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Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

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Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Introduction

The past two years have seen the growth of world output fall sharply; after reaching almost 4 per cent in 2000, it dropped below 2 per cent for the first time since 1993. In industrial countries, growth more than halved between 2000 and 2002 while in developing countries it fell by 2 percentage points (table 1.1). The downturn in the growth of industrial output was widespread and even sharper (fig. 1.1). While no developing region was able to escape the consequences of the global slowdown, there was considerable diversity in the performance of individual countries. East Asian economies, helped by their low dependence on capital inflows and buoyant intraregional trade, managed to maintain momentum, with growth rates ranging between 5 and 8 per cent in many countries in 2002. In contrast, output declined in Latin America for the first time since the 1980s, on account of a sharp drop in growth or outright recession in most of the major economies. Africa and the transition economies were less affected by the global slowdown, maintaining growth rates of around 3 and 4 per cent, respectively.

The recovery of global economic activity after its sharp decline in 2001 has been much slower and more erratic than expected. In the United States, gross domestic product (GDP) rose at the end of 2001, after falling during the first three quarters of that year, and growth accelerated in 2002. This appeared to signal the start of a sustained recovery that would help reverse the slowdown of the world economy. However, the upturn, supported by the rebuilding of inventories and the shift of the United States federal budget to deficit, could not be sustained in the absence of a recovery of investment in the manufacturing sector. Furthermore, growth in Europe and Japan, instead of accelerating to offset the slowdown in the United States, actually fell in 2002 (table 1.1) and turned negative in the beginning of 2003. The industrialized countries have been growing at rates well below their potential: in the G-7 countries taken together, the output gap, an indicator of deflationary pressures (measured as the difference between actual and potential GDP and expressed as a percentage of potential GDP),

Table 1.1

WORLD OUTPUT GROWTH, 1990–2003

(Percentage change over previous year)

								2003 forecast		
Region/economy	*1990–2000*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*FUGI*	*EIU*	*IMF*
World	2.7	3.4	2.2	2.9	3.9	1.2	1.9	1.9	3.1	3.2
Developed economies	2.4	3.1	2.5	2.7	3.4	0.9	1.5	1.4	1.8	1.9[a]
of which:										
United States	3.4	4.5	4.3	4.1	3.8	0.3	2.4	1.9	2.2	2.2
Japan	1.3	1.8	-1.1	0.1	2.8	0.4	0.3	-0.1	0.2	0.8
European Union	2.0	2.5	2.9	2.7	3.5	1.5	1.0	1.4	1.2	1.3
of which:										
Euro area	1.9	2.3	2.9	2.7	3.6	1.4	0.8	1.3	1.1	1.1
Germany	1.5	1.4	2.0	1.8	3.0	0.6	0.2	0.4	0.4	0.5
France	1.8	1.9	3.4	3.2	3.8	1.8	1.2	1.4	0.9	1.2
Italy	1.6	2.0	1.8	1.7	3.1	1.8	0.4	1.2	1.1	1.1
United Kingdom	2.7	3.4	2.9	2.4	3.1	2.1	1.8	1.9	1.8	2.0
Transition economies	-2.5	1.9	-0.7	3.6	6.4	4.6	4.0	3.6	3.7	4.0
Developing economies	4.8	5.1	1.1	3.4	5.5	2.4	3.3	3.5	.	5.0
Developing economies, excluding China	4.0	4.5	0.0	2.7	5.1	1.5	2.3	2.7	.	.

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators*, *2003*; IMF, *World Economic Outlook*, April 2003; Economist Intelligence Unit (EIU), *Country Forecast* (various issues); FUGI Global Modelling System (FGMS), Centre for Global Modelling, Tokyo.

a IMF forecast for “advanced economies” that include developed countries and Hong Kong (China), the Republic of Korea, Singapore and Taiwan Province of China.

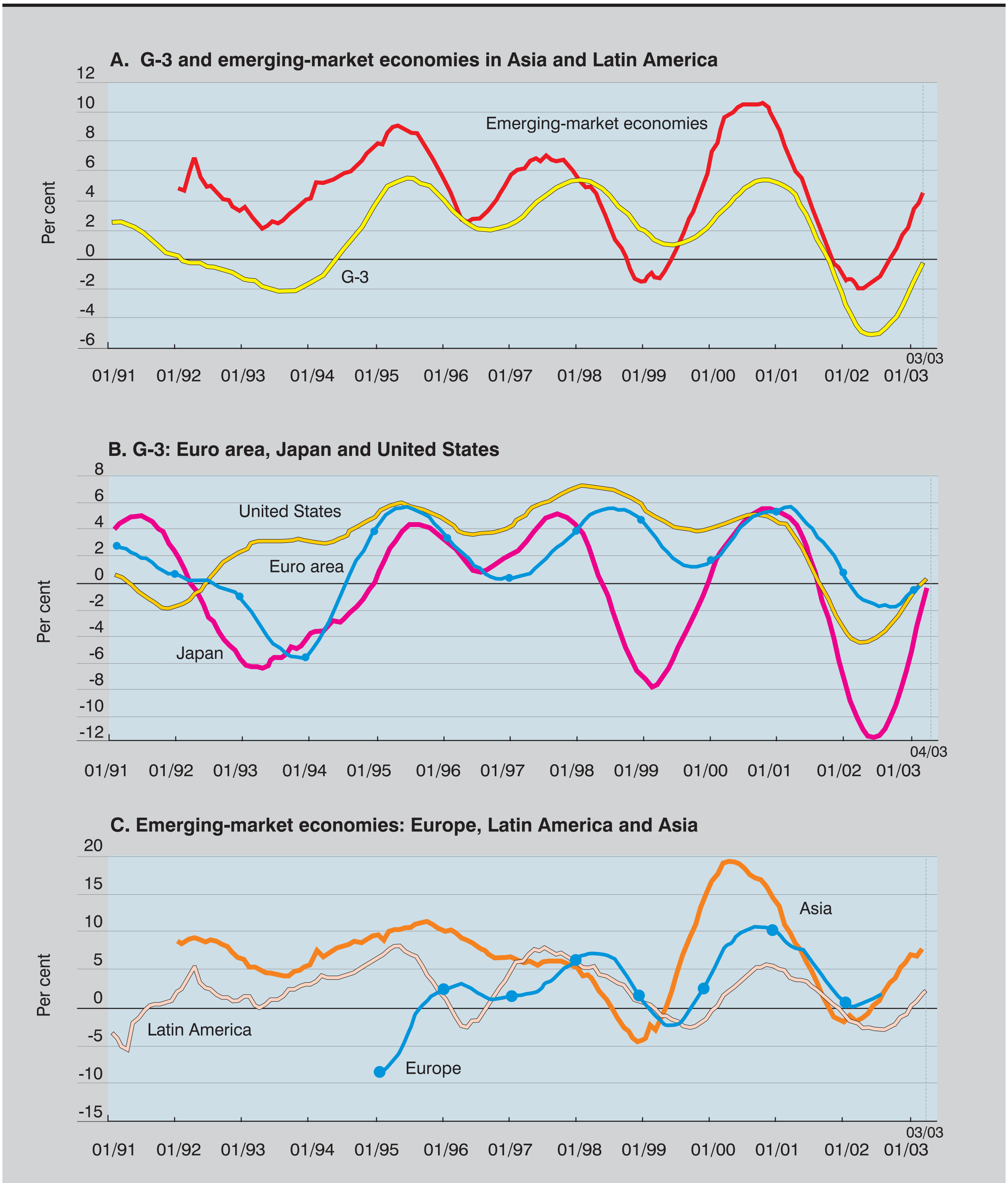
is expected to rise to 2.5 per cent in 2003, compared with 0.1 per cent at the end of the 1990s (IMF, 2003, table 1.5).

