in consumer confidence, resulting in a slowdown in consumer spending.

One of the most striking characteristics of the United States expansion has been the sustained boom in gross domestic fixed investment which lasted much longer than in other major industrial countries and in previous investment cycles in the United States itself (chart 1.1). By the first half of 2000, gross fixed investments in the business sector had risen to over 18 per cent of GDP (chart 1.2) and business investment in equipment and software to over 10 per cent. Spending on investments in ICT has contributed to about a quarter of real GDP growth over the past six years.[9] Much of the investment was in the formation of new start-up companies which needed structures, equipment, and a full range of more traditional services such as legal support and advertising. A good deal of this new investment has been financed by venture capital funds in preparation for raising equity in these companies through initial public offerings

(IPOs). In 1999, new IPOs raised close to $60 billion, a figure matched in 2000 (most of it being raised in the first half of the year) (NVCA, 2001). Such IPOs originated from companies that had benefited from the high-tech bubble in the NASDAQ index, which produced triple-digit price-earnings ratios and extremely easy financing conditions.

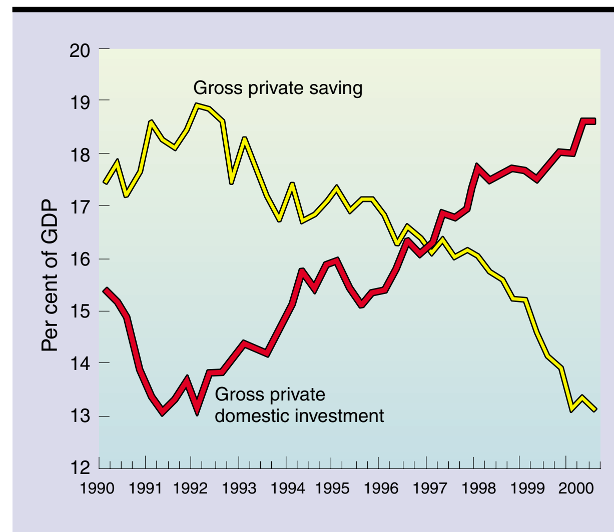
It is now clear that many of the new technology companies could never have developed without the easy financial conditions made possible by the boom in venture capital funding and the stock market bubble. It is also clear that as a result more capacity was created in the sector than if the financing had been made available under normal conditions by bank lending or retained earnings. A sharp reversal of expectations concerning the future earnings capacity of these companies led to a collapse in their share prices in the first quarter of 2000. The NASDAQ index, which contains a high proportion of ICT-based companies, finished the year down nearly 40 per cent. The resulting loss in stocks initially issued in 1999 and 2000 has been estimated at nearly $300 billion, and new issues were halted at the end of 2000 and the beginning of 2001. Thus, in the second half of 2000, the new borrowing that these companies needed to cover their negative cash flows came to an end and many had to close down or default. As a result, investment and related expenditures came to a halt; in the fourth quarter, real non-residential fixed investment in equipment and software decreased by 4.7 per cent on an annualized basis.

All this bears more than a passing resemblance to the Asian experience[10] of easy access to cheap credit and excessively optimistic expectations of higher future earnings, leading to investments that could not possibly be profitable. The Asian boom was followed by a stock market bust and recession, and a similar result appears to be in prospect for the United States. The decline in equity prices has reduced household wealth and dampened consumer spending, which already appears to have been affected by rising domestic prices for energy. In particular, the deregulation and liberalization of electricity and natural gas prices – which in some states have increased fivefold along with the return to more normal cold winter – have resulted in sharply increased heating costs for many households. The decline in consumer confidence and outlays is likely to be further reinforced as the effects of layoffs due to corporate restructuring and inventory adjustment spread throughout the economy.[11] Growth in consumer expenditure fell from an annual rate of 4.5 per cent in the third quarter to 2.9 per cent in the fourth quarter.

Chart 1.2

UNITED STATES: PRIVATE INVESTMENT AND SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

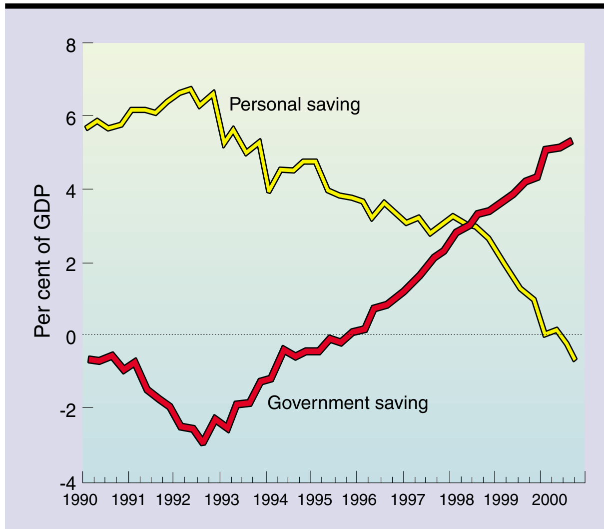
Basically two scenarios are envisaged for the United States economy: a normal cyclical downturn which will quickly bring about adjustments to productive capacity and inventories through a short deceleration in growth during two or three quarters, to be followed by a rapid recovery; or, alternatively, a sustained period of disinvestment, producing recessions similar to those in Japan or Europe in the early 1990s.

At the beginning of 2001 certain developments suggested there might be a quick recovery: petroleum prices were in the range of $20–25 a barrel, inventory accumulation appeared to have come to a halt, equity prices seemed to be stabi-

Chart 1.3

UNITED STATES: PERSONAL SAVINGS AND GOVERNMENT SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

lizing and the trade balance had started to improve. Furthermore, the dollar had depreciated by over 10 per cent against the euro from its earlier highs, and prospects for increased dollar earnings provided support for equity prices of companies with large international operations. The Federal Reserve moved aggressively to lower rates and announced that it had changed its policy bias from fighting inflation to fighting a rapid slowdown.

Despite these positive developments the risk of a sustained recession cannot be overlooked, since the late stages of the boom were underpinned by historically large increases in private-sector indebtedness, which is the counterpart of the historically large fiscal surplus (chart 1.3). Since 1997, total private expenditure has exceeded disposable income, reversing the normal relation that has held since 1952; by the third quarter of 2000 the private-sector financing gap had reached 8 per cent of GDP, the personal savings ratio had become negative, and household debt had reached 110 per cent of annual disposable income. Thus, while the Government prepares to pay off its outstanding debts, the private sector has been accumulating record amounts of debt relative to its ability to service that debt. Just as start-up companies in the ICT sector needed to borrow to stay in business, households need to borrow in order to sustain their current rate of consumption. A decline in income growth associated with a recession would mean that households would have to increase borrowing just when their ability to meet the payments on their outstanding debt is declining.

The fact that such a long period of expansion is unprecedented should make for a cautious assessment of the current slowdown. However, if, as already noted, the investment boom does share some resemblance to that in Asia in the early 1990s, the conflicting pressures on the economy from expansionary macroeconomic and stagnationary structural impulses point to a more uncertain future than either the V-shaped cyclical downturn and recovery or sustained recession scenarios suggest (box 1.1). Moreover, although the United States economy is in a much stronger position than in the past to make appropriate fiscal and monetary adjustments to avoid a prolonged recession, it seems unlikely that the economy will return smoothly to its growth path of the past decade, and certainly not to the nearly 5 per cent growth it had reached after the Asian crisis.