Nor has the rapid end to the war in Iraq, in May 2003, produced the anticipated improvement in economic conditions. Growth in the first half of 2003 in the United States was around one percentage point lower than the 2.5 per cent achieved in 2002. Following the slowdown in the United States, prospects have soured in the rest of the world, particularly in East Asia, but also in parts of South America such as Brazil and Argentina, where growth had been largely based on exports to the United States. Although the sharp decline in production in Argentina and Venezuela in 2002 is expected to be reversed, growth in Latin America as a whole is likely to be modest in 2003. In East Asia output growth in 2003 is likely to be weaker than in 2002, not least because the spread of Severe Acute Respiratory Syndrome (SARS) has adversely affected earnings from trade and services. The transition economies in Eastern Europe will find it difficult to sustain the increase in domestic demand that allowed the region as a whole to expand at around 4 per cent in 2002, substantially faster than the growth of demand in their major export markets in Western Europe. While Africa has remained relatively insulated from recent shocks, the region depends on the Western

Figure 1.1

INDUSTRIAL PRODUCTION IN THE G-3 AND EMERGING-MARKET ECONOMIES, 1991–2003

(12 months moving average of percentage changes over same period in the previous year)



Source: Thomson Financial Datastream.
Note: G-3 includes Euro area, Japan and the United States. Emerging-market economies include: Czech Republic, Hungary, Poland, Russian Federation and Turkey in Europe; Malaysia, the Republic of Korea, Singapore, Taiwan Province of China, and Thailand in Asia; and Argentina, Brazil, Chile, Mexico and Peru in Latin America.

European economies for its export growth. In addition, the decline in the prices of its major commodity exports and the stagnation of official aid flows mean that Africa may not be able to repeat its growth performance of the past two years.

Support for an acceleration of global growth above the rate of nearly 2 per cent in 2002 has thus weakened considerably in the first half of 2003. There is little prospect of reaching growth of 3 per cent, the rate that is generally considered to be the minimum necessary to provide employment for the expanding population of the developing world and to provide the resources needed to attain the Millennium Development Goals. Indeed, a return to global growth of 3 per cent will require a much more vigorous and balanced recovery than during the sustained expansion of the 1990s, and will need to involve all the developed and the major developing countries.

B. Persistent weaknesses in the developed economies

1. The legacy of the 1990s

Despite the acceleration of growth of the United States economy in the 1990s, reaching an average rate of 4 per cent in the last half of the decade, the global growth rate barely averaged 3 per cent throughout the decade. The failure to emulate the United States economy in this period with a vigorous expansion across the developing world was largely due to the disappointing performance of Europe and Japan – which grew at about 2.5 per cent and 1 per cent respectively – as well as a series of financial disruptions in the developing world that kept growth at modest rates. Growth in Latin America was disappointing, at an average rate of about 2 per cent, even before the collapse of the Argentinean economy and the political turmoil in Venezuela. While Asian developing countries recovered rapidly from the 1997 crisis, growing at nearly twice the Latin American rate, their average growth was significantly lower than that achieved before the crisis.

As discussed in some detail in previous *TDRs*, although the acceleration of growth in the United States helped to eliminate the fiscal deficit, it was nevertheless associated with increased fragility and imbalances in certain sectors of the economy. These included excessive investment in the high-tech sectors of information and telecommunications, supported by a stock market bubble and highly inflated asset prices, a sharp decline in savings, and a rapid increase in the debt of the household sector. In addition, corporate excesses, which were exposed by the subsequent slowdown in economic activity, became an obstacle to recovery by undermining confidence. Equally important, disparities in the level of demand among the major industrialized countries, together with the increased attractiveness of United States corporations to foreign investors, and exchange rate misalignments led to trade imbalances. While in 1995 the United States attracted about $60 billion of inward FDI, by 2000 the figure had risen to over $300 billion. Allowing for outward investment by United States companies, there was a swing from a net outflow of direct investment of $33 billion in 1995 to a net inflow of $165 billion in 2000. In addition, there was a sharp increase in the net inflow of funds for the purchase of securities, with monthly flows more than doubling during the same period to reach a high of around $45 billion per month. An important part of portfolio inflows after 1997 was due to the investment of reserves generated by the large current-account surpluses of the recovering East Asian economies and China.

The result of this large increase in capital flows to the United States was a persistent appreciation of the dollar and a deterioration of the United States external balance, from a little over $100 billion in 1995 to more than $400 billion in 2000, or an increase from 1.5 per cent of GDP to over 4 per cent. Almost every region benefited from the increasing United States deficit. In 2000, Western Europe accounted for nearly $60 billion, Japan for more than $90 billion, Latin America for $30 billion and the "rest of the world", mainly Asia, for more than $210 billion. Clearly, the rapid growth of the United States economy played a crucial role in the recovery of East Asian countries from the 1997 crisis, as well as in the rebound of growth in Latin America during 2000 (table 1.2).

The increased dependence on the United States economy as the main source of global growth during the 1990s magnified the impact of the inevitable slowdown in that economy.

2. *A shallower and longer recovery in the United States*

The increased dependence on the United States economy as the main source of global growth during the 1990s magnified the impact of the inevitable slowdown in that economy which was triggered by the end of the high-tech stock market boom in the first half of 2000. However, contrary to general expectations of a short and sharp recession, the United States economy entered a more persistent but less severe slowdown, with a growth rate well below potential. The events of September 2001 and the subsequent geopolitical uncertainties contributed to sluggish growth. However, the delay in a vigorous recovery is primarily due to the failure of investment spending to recover because of continued excess capacity despite the elimination of productive assets. During the period 1995–2000, capacity utilization in the high-tech sector had exceeded 85 per cent, despite an extremely high rate of growth of investment spending, but it fell to around 60 per cent in 2001 and had failed to improve by mid-2003 despite virtually no investment in new capacity and the scrapping of much existing equipment through bankruptcies. For industry as a whole, capacity utilization fell to around 75 per cent after peaking at some 85 per cent, the decline continuing in the first half of 2003 (Federal Reserve System, 2003: 11).

The falling rate of capacity utilization has not only reduced the demand for new investment goods, but has also translated into a sustained growth of labour productivity as a result of large cuts in employment. Since the return to positive growth in the last quarter of 2001, the annual rate of productivity growth in the business sector was 4.5 per cent in 2002, roughly double the rate of output growth. As a result, job losses, which had started to rise at the beginning of the recession, persisted through the recovery in 2002 and into 2003, especially in the manufacturing sector. The result has been a loss of over 2 million jobs and a 50-per-cent increase in involuntary part-time employment. The recovery has thus started to look rather similar to the "double dip, jobless recovery" of the kind observed in the early 1990s (see *TDR 1992*, Part Two, chap. II), when positive output growth was also associated with falling employment. As pointed out in *TDR 2002* (Part One, chap. 1: 9), the basic difference is that in 2003 consumption demand has remained positive while investment has failed to respond to signs of improvement.

Thus, despite the rapidly deteriorating employment conditions, the downturn has been relatively mild in the United States thanks to continued growth in personal consumption expenditures, although at less than half the annual rate at the end of the 1990s. This can be explained, at least in part, by the rapid action of the Federal Reserve in reducing interest rates. While this has had little impact on investment spending, the reduction in 10-year bond yields has fed directly into lower rates for household mortgages. The

Table 1.2

GDP GROWTH IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 1990–2003

(Percentage change over previous year)

Region/economy	1990–2000	1997	1998	1999	2000	2001	2002	2003 forecast FUGI	2003 forecast EIU	2003 forecast IMF
Developing economies	4.8	5.1	1.1	3.4	5.5	2.4	3.3	3.5	.	5.0
Developing economies, excl. China	4.0	4.5	0.0	2.7	5.1	1.5	2.3	2.7	.	.
Latin America	3.3	5.2	2.1	0.0	3.7	0.3	-0.8	1.5	1.6	1.5
of which:										
Argentina	4.3	8.1	3.9	-3.4	-0.8	-4.5	-11.0	3.0	4.0	3.0
Brazil	2.9	3.3	0.1	0.8	4.4	1.5	1.5	1.8	1.9	2.8
Chile	6.7	7.4	3.9	-1.1	4.4	2.8	2.0	3.3	3.5	3.1
Colombia	3.0	3.4	0.6	-4.1	2.6	1.4	1.6	2.5	2.5	2.0
Ecuador	1.8	3.4	0.4	-7.3	2.3	5.6	3.0	3.0	3.0	3.5
Mexico	3.1	6.8	5.0	3.6	6.6	-0.3	0.9	1.0	2.5	2.3
Peru	4.7	6.7	-0.5	0.9	3.1	0.2	5.2	4.0	3.6	4.0
Uruguay	3.4	5.0	4.5	-2.8	-1.4	-3.1	-10.8	-2.0	-1.5	-2.0
Venezuela	1.6	6.4	0.2	-6.1	3.2	2.7	-8.9	-12.1	-12.1	-17.0
Africa	2.9	3.2	3.3	3.1	3.3	3.4	2.9	2.5	.	3.9
of which:										
Algeria	1.9	1.1	5.1	3.2	2.4	2.1	3.1	2.7	6.8	3.5
Cameroon	1.7	5.1	5.0	4.4	4.2	5.3	4.3	4.2	4.3	4.7
Côte d'Ivoire	3.4	5.7	4.8	1.6	-2.3	0.1	0.5	0.5	-3.2	-2.0
Egypt	4.5	5.5	4.5	6.3	5.1	3.5	2.0	3.1	1.6	3.0
Ghana	4.3	4.2	4.7	4.4	3.7	4.0	4.5	4.6	4.7	4.7
Kenya	2.1	2.1	1.6	1.3	-0.2	1.1	1.0	1.2	2.5	1.8
Morocco	2.3	-2.2	7.7	0.0	0.9	6.5	4.5	3.9	4.0	5.5
Nigeria	2.4	2.7	1.9	1.1	3.8	3.9	1.6	3.8	3.1	6.7
South Africa	2.1	2.6	0.8	2.1	3.4	2.2	3.0	2.8	3.0	2.8
Tunisia	4.7	5.4	4.8	6.1	4.7	4.9	1.8	3.6	4.2	5.0
Zimbabwe	2.5	2.7	2.9	-0.7	-4.9	-8.4	-12.5	-11.0	-8.8	-11.0
Asia, excluding China	4.8	4.4	-2.2	4.5	6.5	1.8	4.4	3.4	.	.
Asia	6.0	5.4	0.3	5.2	6.9	3.3	5.4	4.4	.	6.3
of which:										
China	10.3	8.8	7.8	7.1	8.0	7.3	8.0	7.1	7.6	7.5
Hong Kong (China)	4.0	5.0	-5.3	3.0	10.5	0.6	2.3	1.5	2.7	3.0
India	5.9	4.4	6.5	6.1	4.0	5.4	4.5	5.4	5.9	5.1
Indonesia	4.2	4.7	-13.1	0.8	4.9	3.3	3.7	3.3	3.3	3.5
Iran, Islamic Republic of	3.6	3.4	2.0	2.5	5.9	4.8	5.9	5.7	5.7	6.5
Israel	5.1	3.2	2.6	2.2	6.0	-0.9	-1.1	1.3	0.3	0.5
Malaysia	7.0	7.3	-7.4	6.1	8.2	0.4	4.2	4.6	4.6	5.0
Pakistan	3.7	1.0	2.6	3.7	4.2	2.7	4.6	4.3	4.6	5.0
Philippines	3.3	5.2	-0.6	3.4	4.0	3.4	4.6	3.8	3.8	4.0
Republic of Korea	5.8	5.0	-6.7	10.9	9.3	3.0	6.0	4.1	4.1	5.0
Saudi Arabia	1.5	2.0	1.7	-0.8	4.9	1.2	1.4	4.0	2.9	4.0
Singapore	7.9	8.5	-0.1	6.9	10.3	-2.0	2.2	3.0	3.1	3.0
Taiwan Province of China	6.4	6.7	4.6	5.4	5.9	-2.2	3.5	3.1	3.7	3.2
Thailand	4.2	-1.4	-10.5	4.4	4.6	1.8	5.2	3.9	4.4	4.2
Turkey	3.8	7.5	3.1	-4.7	7.4	-7.5	7.8	5.1	3.1	5.1
Transition economies	-2.5	1.9	-0.7	3.6	6.4	4.6	4.0	3.6	3.7	4.0
of which:										
Belarus	-1.6	11.4	8.4	3.4	5.8	4.1	4.5	4.7	2.5	4.0
Bulgaria	-1.8	-5.6	4.0	2.3	5.4	4.0	4.2	4.2	4.2	5.0
Croatia	0.6	6.8	2.5	-0.4	3.7	4.1	4.8	4.2	4.4	4.2
Czech Republic	1.1	-1.3	-1.0	0.5	3.3	3.3	2.0	3.2	3.0	1.9
Hungary	1.5	4.6	4.9	4.2	5.2	3.8	3.3	3.7	3.8	3.6
Kazakhstan	-4.1	1.7	-1.9	2.7	9.8	13.2	9.5	7.7	7.2	8.5
Poland	4.6	6.8	4.8	4.1	4.0	1.0	1.3	3.0	2.7	2.6
Romania	-0.7	-6.1	-5.4	-1.2	1.8	5.3	4.9	4.9	4.8	4.9
Russian Federation	-4.8	0.9	-4.9	5.4	9.0	5.0	4.3	4.1	3.8	4.0
Slovakia	1.9	5.6	4.0	1.3	2.2	3.3	4.4	4.0	4.2	4.0
Slovenia	2.7	4.6	3.8	5.2	4.6	3.0	3.0	3.2	3.4	3.2
Ukraine	-9.3	-3.0	-1.9	-0.2	5.8	9.1	4.6	4.3	4.0	4.5
Uzbekistan	-0.2	5.2	4.3	4.3	3.8	4.5	3.5	3.5	3.5	3.1

Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2003*; EIU, *Country Forecast*, various issues; IMF, *World Economic Outlook*, April 2003; and national sources.

possibility to prepay existing fixed-rate mortgages has led to repeated waves of mortgage refinancing as interest rates have declined. This allowed households to extract equity from the market value of the housing stock, which has increased by nearly 40 per cent since 1998, thus offsetting some of the loss in stock values. In 2002, it is estimated that as much as $100 billion was generated to support consumer spending through this mechanism. Not only did this support consumption, it also kept the construction industry expanding, as both new and existing home sales recovered in 2002. However, more recent data suggest that households are now using such funds to pay off outstanding debt rather than to increase consumption.

> The recovery in the United States has started to look similar to the "double dip, jobless recovery" of the early 1990s.

With the impact on growth of rising consumption expenditures offset by the deterioration in the trade balance and the continued decline in non-residential fixed investment, the only other component of effective demand contributing to growth during the recovery since 2001 has been the rising deficit in the federal budget. It was widely expected that the conflict in Iraq, entailing an increase in military expenditure, would give a boost to United States growth. However, no such effect was visible in the first half of 2003, when there was a downturn in overall industrial production. Moreover, the federal tax cuts are not expected to be very effective in stimulating aggregate demand as they benefit primarily the higher income groups, and their effect on disposable incomes has been largely offset by increased State taxes on income, sales and property.

3. The downturn in Europe and Japan

Weak global growth has also been due to the failure of growth in the rest of the developed world to offset the decline in the United States in 2001 and to support the recovery in 2002. In Europe, where the large number of mergers and acquisitions between EU and United States firms in the second half of the 1990s has increased the interdependence of activity with the United States, growth was virtually flat in the last three quarters of 2001. The recovery in 2002 was much weaker than in the United States, averaging less than 1 per cent, with domestic demand increasing by just 0.2 per cent before declining in the first quarter of 2003.

The failure of European growth to pick up is partly due to the increasing difficulty of implementing a counter-cyclical economic policy in the Euro area. Since the larger European economies have the largest direct exposure to the United States, they were the most affected by the downturn in the United States economy. The deterioration in their budget positions thus occurred much earlier than in the smaller, more rapidly growing economies in the Euro area. Accordingly, they have been under pressure to introduce measures to keep their budget deficit ratios within the limit set by the Stabilization and Growth Pact. At the same time, disparities in growth among the Euro area countries create difficulties for monetary policy, which is expected to take into account the higher inflation risks of the more rapidly growing smaller economies. Since the European Central Bank (ECB) has interpreted its mandate as the maintenance of medium-term inflation rate at or below 2 per cent for the harmonized price index of the Euro area, monetary policy has been too restrictive for the larger, slower growing economies with higher deficits, particularly for the German economy, where recovery holds the key to growth in the Euro area. As a result, the economies that account for the largest shares of GDP and employment in the region have had to introduce restrictive fiscal policies and have been subject to restrictive monetary policies at precisely the time when international conditions are also reducing the external demand for European output. Indeed, the best performer among the larger economies in Europe has been the United Kingdom, which has not been subject to these policy constraints and where growth has been based on private consumption.

The rate of growth of final consumption expenditures in the Euro area fell by around 1 percentage point in 2001 and by even more in 2002, dropping below 1 per cent on an annual basis. Despite the deceleration in international trade, the net trade surplus increased from less than 2 per cent of the Euro area's GDP at the beginning of 2000 to nearly 3 per cent in 2002.

The failure of European growth to pick up is partly due to the increasing difficulty of implementing a counter-cyclical economic policy in the Euro area.

In Japan, despite the Bank of Japan's policy of zero interest rates, deflation, as measured by the decline of the GDP price deflator, continued unabated at an annual rate of about 2 per cent in 2001 and 2002, and real GDP in the last quarter of 2002 only returned to its level of the fourth quarter of 2000. Although monetary policy led to a flattening of the yield curve, with the yield of 10-year government bonds falling from around 1.5 per cent in 2002 to around 0.6 per cent at the beginning of 2003, lending by domestic banks continued to decline. Private investment remained dormant, public investment continued to be cut, and private consumption was stagnant. As a result, the economy started to contract again in the first quarter of 2003: this revealed continued weakness in the financial sector, and the government had to intervene again to support institutions in difficulty. Thus, as in Europe, instead of supporting the United States recovery in 2002, growth in Japan declined, and by the first quarter of 2003 it was actually pulling back global recovery.

As noted above, weak domestic demand in continental Europe and Japan is partly due to the sluggish growth in consumer spending compared with the United Kingdom and the United States. This is explained partly by the savings habits of the household sector. In the United States and the United Kingdom, recent periods have seen a steady increase in the average propensity of the household sector to consume. Between the early 1990s and the beginning of the new millennium the household savings rate fell from 8 per cent to less than 2 per cent in the United States and from 10 per cent to 4 per cent in the United Kingdom. No such trend is discernible in Japan and continental Europe. In Japan, deflation has been deterring households from spending, thereby threatening to set off a downward spiral.