2. European Union

In 2000, the European Union experienced one of its best growth performances since the 1990–1991 recession (table 1.1). Growth finally exceeded 3 per cent and unemployment dropped to below 9 per cent. The growth disparities between the larger and smaller economies that had created difficulties in formulating a uniform monetary policy also narrowed. France, Germany and Italy grew at about 3 per cent in 2000, while the Spanish economy grew by more than 4 per cent. Among the smaller economies, Ireland continued to surge ahead of the pack, achieving a remarkable 11 per cent growth rate. With investment and consumer spending leading the recovery, the euro area appeared to be emulating the kind of private-sector-led growth enjoyed by the United

States. Indeed, the growth differential of about one and three-quarter percentage points between the United States and the euro area over the last three years was reversed in the second half of 2000.

The failure of Europe to achieve a strong and sustained recovery after 1991 reflects, in part, the responsiveness of European interest rates to those of the United States because of increased integration of financial markets. Furthermore, attempts by the ECB to establish credibility resulted in rising rates in response to United States monetary tightening, regardless of whether that was consistent with European growth and employment trends. The tight fiscal policies to meet the convergence requirements for the single currency and the Stability and Growth Pact meant that the main source of demand expansion had to come from net exports. The stimulus from this source after 1999 reflected increased competitiveness created by the depreciation of the euro, which went unchecked until the third quarter of 2000 when joint intervention by G-7 central banks seemed to halt any further slide. Growth appears to have peaked in mid-2000, around the same time as in the United States. France has continued to grow vigorously on the basis of domestic demand and managed to reduce its unemployment rate, but the German economy registered an unexpectedly sharp downturn in the last quarter of 2000, and most leading indicators of economic activity point to a slowdown in the euro zone in 2001.[12] Net exports are expected to drag down growth and the important question is whether Europe can continue to build on last year's growth performance in the face of the United States slowdown.

The United States slowdown will have an impact not only through trade. Sales of German and United Kingdom affiliates in the United States were roughly five times their exports to the United States in 1998, a figure which is roughly double that for smaller European economies such as the Netherlands. Lower sales will hit profitability, which could make it more difficult to carry out the restructuring necessary to introduce the high-tech production and organizational methods required to compete with United States companies. Economic integration between these two industrial blocs appears to be more significant than a casual discussion of trade ratios might suggest. According to recent estimates, the elasticity of euro-area growth with respect to the United States is as high as 0.4.[13] This suggests that the recent decline in the United States growth rate of more than 3 percentage points from its average over the last five years, could cause a decline of around 1.5 percentage points in European growth, bringing it below 2 per cent, irrespective of any further impact from a loss of export competitiveness due to the strengthening of the exchange rate.

Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.

Nevertheless, Europe seems better placed than ever to decouple from the United States. Since European companies are not as highly leveraged as their United States counterparts, investment should be less influenced by liquidity shortages, increasing spreads in high-yield and corporate capital markets, or difficulties in the ICT sector. The lower share of equity in personal wealth also suggests that consumption expenditures should be less constrained by declining global equity prices. In addition, the macroeconomic picture is broadly favourable. A necessary degree of convergence has been achieved across the region and the launch of the euro has been successful; its initial weakness reflected cyclical rather than structural factors. Moreover, the fall in United States interest rates eases pressure on the ECB, and the fiscal situation is healthy; changes in the fiscal regime of the major economies (Italy, France and Germany) will provide a stimulus of between 35 and 50 billion euros in 2001, adding as much as 1 per cent of GDP. The reversal in the upward trend of petroleum prices should also have a greater positive impact on Europe, since it is a larger net importer of oil than the United States, and this will be reinforced by a stronger euro, creating further increases in purchasing power for households and lower costs for European firms.

Box 1.1

DISSECTING THE UNITED STATES DOWNTURN

Many observers expect that the United States economy will experience a short Keynesian-type downturn, associated with overinvestment and excessive inventories accumulation, followed by a relatively rapid recovery. Such an outcome places considerable faith in discretionary fiscal and monetary adjustments. However, there are a number of factors suggesting that the current downturn is quite different from that which is typical of the Keynesian cycle.

While the sustained high rate of expansion in business investment has played an important part in the unprecedented period of expansion, even more striking has been the increase in investment in new computer and peripheral equipment, with average annual increases close to or above 50 per cent during 1995–2000. Total investment in information-processing equipment and software rose more slowly, at rates of around 25 per cent per annum. Although such spending represented less than 10 per cent of GDP in 2000, it accounted for almost one third of all output growth during 1995–1999.

This exceptionally rapid increase in investment was driven primarily by new business ventures attempting to exploit in full the benefits of a Schumpeterian wave of technological innovation in information processing and telecommunications. The boom in venture capital funding and the bubble in the IPO market allowed the financing of new start-ups with no current earnings and highly uncertain expectations of future earnings.[1] The sharp rise in equity prices after initial public offerings lowered the cost of finance. Venture capital funds were thus able to recover their investments and explore new business plans. As long as the equity market remained bullish, even unsuccessful and never profitable technology firms were able to continue to count on low-cost funding to meet ongoing losses. However, such firms represent excess capacity that will not be absorbed even by an increase in aggregate demand on the cyclical upswing. In a downturn, they are likely to be eliminated by bankruptcy.

This process now seems to be under way. It started with the collapse of the NASDAQ index in the first quarter of 2000, when investors began to distinguish the new start-up companies that were making their way and held out good profit prospects from those that were being kept alive only by continuous cash infusions, with little hope of future earnings to justify their elevated share prices. It is possible to look at the cyclical downturn as the market finally exercising its role selecting from the wide range of information technology innovations those that will be viable in the long run. The kind of excess capacity that is present in the economy may thus be rather different from the excess capacity in steel or automobile plants that had been associated with typical post-war cycles.

But even successful high-tech companies with positive earnings may not be immune from the current process of market selection. Many of them have acquired smaller start-up companies. Others have created their own venture capital funds to invest in start-ups, or financed new start-ups via reduced prices and the provision of credit through vendor financing. Some have accepted stock options in lieu of payment. Thus, sharp declines in stock prices, liquidity difficulties or bankruptcies of the weaker companies will adversely affect the earnings prospects of the more successful ones.

Box 1.1 (concluded)

Although the formal banking system has largely shunned the financing of new technology companies, the share of business lending in bank portfolios rose during the second half of the 1990s. Much of this lending has been to the so-called “old economy” or “blue chip” companies with high credit ratings, either in term lending, in back-up credit lines for commercial paper issues, or in underwriting and supporting bond financing. However, the survival of these companies is threatened by the process of Schumpeterian creative destruction that occurs as successful high-tech companies adopt new, more profitable technological approaches. The performance of these “old economy” companies will suffer from the overall slowdown in activity, which may also entail problems for banks that have substantial exposure to them. Recent weakness in high-yield bond markets, and difficulties in the issuance of commercial paper experienced by many such companies suggest that this is indeed happening (Silverman and Hill, 2001).