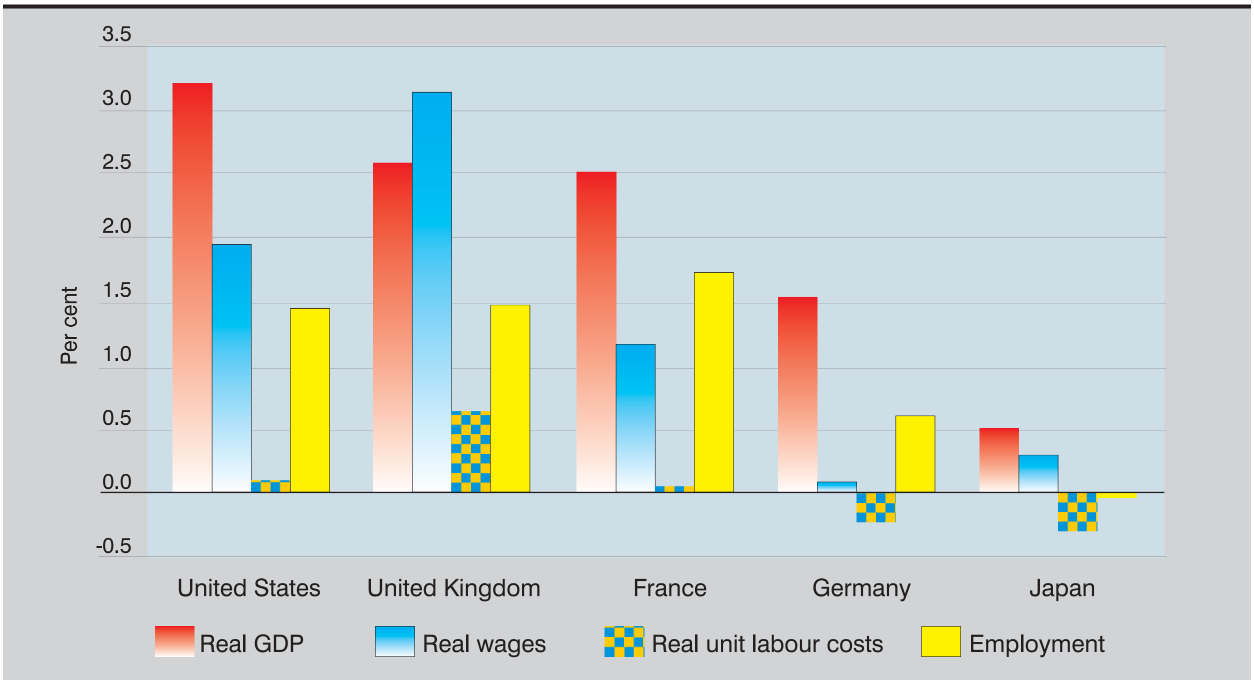
Perhaps an equally important factor behind weak consumer spending in continental Europe and Japan is the behaviour of wages relative to productivity. In the United States and United Kingdom, real wages broadly kept up with productivity growth after the mid-1990s, growing by 2 to 3 per cent per annum between 1996 and 2002. In the United Kingdom, real wages rose in 2002 by more than 2.5 per cent, and further increases are expected in 2003; in the United States the increase in 2002 was around 1 per cent. In contrast, real wages in Germany and Japan have been virtually stagnant during the past seven years, rising by an annual 0.1 per cent and 0.3 per cent respectively. However, contrary to expectations that falling real unit labour costs and rising profits would help to create jobs, employment has generally fallen in countries where wage growth has been weak (fig. 1.2), and falling unit labour costs have fed deflation. Thus, it will be difficult for Germany and Japan to overcome the persistent weakness in domestic demand under their current wage policies. Companies have not been hiring in the current depressed state of the economy and employees are not spending until prospects for jobs and wages improve. This deadlock can only be overcome by fiscal policy aimed at increasing the disposable income of households through tax cuts and public investment.

An important factor behind weak consumer spending in continental Europe and Japan is the behaviour of wages relative to productivity.

Figure 1.2

WAGES, EMPLOYMENT AND GDP IN THE MAJOR INDUSTRIALIZED COUNTRIES, 1996–2002

(Average annual change over previous year)



Source: EU Commission, AMECO database.

C. Developing countries and transition economies: disparities in growth performance

Mirroring the cycle in the developed economies, growth in the developing world fell sharply in 2001, and the rebound in 2002 was generally weak, leaving the average growth rate for developing countries as a whole slightly above 3 per cent. However, there have been large differences between and within different regions. After a sharp decline in 2001, economic growth picked up rapidly in East Asia, and, until early 2003, the region proved to be less susceptible to the effects of weakness in the industrialized world. In Latin America, the slowdown in the world economy came on top of a number of domestic problems; the decline of economic activity that started in 2001, after relatively rapid growth (by the standards of the region) in 2000, deepened with the impact of the Argentine default at the end of 2001 and the region plunged into recession. Africa has been affected less than other regions by recent trends in the world economy, maintaining an average growth rate of around 3 per cent. However, there are major differences among the countries of the region in their ability to raise per capita incomes and reduce poverty. In the transition economies, where growth remained relatively strong on the basis of domestic demand, there were also considerable differences between countries.

1. Asia and Latin America: the widening gap between the developing East and the developing West

Asia is the region that has been most directly affected by the end of the IT boom in the United States. This is due to its closer trading and production linkages, particularly in the supply of high-tech and consumer electronic products, and the emergence of China as a major trading partner of the United States. Accordingly, Asia was the first region to feel both the impact of the United States recovery in 2002 and its slowing down at the end of that year. Thus most of Asia was already experiencing falling external demand in the first quarter of 2003, before the impact of the SARS outbreak on economic activity. In the Republic of Korea, GDP actually fell in the first quarter compared with the last quarter of 2002, and in economies such as Malaysia and the Philippines growth rates were falling although they have not felt a major impact from SARS.

> The weakness in global demand over the past couple of years has had a limited impact on Asian economic performance because the strong external position of the region has allowed greater leeway for counter-cyclical economic policy.

However, the weakness in global demand over the past couple of years has had only a limited impact on Asian economic performance because the strong external position of the region has allowed greater leeway for counter-cyclical economic policy. Both China and India have increased government deficit spending and most countries in the region have reduced interest rates along with falling inflation. With little dependence on international capital flows, policy interest rates were cut aggressively and have been kept at very low levels. In the Republic of Korea, for example, interest rates were reduced from 15 per cent in 1998 to 4.5 per cent at the beginning of 2003. In Malaysia, Taiwan Province of China, and Thailand, interest rates fell below 2 per cent and in Singapore they were less than 1 per cent. For emerging Asia as a whole the real policy rate has been around 2 per cent on average. Given that the average growth rate has been over 5 per cent, there is a considerable incentive for private investment in fixed capital. Private consumption expenditure, stimulated by rising wages and employment throughout the recovery from the 1997–1998 crisis, has also been an important factor in the region's stable growth. The expansion of domestic demand in the major economies of the region has provided an independent momentum to growth, which has been further supported by regional integration and the expansion of intraregional trade. In this respect a surge in China's imports from the region has played a crucial role (see chap. III).

Consequently, economic growth accelerated rapidly in 2002 after a sharp drop in the previous year. China regained its traditional 8 per cent growth target after a marginal deceleration to just over 7 per cent in 2001, while the Republic of Korea doubled its rate of expansion to 6 per cent. Singapore and Taiwan Province of China both managed to return to positive growth in 2002, recovering from recessions in 2001, and Thailand, which relied primarily on domestic policy measures to stimulate the recovery, growth exceeded 5 per cent. Indonesia, which is still influenced by the effects of the 1997 crisis, continued to expand by around 3.5 per cent in 2001 and 2002. India, with much looser links to the United States economy, increased its growth rate to well over 5 per cent in 2001 and maintained a rate of 4.5 per cent in 2002.

In Latin America, where most countries experienced a sharp drop in capital inflows and tighter payments constraints (see chap. II), only a handful of countries were able to respond to the fall-off in global demand with policy changes, and in general these were not very effective. Chile managed to grow despite the regional downturn in 2001, using the relative strength of its currency to lower short-term interest rates substantially, to an historical low of 3 per cent. Fiscal policy also played a stabilizing role in Chile thanks to its low level of public debt and a small structural deficit, but it was still unable to benefit from the United States upturn in 2002 as its growth rate fell from just under 3 per cent to 2 per cent in 2002.