A lack of precedent in the current United States economic situation calls for a cautionary assessment. However, there are good reasons to view the current cycle as an interruption in a wave of Schumpeterian innovation rather than as a simple Keynesian problem of insufficient aggregate demand.[2] If that is so, the confidence that has been placed in monetary and fiscal policy in ensuring that the downturn is short may be misplaced. Only a wave of bankruptcies, the extent of which is uncertain, can eliminate the excess capacity in much of the ICT sector and allow more promising investment to resume. The length of the downturn will depend on how rapidly non-viable businesses can be wound up, on the extent to which successful companies elsewhere in the economy will face financial difficulties as a result of this process, and on the impact of possible macroeconomic stimuli on the rest of the economy.

It does not follow from the above that monetary and fiscal stimuli would be inappropriate. However, they would have a much smaller impact than in the past because they can do little to recreate the investment momentum and liquidity conditions that allowed the recent rapid experimentation with new technologies. The improvement that many observers expect from a rapid easing of monetary conditions may be slow to appear unless financial institutions, venture capitalists and households are again willing to return to their exuberant support of new businesses that have no current earnings and highly uncertain expected future earnings. But this is where the problem originated in the first place.

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1 Venture capital funds usually expect a success ratio of 1 to 10 on their investments.

2 Some aspects of the current cycle resemble that described by von Hayek, who argued that an excessively low cost of capital would create investments in techniques that were excessively capital-intensive; the subsequent return to a more normal level of capital costs would show that these investments are unprofitable, and the surplus capacity generated would have to be eliminated by a sharp downturn and widespread bankruptcies. However, while many companies have invested without achieving their expected sales, and the capital-output ratios may have increased, the problem is not one of excess capital intensity, but rather the fact that overgenerous financing conditions allowed unprofitable investments to come on stream.

For all these reasons Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. A rapid expansion in Europe of domestic demand is also essential to deal with its legacy of high unemployment. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.[14] The creation of an internal momentum for growth in Europe and its contribution to an expansion of demand are likely to depend in large part on the willingness and ability of governments to use economic policy to anticipate, rather than react to, worsening conditions.

The structural changes that have been made in fiscal policy should boost real incomes and partly offset the adverse impact of higher energy and heating costs. Nonetheless, consumer confidence in Europe does not appear to be improving, and growth in real compensation, which peaked in 1999 at around 3 per cent, had fallen to below 2.5 per cent by the end of 2000. Current wage agreements in some of the larger economies were negotiated under less advantageous conditions and will not be renewed during 2001. For example, the very moderate wage settlements reached in Germany in 2000 still have a year to run. Where wage agreements have been linked to an expected inflation rate that in the event has been exceeded on account of petroleum prices and the weakness of the euro, there should be some recovery of real incomes.

The appreciation of the euro towards the end of 2000 has produced a de facto tightening of monetary policy, with real interest rates reaching cyclical highs – up from around 2 per cent in 1999 to around 3.75 per cent[15] in early 2001. With lower petroleum prices, the strengthening of the euro and monetary growth moving towards ECB targets, there should be ample scope for discretionary monetary easing to accompany any expansive fiscal policy. However, recent pronouncements from the ECB indicate that it will continue to be solely concerned with internal price stability. This sits ill with the spirit of the preparatory discussion of the EMU, when there was a broad consensus that monetary policy could be used to counter symmetric external shocks, such as an oil price hike or a fall in global demand. Failure to counter these influences could result in global imbalances producing disruptive movements in exchange rates similar to those between the yen and the dollar that helped precipitate the Asian crisis.

The United Kingdom economy, which remains outside EMU, has had a consistently better growth performance than that of the euro area since the 1990–1991 recession and was one of the first economies to lead the global recovery. However, during 2000 growth was slightly below the EMU average and appeared to have peaked by mid-year. With industrial production falling sharply in the last quarter of 2000, performance looks set to mirror that in the United States, unless electoral or other considerations result in provision of a more direct stimulus.

3. Japan

Growth in Japan – led by exports – picked up in the first half of 2000 and fed through to increased corporate profits, investment, industrial production and output, suggesting that the foundation for recovery might be in place. The impression of an accelerating recovery was reinforced when the Bank of Japan raised its interest rate to 0.25 per cent in August, since the Bank had maintained that policy would not be tightened until there were clear signs that the threat of a deflationary spiral had subsided. However, growth slipped to an annual rate of -2.4 per cent in the third quarter, and unemployment continued to rise, reaching 4.9 per cent by December despite the rise in employment. Figures for output and private consumption in the second half were also disappointing and, with the decline in exports, inventories began rising. As a result, subsequent Government estimates for growth in the fiscal year ending in March 2001 were lowered to below 0.5 per cent, measured in current prices.[16] Final data for the fourth quarter may well show a new decline in output, returning Japan to recession.

Although weaker markets in the United States and in developing Asia have sharply dampened the export-led recovery, it is still unclear what the effect has been on corporate earnings and investment.[17] Machinery orders from sectors other than export and ICT-related industries started to rise

in the second half of 1999 and this should have been reflected in production figures by the beginning of 2000.[18] Whether this will be sufficient to offset the decline in export and ICT-related sectors due to the slowdown in the United States will be a factor determining whether or not the economy falls back into recession.

The Government has traditionally opted for the fiscal tool to spur expansion. However, the fiscal stance became increasingly cautious as government indebtedness rose. In response to the signs of a slowdown in the second half of 2000, a further budget was introduced in November which proposed to increase government spending by 4.8 trillion yen. However, not all of this amount constitutes a new stimulus, since the legislation limits the issuance of new government securities to 2.0 trillion yen and provides for the balance to come from a rollover of the 1999 fiscal year surplus of 1.5 trillion yen (i.e. carry-over of budgeted expenditures that did not in fact take place) and an estimated increase of 1.2 trillion yen in tax revenues. The stimulus resulting from the proposed budget for the fiscal year starting in April 2001 is again modest, and another supplementary budget will, in all likelihood, be required by mid-year.

Local governments are under heavy pressure to shore up their finances by cutting expenditure. Consequently, with little contribution expected from exports, continued recovery will depend primarily on private domestic demand. Investment has shown signs of acceleration, but the implication is that the consumer demand is expected to take the lead. This will mean wage growth will have to pick up to at least match productivity growth.

Considerable uncertainty remains over the future direction of monetary policy. There are increasing concerns that a return to a zero interest rate policy could delay corporate restructuring measures that are urgently needed to restore profitability. However, the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.[19] The fact that the unemployment rate is still increasing in conditions of rising employment indicates that previously discouraged workers are being drawn back into the labour force and that the economy could expand without inflationary risks substantially faster than at the potential rate (estimated at 1 per cent).

In Japan the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.

Assessment of the impact of the current monetary policy stance is difficult because prices have been falling for most of the 1990s, so that real interest rates are positive even if they are close to zero in nominal terms. Problems with the balance sheets of financial institutions also make it difficult to assess the amount of liquidity that has been injected. Bank profitability and capital have improved over the last several years, without this having led as yet to an increase in bank lending or equity values. The loan books of domestic commercial banks continue to contract at about 4 per cent per annum and the Tankan surveys during the year do not indicate any change in the negative perception of banks' willingness to lend.

The tightening of monetary policy since August 2000 has been reinforced by the appreciation of the yen. At the same time, equity prices peaked in April 2000, but following the trend in the NASDAQ in the United States, fell sharply in April and May. However, rather than stabilizing, as in the United States, equity prices continued to fall, with a particularly sharp drop in mid-December as it became clear that the economy was slowing down. This set off renewed speculation about difficulties in the banking sector and a proposal for a special government investment fund to shore up equity prices. If the recent increase in investment is cyclical – primarily due to the recovery in Asia and the prolonged growth of the United States economy – rather than the result of microstructural factors and the spread of investment to non-export sectors, it may not survive the anticipated slowdown in global demand.

C. Developing countries

1. Latin America

In all Latin American countries economic performance improved in 2000 (table 1.2). In some there was a very strong recovery, pushing the regional rate of expansion to nearly 4 per cent, the highest since the outbreak of the Asian crisis. However, marked differences in performance among countries that prevailed in 1999 persisted in 2000. Mexico and the economies of Central America and the Caribbean, with close trading links to the United States, continued to outperform those economies that are more dependent on commodity exports and intra-regional trade.

Growth accelerated strongly in the two largest economies, Brazil and Mexico. Thanks to higher oil prices, continued expansion in the United States and robust domestic demand, growth in Mexico reached 7 per cent, the best performance in many years, while an aggressive policy of monetary easing allowed Brazil not only to raise output growth (to 4 per cent) but also to reduce its fiscal deficit. The effect on prices of the currency depreciation of early 1999 remained muted despite the recovery, but the current-account balance improved less than had been expected. In Chile, too, there was a sharp rebound in growth (to almost 6 per cent) from a recession in 1999.

In both Argentina and Uruguay the economy contracted (but more slowly) for the second consecutive year. In Argentina deflationary adjustment to the external shocks of 1998–1999 continued, resulting in some improvement in competitiveness and a trade surplus. However, since the services balance deteriorated due to considerably higher financing costs, there was only a modest reduction in the large current-account deficit. International financial markets, which are crucial for financing the deficit, have been closely watching the Government's efforts to bring its debt under control and to curb wage and price increases sufficiently to restore competitiveness and achieve current account sustainability (see chapter II, box 2.1).

> Prospects for most countries in Latin America depend on the extent of the downturn in the United States. For the region as a whole growth is expected to slacken, although further depreciation of the dollar would help increase competitiveness in the "dollarized" economies.

The external environment for the Latin American economies was generally favourable as the recovery of certain commodity prices, which had started during the second half of 1999, continued into 2000. In particular, the hike in petroleum prices benefited several countries, especially Venezuela, where GDP growth rebounded to over 3 per cent in 2000 after a sharp decline of more than 7 per cent in 1999. Several other countries, however, particularly Chile, Paraguay and Uruguay, suffered seriously from higher oil prices.

Prices of metals, including copper, aluminium, iron ore, nickel, tin and zinc, also recovered, as they did for some soft commodities, such as

Table 1.2

GROWTH IN DEVELOPING COUNTRIES BY REGION, 1990–2000

(Percentage change over previous year)

Region/country	1990–1995[a]	1995–2000[a]	1990–2000[a]	1998	1999	2000[b]
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
of which:						
Argentina	5.8	2.7	4.2	3.9	-3.2	-0.5
Bolivia	4.1	3.2	3.7	4.7	0.6	2.0
Brazil	3.1	2.2	2.7	-0.1	0.8	4.0
Chile	8.7	4.5	6.6	3.4	-1.1	5.7
Colombia	4.7	0.9	2.7	0.5	-4.5	3.0
Ecuador	3.4	0.1	1.8	0.4	-7.3	2.6
Mexico	1.5	5.5	3.5	4.8	3.7	7.0
Peru	5.5	3.4	4.5	0.3	3.8	3.9
Uruguay	3.7	2.1	2.9	4.6	-3.2	-1.0
Venezuela	3.4	0.3	1.9	-0.1	-7.2	3.2
Africa	1.5	3.6	2.5	3.2	2.9	3.5
of which:						
Algeria	0.1	3.5	1.8	5.1	3.3	4.3
Cameroon	-1.9	4.8	1.4	5.1	4.4	4.2
Côte d'Ivoire	1.9	4.6	3.2	4.5	2.8	2.2
Egypt	3.4	5.2	4.3	5.6	6.0	3.9
Ghana	4.3	4.4	4.3	4.7	4.4	4.0
Kenya	1.6	2.3	1.9	2.1	1.5	1.6
Mozambique	3.3	8.7	5.9	12.0	8.8	4.5
Nigeria	2.4	3.2	2.8	1.9	1.1	3.5
South Africa	0.8	2.2	1.5	0.6	1.2	2.7
Uganda	7.0	6.2	6.6	5.5	7.8	5.0
Asia	6.1	5.0	5.6	1.1	4.9	6.6
Newly industrializing economies	6.9	5.0	6.0	-2.6	7.6	8.6
Hong Kong, China	5.3	3.5	4.4	-5.1	3.1	10.4
Republic of Korea	7.4	4.8	6.1	-6.7	10.7	9.3
Singapore	8.6	6.3	7.4	0.4	5.4	10.1
Taiwan Province of China	6.4	5.8	6.1	4.7	5.7	6.0
ASEAN-4	7.0	1.6	4.3	-9.4	2.8	5.3
Indonesia	7.1	0.7	3.9	-13.0	0.3	5.2
Malaysia	8.7	4.6	6.6	-7.4	5.4	8.7
Philippines	2.2	3.4	2.8	-0.6	3.2	3.5
Thailand	8.6	0.3	4.3	-10.2	4.2	4.2
ASEAN-4 plus Republic of Korea	7.2	3.2	5.2	-8.2	6.5	7.3
South Asia	4.5	5.5	5.0	5.6	5.7	5.5
Bangladesh	4.4	5.1	4.7	5.1	4.4	5.5
India	4.5	6.1	5.3	6.3	6.4	5.7
Nepal	5.2	4.1	4.6	2.3	2.3	5.5
Pakistan	4.8	3.2	4.0	2.6	2.7	4.7
Sri Lanka	5.4	4.8	5.1	4.7	4.2	5.0
West Asia	1.3	3.4	2.4	3.3	-0.5	4.3
China	12.0	8.3	10.1	7.8	7.1	8.0

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.

a Annual average.

b Estimates.

cotton, fish meal, pulp, soybeans and wool. On the other hand, there was a continued decline in prices for food and beverages, particularly cocoa, coffee and sugar. Nevertheless, the terms of trade for the region as a whole improved. Since, in addition, relatively weak domestic demand kept increases in imports well below those of exports, there was a (modest) improvement in the regional current-account deficit. FDI inflows declined in 2000 and total net capital inflows remained far below the levels of 1996–1998.

For 2001, prospects for most of the Latin American countries depend on the extent of the downturn and the speed of the recovery in the United States economy. For the region as a whole, growth is expected to slacken as a result of a weaker export performance, although further depreciation of the dollar would help increase competitiveness in the "dollarized" economies. The impact of reduced import demand in the United States will be the greatest in Mexico, and probably small in Brazil, Chile and Peru. The two latter countries, in particular, will continue to benefit from higher prices for base metals and from relatively robust growth in the Asian economies, which are important export markets. The outlook is particularly uncertain for Ecuador, where hyperinflation continues to pose a major challenge to policy makers, as well as in Venezuela and Colombia. Fiscal imbalances remain a serious problem in some countries, including Argentina and Brazil, while others, having experienced financial crises during the 1980s and 1990s, are still contending with weak and fragile banking systems.