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Another country in Latin America with a relatively comfortable external position and some room for policy manoeuvre is Mexico. Given its close trading links through NAFTA, Mexico was influenced most directly by the cyclical developments in the United States. It introduced counter-cyclical measures to offset the impact of the downturn in exports, reducing interest rates to record lows. Since there was no sharp decline in capital inflows, its exchange rate has remained relatively stable against the dollar, a small depreciation in the first quarter of 2003 being largely reversed in the second. Mexico's external position improved primarily as a result of higher petroleum prices, increased remittances from workers abroad, and reduced debt service payments due to lower risk premia. However, exports declined over the last three quarters of 2002 and increased only marginally in the first quarter of 2003 as the *maquiladora* sector has come under competition from Asian producers, especially in the United States market. Thus, United States imports from Mexico barely increased in 2002, while those from China rose by almost 20 per cent. As a result, employment in the sector has fallen by almost 20 per cent from its peak at the end of the 1990s. According to the Bank of Mexico, the failure of exports to recover is not only due to weak foreign demand, but also to a failure to adjust to increased international competition – an issue taken up in Part Two of this Report.[1] As in Chile, while the adverse effect of global conditions on Mexico was quite strong, leading to negative growth in 2001, the upswing in the United States brought little respite in 2002, the growth rate remaining below 1 per cent.

In most other countries in the region, the global downturn came on top of financial difficulties and both monetary and fiscal policy had to be focused on reducing current-account deficits, stabilizing currencies, and restoring confidence in the financial markets. The region's economic performance has been dominated by the negative impacts of the Argentine default at the end of 2001, which quickly extended to Uruguay, the political uncertainty in Brazil and the disruption of economic activity in Venezuela and Colombia, rather than by global conditions. The fall in capital inflows during 2002, reinforced by domestic political difficulties, generated substantial exchange-rate volatility: in a number of countries, such as Brazil and Argentina, this involved such large depreciations that external account positions improved even in the face of sluggish global trade and declining primary commodity prices. At the same time, such depreciations led to a rapid increase in import prices and a return of inflation, which in turn led to tighter monetary policy and higher interest rates, further depressing domestic demand. While growth remained sluggish in Brazil, economic activity collapsed in Argentina, Venezuela and Uruguay, with output losses reaching double-digit rates. Only in two Latin American countries were growth rates relatively high in 2002. Peru recovered from near stagnation and grew by more than 5 per cent, and economic growth in Ecuador, although down from 5 per cent in 2001, still reached 3 per cent.

East Asia as a whole is expected to continue to grow faster than Latin America in 2003, despite some weakening due to the SARS crisis and falling external demand. Although the SARS virus was first identified in the last quarter of 2002, it spread in the first quarter of 2003 and its impact will probably become more visible in the figures for the second quarter of the year. The overall impact of SARS will depend, of course, on the extent to which the outbreak is contained. Reports available in the second quarter of 2003 suggest that the number of new cases has been falling. Initial estimates suggest that the major impact will be on the initial centres of contagion: Chinese GDP is reported to have been stagnant in the first quarter, Hong Kong (China) and Taiwan Province of China are also expected to grow at substantially lower rates, and Singapore may even fall back into recession. In addition to the initial impact on domestic production and trade, there has also been a large indirect impact on services such as transport and tourism, which together account for around 10 per cent of regional GDP and which had already slowed down as a result of terrorist activity. These effects extend well beyond the region (see chap. III). Assuming that SARS has been contained, the Asian Development Bank estimates that in the second quarter the overall loss of GDP in individual countries could range between 0.2 and 2.0 percentage points, with the largest reductions in Hong Kong (China) and Singapore, and the smallest in China and the Republic of Korea. For the region as a whole, the GDP loss would be around half a percentage point, although that would more than double if the impact extends into the third quarter.[2]

The short-term prospects for Africa do not suggest any significant divergence from recent growth trends. There is now a growing consensus that, as a result, it will be impossible to meet the Millennium Development Goals.

In Latin America, recovery is likely to be weak and fragile, driven by some improvement in financial conditions rather than by strong export growth. The continuing decline in equity and bond yields in the United States has led to renewed interest from some international investors in the high yields that can be obtained in some Latin American emerging markets. For example, there has been an increase in short-term inflows in the form of investment in exchange-rate indexed government bonds in Brazil. Such inflows have been encouraged by the fact that in both Brazil and Argentina the political risks that dominated 2002 had subsided in the first quarter of 2003, and by the new Governments meeting and often exceeding the conditions set for their IMF support programmes. Thus, much as in the period after the introduction of stabilization plans in the 1990s (see chap. VI), short-term capital inflows are attracted by perceptions of improving macroeconomic fundamentals and arbitrage profits. Coupled with the rise in the United States external deficit and the belief that the United States Government has abandoned its policy of a strong dollar, these short-term capital flows have reversed the currency depreciations that had earlier improved export competitiveness. As a result, these countries now have appreciating currencies just when there is a global slowdown in output and trade and a shift to short-term capital flows in an international environment of reduced external financing (see chap. II).[3] There is a risk that if expectations of improved political conditions and of successful economic reforms are disappointed, or if there is some other external shock, there could be a rapid reversal of short-term flows with consequent pressure on exchange rates. This, in turn, would require interest rates that would not be appropriate for sustaining internal demand and economic growth.

2. *Africa remains relatively insulated from global trends*

Performance in Africa was largely independent of the impact of the downturn in the United States in 2001 and more closely linked to demand conditions in Europe. Like Latin America, the region benefited little from the upswing in 2002. Climatic and political factors continued to have a major impact on economic performance. Eastern and Southern Africa were adversely affected by drought, which created severe food shortages, and by depressed export prices. In these subregions, growth remained well below the African average. Conditions in Nigeria and Zimbabwe were dominated by political tension. The conflict in Côte d'Ivoire had an adverse impact on trade in the neighbouring landlocked countries, Mali, Burkina Faso and Niger, which had to rely on port facilities in other West African countries as the Nigerian facilities were no longer accessible. Trade in the subregion has been seriously disrupted with a consequent loss of income, in part because of longer transportation routes for both exports and imports. It has also had a direct impact on cocoa prices.

The strength of oil prices in 2002 underpinned a 5 per cent growth rate in Angola. Among the subregions, the highest rate (5.0 per cent) was achieved in the Horn of Africa, reflecting relatively good performance in Ethiopia and Sudan. Similarly, growth in the Great Lakes region exceeded 4 per cent (compared with 2.3 per cent 2001) following efforts to restore peace and the concomitant recovery in the Democratic Republic of the Congo, where growth reached 3.0 per cent in 2002 (compared with a fall of 2.0 per cent the previous year). Expansion continued strongly in the United Republic of Tanzania and Uganda, which grew at 6.0 per cent and 6.6 per cent, respectively. In North Africa and Central Africa, growth was close to the regional average.

Despite the relatively stable performance, with 15 countries in the region reaching growth rates of 5 per cent in 2002, only six (Angola, Chad, Equatorial Guinea, Mali, Mozambique, and Rwanda) achieved rates of 7 per cent or more, which are required every year if the goal of halving poverty by 2015 is to be reached. Indeed, there are very few countries that have been able to maintain rapid growth for long enough to have a tangible impact on reducing poverty. Only three countries (Chad, Equatorial Guinea, and Mozambique) met this target in both 2001 and 2002, and only Equatorial Guinea has done so since 2000.