Latin America continues to face large financing constraints. While the region remains dependent on capital inflows, it continued in 2000 to experience a negative net resource transfer. Lower United States interest rates mean reduced costs of new borrowing and, eventually, of carrying of old debt, provided that sovereign risk spreads do not increase by more than the reduction in the benchmark rates. On the other hand, the financing constraints may be aggravated if the slowdown in the United States leads to reduced global trade growth. With more countries choosing a regime of full dollarization, the region will become increasingly dependent on conditions and policy decisions in the United States.

2. Asia

Growth in the developing countries of Asia as a whole (excluding China) accelerated further in 2000, reaching 6.2 per cent, after having already recovered in 1999 from the contraction of almost 1 per cent in the previous year (table 1.1). There were, however, considerable differences in performance among the subregions and their constituent countries (table 1.2).

A sharp turnaround was registered in West Asia, from slightly negative growth in 1999 to more than 4 per cent in 2000. Wary of the volatility of oil prices, oil producers in the subregion were initially cautious about spending their windfall of additional earnings, preferring to replenish their foreign exchange reserves and increase their holdings in foreign assets. However, as oil prices remained high because of strong world demand and low world stocks (see chapter II, section C), governments started to increase their spending on infrastructure, education and health care. Higher revenues reduced borrowing requirements and domestic arrears. At the same time, stronger fiscal and external balances, improved confidence and strong domestic demand greatly boosted economic activity, contributing to overall economic growth in the oil-exporting economies of the region. Many oil-importing countries in the subregion, however, suffered from substantial terms-of-trade losses.

The Turkish economy recovered well from the severe damage caused by the earthquake in 1999 and the spillover effects of the Russian crisis. However, its exchange-rate-based stabilization programme started running into difficulties in late 2000, casting doubts on its ability to sustain growth (see chapter II, box 2.2).

The outlook for West Asia in 2001 is broadly favourable. Driven by increases in oil revenues, growth is expected to accelerate in Kuwait, Oman, Saudi Arabia, United Arab Emirates, Yemen and, to a lesser extent, in the Islamic Republic of Iran, where external debt repayments and higher food imports because of drought are offsetting features. Qatar will additionally benefit from the rise in its gas production and exports. Drought will also, to some extent, offset the gains from higher oil prices

in several countries. From a longer-term perspective, for most countries in the subregion growth will continue to be constrained by low investment rates. Moreover, without substantial diversification of production, they will remain exposed to terms-of-trade shocks. Many countries are pressing ahead with reforms to improve the efficiency of the public sector and have also introduced measures to privatize and deregulate economic activity with a view to encouraging the private sector and promoting domestic and foreign investment.

In South Asia, overall economic activity continued to be dominated by the performance of the Indian economy. Despite the lingering effects on exports of the Asian financial crisis and the more recent sharp increase in oil prices, growth for the region as a whole remained at the level of the two preceding years. Growth in India, which has expanded strongly in recent years, slowed down slightly. The drought in northern India affected agricultural production less than anticipated and, despite flooding in the state of Andhra Pradesh during late August and early September, which affected the rice crop, the country has a large grain surplus. Strong overall growth was underpinned by a robust industrial performance and rapidly growing foreign demand for ICT-related services; in order to promote exports of services, legislation was introduced to support the ICT sector and develop e-business infrastructure.

Continued strong growth in Sri Lanka in 2000 was led by exports, especially garments. Higher tea and rubber prices also contributed to the sharp rise in export earnings. The more than 5 per cent growth in Bangladesh was also export-led. In Pakistan growth accelerated, but still lagged behind the other countries in the region; the external sector remained fragile, reserves continued to decline from already low levels and the currency came under pressure following the depreciation of other currencies in the subregion.

The short-term prospects for the subregion are mixed. Growth in India will remain relatively strong, despite some negative repercussions from world trade, underpinned by the country's huge agricultural sector, which stands to benefit from moves to reform price-control policies and stimulate domestic trade in agricultural products. Export-oriented manufacturing sectors are also expected to benefit from a relaxation of the FDI regime in special economic zones, and robust expansion of the ICT sector will support service activities. In Sri Lanka, growth will continue to be driven by strong demand for its two major exports, garments and tea, whereas in Pakistan, financial difficulties are likely to be a restraining factor. All countries in South Asia, but especially the smaller ones, are heavily dependent on energy imports and agricultural exports. Adjustments to terms-of-trade losses from the recent adverse movements in primary commodity prices may dampen growth to some extent, and further structural reforms in agriculture and industry may be needed to strengthen competitiveness.

In East Asia, almost all major economies further consolidated their recovery. The five countries that had been most affected by the financial crisis – the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) and the Republic of Korea – registered an overall growth in 2000 of more than 7 per cent, compared to 6.5 per cent in 1999. Despite substantial currency devaluations and the rapid pace of recovery, inflation rates have remained low. In Malaysia and Thailand there is a possibility of price deflation (which is already a reality in China and Hong Kong (China)).

In addition to strong export performance, growth has been supported by low interest rates and expansionary monetary policies. Although capital outflows have continued as banks have reduced their foreign exposure, they have not outgrown current-account surpluses. This suggests that the generalized currency depreciation has been the result of deliberate policy. There has been a significant recovery in intra-Asian trade, which is now growing more rapidly than trade with either the United States or EU. For several East Asian economies the internal driving forces behind recovery have started to shift from inventory adjustment and government spending to the more self-sustaining elements of business investment and private consumption. On the other hand, the gains from export volume growth and higher export prices were partly offset by higher oil prices during 2000.

Among the ASEAN-4, Malaysia continued to be the best performer, with growth accelerating to 8.7 per cent. However, by the end of the

year, domestic demand had slowed markedly and manufacturing sales were growing considerably faster than output, which would indicate a decline in inventories. Producer prices have been declining, and the rise in December 2000 of consumer prices was at an annual rate of just over 1 per cent. In Thailand exports rose by 20 per cent in 2000, contributing more to growth than in previous years, when domestic consumption had been the driving force. Despite higher energy prices, inflation has virtually disappeared; capacity utilization is still below 60 per cent and there is still excess labour. As in Thailand, recovery in the Philippines has been relatively slow. At the beginning of 2001, the country faced an extremely large fiscal imbalance and the peso came under pressure, despite a very strong current-account position. Indonesia experienced its first year of strong growth since the financial crisis, but domestic demand, which has become increasingly important in sustaining growth in the other ASEAN countries, remains weak.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States.

In the Republic of Korea, which has already regained its pre-crisis level of per capita income, growth slowed somewhat in 2000, but still exceeded 9 per cent. Economic activity continued to be driven by exports, particularly of computers, and there was a strong increase in manufacturing output, notably of semiconductors. A second year of fast growth has led to a resurgence of capital inflows, and although the currency depreciated by an average of around 10 per cent, there was a recovery in the exchange rate at the end of the year. Inflation started to rise, reflecting, in part, the impact of higher oil prices in a country that relies on imported oil for about half its energy needs. This prompted the Bank of Korea to raise its overnight call rate in October for the second time in 2000. Consumer prices declined in October and November, resulting in an annual increase in the price index of just over 2 per cent.

Output growth picked up sharply in Hong Kong (China) as tourism recovered, and Singapore experienced another sharp acceleration of growth in 2000. However, in all the NIEs exports began to fall in the course of the year. For example, in Singapore, electronic exports in December were over 11 per cent lower than in December 1999 and exports of semiconductors some 17 per cent lower. Exports to all major markets except Japan and China declined. In Hong Kong (China) consumption has remained weak despite a fall in real interest rates and in the unemployment rate and a stabilization of the property market, and in Taiwan Province of China the revival of domestic demand in the first quarter of 2000 could not be sustained.

In China, economic activity continued to gather momentum in 2000, resulting in a one percentage point increase in output growth over the previous year and reversing the deflationary trend that had been caused by weak domestic demand in recent years. Expansionary policies, strong exports and progress in structural reforms resulted in rapid growth in construction and industry, which more than compensated for a sluggish performance in agriculture. Exports and imports also benefited from a real depreciation of the renminbi and higher export tax rebates. There was also a sharp increase in new FDI commitments, which had been declining for nearly four years. However, given its growing dependence on the United States market, the slowdown in that country is likely to reduce export growth in 2001. Exports and imports may also be affected by the prospect of China's accession to WTO and the implications thereof for the exchange rate. Although export growth is expected to be slower in 2001, the economy should receive a stimulus from current stimulative fiscal and monetary policies. Infrastructure investment, in particular, can be expected to increase, especially in the western provinces.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States and the movement of their currencies against the dollar and the yen. Growth in the subregion depends to a large extent on external demand for electronics, and would therefore be hit by any deceleration of global demand. The rate of increase in new orders received from the United States for electronic goods had

already declined by half in October 2000. The outlook is for further declines as inventories in the United States continue to increase, and there were clear signs of declining semiconductor prices in early 2001. Additionally, there is still a drag on growth from ongoing financial and corporate sector restructuring. The NIEs are likely to grow at a slower pace in 2001, and Singapore and Taiwan Province of China, in particular, will be affected by weak demand for electronic products. Slower growth in the Republic of Korea will be a reflection, in part, of the continuing problems of the major *chaebols* and the associated risks of further problems arising in the banking sector.

In Malaysia, lower electronics exports may cut the growth rate considerably in 2001. This may require reconsideration of the policy of maintaining a fixed exchange rate, but a lower dollar may alleviate the need to move the peg. Reversing the expectations of deflation and lower growth will require aggressive monetary easing and fiscal stimulus. Growth prospects for Thailand are also dampened by the likelihood of slower export growth in 2001; and the slow pace of debt restructuring and the weakness of the banking sector are also matters of concern in that country. However, with ample room for interest rate reductions and the expectation of a vigorous fiscal stimulus, Thailand is better placed to resist the downturn in the United States than other countries in the subregion. The impact of external shocks remains a threat for Indonesia and the Philippines. Moreover, fiscal positions are a cause for concern in these countries, and much remains still to be done in the area of financial and corporate restructuring. In those two countries prospects are thus fraught with considerable downside risks.

3. Africa

Even more than in other regions, external factors continue to dominate growth and development prospects in Africa. Economic activity in the oil-exporting countries was boosted by the rise in oil prices, which led to significant improvements in fiscal and external balances. The economies of oil-importing countries, however, were severely affected by high oil prices and external financing constraints. In particular, sub-Saharan countries continued to be affected in varying degrees by the fallout from the 1997–1999 emerging-market crises as prices of some of their major non-fuel export commodities remained depressed.

GDP growth in Africa picked up from 2.9 per cent in 1999 to 3.5 per cent in 2000 (table 1.2). In contrast to some recent years, it was the lowest among developing regions and barely kept pace with population growth. Even before the confirmation of the slowdown in the United States, growth forecasts for Africa were being lowered, owing to weaker performance by some of the larger economies, worsening weather conditions and disruptions caused by civil and political unrest.

Growth performance in 2000 varied much among the different subregions.[20] Growth was close to the continental average in Central, East and West Africa, whereas it was higher in North Africa but lower in Southern Africa. Output growth in Botswana, Mozambique, Uganda and the economies of the CFA franc zone was above the African average, but in Angola, the Democratic Republic of the Congo, Ethiopia, Sierra Leone and Zimbabwe it was well below this average.

Among the countries of North Africa, Algeria and the Libyan Arab Jamahiriya benefited from higher oil revenue, which provided a strong boost to growth. In Algeria, however, these benefits were offset, to some extent, by adverse weather conditions, especially poor rainfall, which also seriously affected Morocco and Tunisia. After a decline in 1999, output growth in Morocco is estimated at 0.7 per cent in 2000, despite a decline of 17 per cent in agricultural production, which accounts for some 40 per cent of aggregate output. Agricultural output also fell in Tunisia (by 15 per cent), leading to a reduction of the growth rate from 6.2 per cent in 1999 to 4.2 per cent in 2000. With more favourable weather conditions, both countries may experience faster growth in 2001. In Egypt, growth slowed to less than 4 per cent in 2000, due to a tightening of monetary policy to keep inflation in check. The rapid expansion of domestic credit in recent years and the rise in the real effective exchange rate as a result of a de facto peg to the dollar led to mounting

pressures on the external accounts and a substantial loss of foreign reserves.

Growth in Southern Africa in 2000 was restrained by the continued weakness of the economy of South Africa. While in most countries in the subregion growth continued to be healthy, recovery in the continent's largest economy continued to remain fragile. GDP growth rose to 2.6 per cent in 2000, supported by improved competitiveness and the expansion in global output and trade, but a depreciation of the rand, a surge in food prices after flooding in some areas, together with higher oil prices, led to a build-up of inflationary pressure. In Zimbabwe, the economic crisis continued to deepen and is estimated to have resulted in an output contraction of some 6 per cent in 2000. In Mozambique, where the implementation of the Government's comprehensive reconstruction plan received generous and timely international support, output is estimated to have grown by more than 4 per cent (after 8.8 per cent in 1999), although flooding caused substantial damage early in the year.

> Most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure.

The potential for higher growth in East Africa failed to be realized partly on account of policy formulation and implementation and partly because of various adverse shocks. Economic activity in the Democratic Republic of the Congo was adversely affected by war, and in Eritrea and Ethiopia by both drought and war. On the other hand, the United Republic of Tanzania managed to withstand the adverse impact of weak prices for its main exports (coffee and cotton) even though it was hit by food shortages due to the failure of seasonal rains. Kenya, which has been among the slowest-growing economies in Africa in recent years, was also plagued by drought and weak export prices, but the resumption of IMF lending may boost confidence and the inflow of aid. Uganda, a major coffee producer, continued to achieve growth of about 5 per cent, despite a further drop in international coffee prices.