The short-term prospects for Africa do not suggest any significant divergence from recent growth trends. There is now a growing consensus that, as a result, it will be impossible to meet the Millennium Development Goals for the region, particularly that of halving poverty by 2015. A durable improvement in African economic performance will depend on success in the fight against the HIV/AIDS pandemic and other diseases such as tuberculosis and malaria, and on resolving the deep-seated problems related to weak and unstable commodity prices, declining levels of aid, the continued debt overhang and political instability. Even though improvements in domestic policies, institutions and governance hold the key to sustained growth, progress on many of these fronts depends primarily on action by the international community – including faster and deeper debt relief, increased and better quality aid, and improved access to the markets of the developed economies.

3. *Growth and imbalances in the transition economies*

Although many of the transition economies in Eastern Europe and the Commonwealth of Independent States (CIS) are highly dependent on trade with Western Europe and less closely linked to developments in the United States, they have faced relatively stable external conditions. Along with an expansion of domestic demand, these contributed to maintaining output growth at a rate considerably higher than the world average in 2002. However, unlike East Asia, growth in many of the countries that are candidates for accession to the EU has relied on increased capital inflows (see chap. II). In some countries, the rise in domestic demand has led to a further deterioration in current-account deficits, while in others a slowdown in growth has not led to a reduction in these deficits. Relatively high nominal interest rates and optimism generated by the agreements on accession to the EU have attracted inflows of short-term capital, leading to an appreciation of real exchange rates and accelerating the deterioration in the current account. Hungary, as well as the Czech Republic and Poland, have experienced a real appreciation of their exchange rates of 20 per cent in the last two or three years. Only in Poland has the appreciation slowed recently in reaction to the slowdown in growth.

Growth in the transition economies has not been associated with an easing of the external constraint and thus remains dependent on capital inflows.

Another cause of concern is that the recent reduction of inflation, coinciding with rapid nominal wage growth, has increased real wages and private consumption but has not been accompanied by a strong increase in investment (ECE, 2003: 101) or by restructuring of domestic industry to improve competitiveness and exports. In other words, growth has not been associated with an easing of the external constraint and thus remains dependent on capital inflows. This is a combination that has frequently been a prelude to financial instability in Latin America (see chap. VI).

In the CIS economies growth was close to 5 per cent in 2002, primarily due to strong petroleum prices, which allowed a rapid expansion of wages and consumption. Although GDP grew by close to 6 per cent in 2002, there was a significant improvement in the Russian Federation's current-account balance as a result of increased oil revenues, a development which also improved its access to international financial markets (see chap. II). However, other sectors continue to be weak and the non-oil trade balance is in large deficit. The region is therefore vulnerable to a weakening of oil prices, an outcome which could be aggravated by reduced access to external finance. On current trends in the oil market, economic growth can be expected to fall in 2003, possibly to below 4 per cent.

D. Economic prospects and policies to promote global recovery

The failure of an expected strong recovery in the United States to materialize and of the rest of the industrialized world to take measures to stimulate domestic demand has made the global recovery process more difficult. With the inevitable slowdown of the United States economy after its historic expansion of the 1990s, preserving the growth of global income and international trade would have required a rapid shift in the policies of the major industrialized countries in Europe and in Japan. To support the expansion of their economies measures were needed to stimulate an expansion of domestic demand, which would have increased their demand for imports and reduced their current-account surpluses. This would have halted the deterioration in the United States external balance and resulted in a slowdown of capital flows to that country, thereby avoiding the appreciation of the dollar vis-à-vis the euro and the yen that occurred in the last half of the decade. If accompanied by increases in capital flows towards developing countries facing payments difficulties, such a process would also have accelerated growth in these countries by reducing their need to introduce restrictive policies in order to balance their external accounts.

However, what actually occurred was a continued contraction in domestic demand in Europe and Japan that kept their growth rates even below the low rate of the United States. As a result, the United States current-account deficit continued to increase despite a sharp slowdown in growth. The Federal Reserve responded promptly by reducing interest rates, and the expenditures associated with the war against terrorism, coupled with the new Administration's political commitment to tax reductions, quickly turned the United States budget from surplus to deficit. In Europe, in contrast, the Stability and Growth Pact prevented expansionary fiscal action. Furthermore, an inflation rate marginally above the 2-per-cent target was interpreted as requiring monetary restriction, especially given the presumption that the continued depreciation of the euro would provide an alternative to monetary stimulus. It was only after a sustained appreciation of the euro and a decline in inflation below the 2-per-cent target in the second quarter of 2003 that the ECB moved to cut interest rates.

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In Japan, interest rates had already reached their technical minimum, and a decade of ad hoc fiscal policy packages had swollen government debt without reversing deflation and stagnation in the economy. The failure of these fiscal packages to lift the economy has eroded political support for additional stimulus measures. Instead, the Government has opted for a longer-term strategy of improving industrial productivity in order to better compete globally with the United States in the knowledge-intensive, high-technology sectors; it is thus relying on exports as the only source of demand expansion.

With growth in the industrialized world remaining uneven and sluggish, there has been increasing resort to currency adjustments to reduce trade imbalances. Indeed, the dollar has come under pressure since mid-2002, due to the sharp decline in capital flows to the United States. As noted in subsection B.1, the recession in the 'high-tech' sectors has made investment and acquisition of United States companies less attractive and so there has been a large fall in FDI in the United States. The rapid lowering of interest rates and the continued weakness of equity markets, which still appear to be overvalued (price-earnings ratios are still roughly double their pre-1995 average) despite a dramatic fall in prices, have also led to a decline in non-resident purchases of private securities. Together with the continued increase in the current-account deficit, which exceeded $500 billion in 2002 (accounting for about 2 per cent of world income), this has created downward pressure on the dollar. The external value of the dollar peaked around February 2002 and had depreciated in real terms by about 15 per cent by the first quarter of 2003, according to the Major Currency Index of the Federal Reserve, but by only 6 per cent when measured by the Broad Index, and by only 2 per cent according to the Other Trading Partner Index, which includes many Asian currencies that are pegged to the dollar.[4] Against the euro, the dollar fell by some 30 per cent between early 2002 and mid-2003, but by only 10 per cent against the yen in the same period. Indeed, according to the Bank of Japan, the real effective exchange rate of the yen remained stable throughout this period.

For the Asian developing countries with relatively stable currencies against the dollar, there will be opportunities for expansion in European markets without losses in the United States. This could be a source of new frictions in the international trading system.

However, it is not clear if the currency realignments alone can help remove trade imbalances and support global growth. Given the substantial interest rate differentials that had emerged between the United States and Japan on the one hand, and the Euro area on the other, the appreciation of the euro against both the yen and the dollar is not a surprise. But since a large proportion of the United States trade deficit is with East Asian countries, a correction of these imbalances would require the dollar to depreciate against the East Asian currencies, including the yen. However, the East Asian economies have so far resisted such an appreciation. Given the impossibility of further interest rate reductions in Japan and its need to rely on external demand for growth, it has prevented any significant real appreciation of the yen by intervening in the currency market and purchasing United States securities to accumulate large amounts of dollar reserves. Since Japanese domestic costs and prices are falling relative to those of its trading partners, the yen is already experiencing real depreciation, and this is reinforced by the attempts to prevent a nominal appreciation. The currencies of China, Hong Kong (China) and Malaysia are pegged to the dollar, while most other developing countries of the region have been intervening in order to stabilize their dollar exchange rates.