Among the countries in West Africa, Nigeria benefited greatly from rising oil prices, raising its GDP growth by more than 2 percentage points, to 3.5 per cent. The Government has initiated steps to restore macroeconomic stability and improve relations with creditors. Ghana, maintained an output growth above 4 per cent, as it has done consistently since 1995. Countries in Central and West Africa which are members of the CFA franc zone (see also chapter V, box 5.2) have been among the best performers on the continent in recent years. Because their currencies are linked to the euro, some of them have benefited from increased competitiveness due to the euro's weakness vis-à-vis the dollar. However, growth in Côte d'Ivoire is estimated to have continued its downward trend since 1998 as the economy had to contend with weak cocoa prices and a significant slowdown in disbursements of external assistance. Overall, output growth in the CFA franc zone has remained fairly robust and is expected to accelerate in 2001.

For Africa as a whole, the rate of output growth in 2001 is expected to pick up moderately, supported by faster recovery in South Africa. It should remain strong particularly in Cameroon, Ghana, Mozambique, Uganda and the United Republic of Tanzania, which have begun to reap some of the benefits of macroeconomic and structural reforms. Underlying this improvement is the expectation that the terms of trade of commodity exporters will stabilize or improve moderately due to lower oil prices. Recent European and United States initiatives to open up their markets to the poorest economies in Africa as well as bilateral debt reduction accorded by some industrialized countries should bring benefits. In addition, around 80 per cent of debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative concerns economies in sub-Saharan Africa. Presently, nine African countries (Benin, Burkina Faso, Cameroon, Mali, Mauritania, Mozambique, Senegal, Uganda and the United Republic of Tanzania) have already qualified, and several more are expected to reach the completion point in the near future.[21] However, the impact of these international measures will not be felt immediately, and many countries in sub-Saharan

Africa continue to suffer from a debt overhang. Moreover, most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure in transport and communications. Levels of official assistance remain insufficient to fill the resource gap.

D. Transition economies

There was a strong recovery in the transition economies in 2000 (table 1.1) and, on average, the growth rate was the highest since 1989. While domestic demand continued to expand in most countries, the main stimulus was from exports. However, it is too early to judge whether this growth will be sustainable in all cases and whether the process of catching up has really begun. The recovery in 2000 was from a very low base and export prospects are less promising in the light of global conditions. The immediate policy challenges vary for the different economies: some will have to accelerate progress towards a market economy, while others will need to correct macroeconomic imbalances or to cope with adverse shocks.

After the devastating financial crisis in 1998, the Russian Federation had one of the highest rates of growth in 2000, at 7.6 per cent (table 1.3). Due to their strong links with the Russian economy, most of the other CIS countries also posted high growth rates in 2000, with double-digit figures in Kazakhstan and Turkmenistan. Depreciation of the rouble and of the CIS currencies stimulated exports and led to import substitution, all of which boosted industrial output. It thus seems that the business sector in these economies may be much more flexible and able to respond to market signals than commonly believed, even though the process of corporate restructuring has yet to be completed.

Among the central European countries, growth in the Czech Republic, Hungary and Slovenia in the first nine months of 2000 exceeded expectations. Hungary was the fastest growing economy (6 per cent). Industrial output accelerated sharply in the Czech Republic and Slovakia. While initially growing much faster than in 1999, the Polish economy showed some signs of slowing down in the course of the year. Romania also reported positive growth but without clear signs of a breakthrough to sustained expansion, while in Bulgaria output continued to grow for the third successive year. The Baltic States recovered early from the recession of 1999, but growth flagged in the second half of 2000.

For the European transition economies as a whole, exports to the rest of the world increased by one third. Whereas the CIS countries benefited from the boom in commodities, those of Central and Eastern Europe increased their exports of manufactured goods, as did also the Baltic States. Imports also increased everywhere, but in most cases less than exports, resulting in a significant improvement in current-account balances. Substantial terms-of-trade gains in the relatively small group of commodity-exporting CIS countries contrasted with sizeable losses for the net commodity importers, comprising all the Central and Eastern European and Baltic States, as well as a number of CIS countries.

Table 1.3

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1998–2000

	GDP			*Consumer prices*			*Current-account balance*		
	Change over previous year[a]								
	(Percentage)						*(Percentage of GDP)*		
Region/country	*1998*	*1999*	*2000*[b]	*1998*	*1999*	*2000*[c]	*1998*	*1999*	*2000*[d]
Central and Eastern Europe									
of which:									
Bulgaria	3.5	2.4	4.5	0.9	6.2	11.0	-0.5	-5.5	-8.1
Croatia	2.5	-0.4	2.8	5.6	4.6	7.3	-7.0	-7.5	-7.7
Czech Republic	-2.2	-0.8	2.7	6.7	2.5	4.2	-2.4	-1.9	-3.0
Hungary	4.9	4.5	6.0	10.4	11.3	9.2	-4.9	-4.3	-3.6
Poland	4.8	4.1	4.2[e]	8.5	9.9	10.6	-4.3	-7.4	-7.4
Romania	-5.4	-3.2	1.5	40.7	54.9	41.0	-7.2	-3.8	-2.9
Slovakia	4.1	1.9	1.6	5.5	14.2	15.4	-9.7	-5.5	-1.6
Slovenia	3.8	4.9	4.8	6.6	8.1	9.9	-0.8	-3.9	-2.7
Baltic States									
of which:									
Estonia	4.7	-1.1	5.5	6.8	3.9	3.0	-9.2	-5.7	-5.5
Latvia	3.9	0.1	4.5[f]	2.8	3.3	2.6	-10.7	-10.3	-5.6
Lithuania	5.1	-4.2	2.1	2.4	0.3	1.3	-12.1	-11.2	-4.2
CIS									
of which:									
Belarus	8.4	3.4	2.5[g]	181.6	251.3	190.7	-7.6	-2.4	-3.3
Russian Federation	-4.9	3.2	7.6[e]	84.5	36.6	20.2	0.4	13.7	22.2
Ukraine	-1.9	-0.4	6.0[e]	20.0	19.2	30.3	-3.2	2.8	1.5

Source: ECE (2000, tables 1.2.1 and 1.2.2) and subsequent updates.
a For consumer prices change from December to December unless otherwise indicated.
b October official forecast unless otherwise indicated.
c June 1999 to June 2000.
d January–June.
e Preliminary estimates.
f 4–5 per cent.
g 2–3 per cent.

The strong performance of most of the transition economies was accompanied by increased inflationary pressures. Despite sharply rising productivity and a predominantly export-driven recovery, consumer prices generally rose faster than expected, mostly on account of soaring prices for fuel. In some cases, the resurgence of inflation spurred a tightening of monetary policy. The rise in fuel prices threatened export competitiveness, since there is still a relatively high energy intensity of output in the transition economies. So far this adverse effect has been more than offset by productivity gains, but if productivity growth slows down and nominal wages are increased to offset past inflation, exports could be adversely affected.

The fiscal position has been better than expected in most transition economies, not only due to the strength of the recovery but also because of windfall gains related to price-sensitive revenue items such as duties and excise taxes. In most countries, the recovery has not led to a significant increase in employment, which suggests that there was slack to be taken up and also that there has been a further deepening of the process of economic restructuring. Indeed, unemployment rates in several countries have increased or remained high.

The factors that were favourable to growth in the transition economies in the last two years are not in place in 2001.

The factors that were favourable to growth in the last two years are not in place in 2001. World trade expansion is slowing, the stimulating effect of currency depreciations in the aftermath of the Russian crisis is fading away and commodity prices have peaked. The stimulus to continued growth will thus have to come from domestic demand. The task will be all the more difficult as inflation was on the rise in 2000. Several transition economies are determined to achieve the conditions necessary for association with, or even accession to, the European Union, to which end they may be obliged to take strong measures, in particular a restrictive monetary policy to combat the inflationary tendencies. However, such measures would aggravate the employment situation, which is particularly serious in south-east Europe, where unemployment already exceeds 20 per cent of the labour force in a number of countries. ■

Notes

1 At the end of September 2000, the International Monetary Fund (IMF) revised its growth estimates upwards because: "The global economic expansion has continued to gain strength, with global output growth now projected at 4.7 per cent in 2000, 0.5 percentage points higher than expected in the May *World Economic Outlook* … Growth is projected to increase in all major regions of the world, led by the continued strength of the United States economy; the robust upswing in Europe; the consolidation of the recovery in Asia; and a rebound from last year's slowdowns in emerging markets in Latin America and the Middle East and Europe" (IMF, 2000a: 1).

2 The proposed tax cuts reflect the policies of the new Administration and their primary purpose is not the short-term stabilization of domestic demand. Hence they may not be reversed in response to a macroeconomic need. If the optimists are proved right, the impact will be felt just when the economy is again growing at its potential, forcing a sharp tightening of monetary policy. This potential inconsistency between fiscal and monetary stances raises familiar concerns for the rest of the world, particularly developing countries. Furthermore, to the extent that the increase in disposable income resulting from tax cuts is spent on consumer goods rather than saved, aggregate domestic savings would be reduced with the effect of aggravating external imbalances.

3 Speech by ECB Governing Council member and Deutsche Bundesbank President, Ernst Welteke, at the University of Hohenheim, 23 January 2001, reported in *Market News International.* The reluctance to revise its estimate of potential growth is based on the view that: "on all the available evidence we cannot as yet conclude that a decisive shift in the

trend rate of productivity growth is discernible" (W. Duisenberg, ECB Press Conference, 14 December 2000).

4 In 1999, non-resident companies spent $283 billion to acquire or establish businesses in the United States, up sharply from $215 billion in 1998 and $70 billion in 1997 (Zeile, 2000: 141). Of Europe's $425.5 billion worth of FDI outflows in 1999, $235 billion were directed to the United States (UNCTAD, 2000a, annex tables B1 and B2; Zeile, 2000, table 16).

5 Indeed, since non-repatriated profits of foreign-owned affiliates are counted as FDI inflows into the United States, a decline in sales there would reduce recorded FDI inflows and may lead to decisions to repatriate more profits, thereby increasing downward pressure on the dollar.

6 Since 1997 the share of cross-border M&As financed by stock swaps rather than cash has increased dramatically. For developed countries as a whole, less than 10 per cent were financed by stock swaps in 1997, but the share rose to 31 per cent in 1998 and reached 40 per cent in 1999. For the United States, it is estimated that roughly half of all inward M&As have not involved direct acquisition of dollar assets with foreign currency, but have been financed by means of stock swaps, and that much of the remaining M&As have been financed by borrowing in the United States. Thus the European M&A boom in the United States after 1997 may have had a smaller direct impact on the foreign exchange market than is commonly supposed. Nonetheless, there may be indirect portfolio effects, since stock swaps increase the foreign currency denomination of assets in United States investors' portfolios. If United States investors were to sell their foreign equity, repatriate the proceeds and invest in dollar-denominated securities, the demand for dollars would increase in much the same way as a direct purchase.

7 The extent of the region's dependence on United States growth is reflected in the share of its exports to the United States. They account for more than 20 per cent of GDP in Malaysia, Singapore and Hong Kong (China), more than 10 per cent in the Philippines and Taiwan Province of China, and 7 per cent in the Republic of Korea.

8 As a result of the new productivity performance and the absence of any wage or price reactions to tight labour markets, the Federal Reserve now appears to accept that the natural growth rate is above the 2.0–2.5 per cent commonly cited in the first half of the decade, although it has not explicitly endorsed a specific target. The latest *Economic Report of the President* estimates a potential growth rate of 3.8 per cent.

9 ICT investment includes business outlays for computers and peripherals, software, communications gear, instruments, photocopying equipment and office equipment. The first three categories account for 88 per cent of the total, while software alone accounts for 43 per cent. Expenditures on communications equipment are only half as important as those on software.

10 Since the United States investment boom was driven primarily by companies attempting to exploit new technological advances to create new markets, it differs from the late 1980s investment boom in Japan and the early 1990s boom in the Republic of Korea, both of which were driven primarily by expanding capacity in existing lines of business or by the entry of new competitors into existing lines.

11 The Conference Board index at year-end was about 11 per cent lower than its peak in May 2000, and the University of Michigan index was about 12 per cent below its peak of January 2000. The declines in these two indices have been especially noticeable since both had previously been at historically high levels for extended periods. The University of Michigan index dropped sharply from December 2000 to January 2001.

12 Confidence indicators in the major EU economies have been in decline since early in the third quarter. The German IFO index of future expectations has declined since October 2000, and that of the overall business climate in industry had already been in decline since May 2000; the French INSEE indicator, which had peaked in July at 40, fell to 17 in January 2001. The Italian ISAE index fell from 40 in January 2000 to 18 in November 2000 and even further in December 2000.

13 See Credit Suisse/First Boston, *Euro Area Weekly*, 12 January 2001.

14 Domestic demand seems to have played a more important role in the strong growth performance of some smaller European economies in the second half of the 1990s than in the larger economies.

15 Nominal interest rates adjusted for core inflation.

16 However, since Japan is still suffering from deflation, the estimated real growth is slightly higher.

17 Over 40 per cent of Japanese exports are to Asia and over 25 per cent to the United States. Exports to EU are less than 20 per cent and are probably more sensitive to exchange rate changes. Consequently, they should improve with a recovery of the euro relative to the yen.

18 Although the December Tankan survey revised second half profits downwards and excess capacity figures rose.

19 The Central Bank appears to take the view that, to the extent that higher interest rates create pressure for restructuring, they will through increased efficiency lead to lower prices and deflation. However, a Bank of Japan study (6 October 1999: 56, box E) finds that: "data do not show evidence that techno-

logical innovation increases the number of industries that make profits while decreasing their prices even more in Japan".

20 The subregions distinguished in this subsection are as defined by the United Nations Economic Commission for Africa: (1) *Central Africa* (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon; Sao Tome and Principe); (2) *East Africa* (Burundi, Comoros, Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Seychelles, Somalia, Rwanda, Uganda and United Republic of Tanzania); (3) *North Africa* (Algeria, Egypt, Libyan Arab Jamahiriya, Mauritania, Morocco, Sudan and Tunisia); (4) *Southern Africa* (Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Zambia and Zimbabwe); and (5) *West Africa* (Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo). North Africa and Southern Africa account respectively for about 40 per cent and 35 per cent of African output, while the shares of West Africa, East Africa and Central Africa were 14 per cent, 7 per cent and 4 per cent, respectively.

21 Potential qualifiers include Chad, Ethiopia, Gambia, Guinea, Guinea-Bissau, Madagascar, Malawi, Niger, Rwanda, Sao Tome and Principe, and Zambia.