Intense competition among the countries of the region is a major reason for their efforts to avoid appreciation. In South East Asia, there is concern about losing competitiveness against China, which so far has resisted demands to revalue its currency against the dollar. In the Republic of Korea and Taiwan Province of China, exchange rate policies appear to focus on the movement of the dollar-yen rate, since these economies see Japan as their main competitor. Although most of the accumulated current-account surpluses of these countries are held as reserves invested in United States assets, there is also an effort to diversify away from the dollar and this seems to have contributed to the large gains made by the euro.

For emerging-market economies, movements in the exchange rates of the major currencies can be an additional source of instability.

Since policy interest rates in Europe have remained higher than those in the United States and Japan, international interest rate arbitrage has attracted funds to the Euro area, contributing to the rapid depreciation of the dollar against the euro. There is a risk that these arbitrage flows could lead to a continuing appreciation of the euro and become self-reinforcing. This in turn could lead to a substantial overshooting of the euro-dollar and euro-yen exchange rates that is unlikely be reversed by the size of interest rate reductions that the ECB would be willing to accept. Japan may thus find better markets in Europe, while losing some market share in the United States. For the Asian developing countries with relatively stable currencies against the dollar, there will also be opportunities for expansion in European markets without losses in the United States. Overall, therefore, the currency movements under way may increase, rather than reduce, the global market share of the Asian countries. This could be a source of new frictions in the international trading system.

The major impact of these exchange-rate realignments would be on Europe, reducing its external demand and economic growth. Furthermore, given the linkages between United States and European firms, a significant impact of the rise of the euro against the dollar will be an improvement in the dollar profits of United States firms operating in Europe and a reduction in the euro profits of European firms with substantial operations in the United States. This will have a negative impact on the profitability, and thus on the investment, of European firms. If these developments exacerbate budget deficits in Europe, they could lead to further cuts in government expenditures, thus adding to deflationary forces.

For the United States, these currency movements may leave the trade deficit unchanged while bringing a marginal improvement to its current account, since the country earns higher returns on its foreign assets than are earned by foreigners on assets held in the United States. To the extent that currency movements prove ineffective in reducing its trade deficit, the required external adjustment may have to rely increasingly on price deflation. Since a large proportion of United States imports of consumer goods is supplied by Asian countries with relatively stable currencies against the dollar, or from Mexico – where capital inflows have kept the currency relatively stable against the dollar – the dollar depreciation has had little impact on United States import prices which, in fact, have been falling. This, together with the falling prices of domestic manufactures over the last few years, is one of the main reasons why the Federal Reserve has been able to pursue an aggressive easing of monetary policy without the risk of importing inflation. However, in the absence of effective currency alignments and rapid growth in Europe and Japan, external adjustment will call for a faster decline in costs and prices in the United States than in the economies that are its main trading partners. Given the risks of such a deflationary process, not only for the United States but also for the global economy, it may become necessary for the East Asian countries to stop resisting the appreciation of their currencies against the dollar. While this may reduce the foreign demand for dollar assets, including United States treasuries, the Federal Reserve has already announced that if there is any fall in the demand for United States securities that pushes up the yield curve, it is willing intervene to keep long rates from rising.

The exchange rate adjustments that are now occurring are unlikely to reduce global trade imbalances by an appropriate redistribution of global demand, nor are they likely to support global recovery.

For emerging-market economies, these currency movements can be an additional source of instability. Indeed, the volatility of capital flows and exchange rates has already made policy in some emerging-market economies, such as Argentina, Brazil and Turkey, more restrictive than is warranted by domestic and global conditions. The sharp devaluations in the currencies of these countries were associated with the reversal of capital flows in the past two years and led to a return of inflation, which has been fought with a large increase in interest rates. Despite the fact that, in general, these were one-off increases in the price level, interest rates have been kept very high relative to domestic requirements, thus threatening the sustainability of public debt. As a result, the currencies of Argentina, Brazil and Turkey have started to appreciate at precisely the moment when they should be preserving competitiveness in order to improve their current-account positions and adjust to reduced inflows of capital. Even after the depreciation of the dollar and the appreciation of their currencies, there has been little easing of monetary policy in these countries despite the fact that inflation rates have started to come down.

> Without a coordinated expansionary action the international monetary and financial system is likely to remain highly unstable.

In the rest of the world prices have been stable or declining, raising the possibility of deflation in a number of countries, including China, Germany, Japan and the United States, and other countries now seem to be following this trend. The basic impact of deflation is to increase the burden of debtors, as countries with large external debts will have to export more to meet debt service requirements in conditions where both export prices and export volumes are falling or stagnant. Since the United States and the emerging-market economies of Latin America are net debtors, and the EU and East Asia are net creditors, this suggests that conditions in the debtor countries will deteriorate relative to the creditor countries if there is a generalized global deflation. However, the depreciation of the dollar allows the United States to avoid much of the negative impact of global price declines, since international claims on the United States are denominated in dollars and are thus reduced by a depreciation of the currency. Since the indebted developing countries do not enjoy this privilege, they are even more exposed to global deflation than other countries.

Thus the exchange rate adjustments that are now occurring are unlikely to reduce global trade imbalances by an appropriate redistribution of global demand, nor are they likely to support global recovery. Rather, they appear to be reinforcing the external imbalances that currently exist, and thus increasing the volatility of capital flows and the instability of exchange rates in developing countries. Global growth will continue to depend heavily on the performance of the United States economy even if expansionary measures are taken by the EU and Japan.

The danger facing the United States economy is that imbalances and excesses created during the boom of the 1990s could result in a long period of unstable and sluggish growth, with occasional surges as well as dips, accompanied by a process of deflation, very much as in Japan during the past 12 years. The evolution of the economy over the past three years suggests that this may indeed be a potential threat. Decisive action may thus be needed in order to avert such an outcome, particularly if deflation starts to deepen and threatens to set off a downward spiral as a result of a sharp drop in consumer spending. The monetary authorities have already indicated their willingness to use all possible means to fight deflation by injecting money into the economy in order to induce price rises through measures including purchases of long-term government paper, making low-interest loans to banks and accepting private debt as collateral.[5] However, much of the task of stimulating the economy will fall on fiscal policy. Although the federal budget is currently running a deficit as a result of tax cuts, there may be a need to re-orient public spending if it is to have a greater impact on employment. This may call for increased public investment in areas that did not share in the rapid expansion of the 1990s, such as public infrastructure, health and environment. Finally, should serious financial difficulties emerge in the household and business sectors, much in the same way as in Japan, more decisive and prompt action would be required to restructure and reduce debt in order to avoid the same outcome as in that country.

In Japan, there is some room for monetary expansion to help ease deflationary pressures, and this can be supplemented by fiscal expansion. But neither is likely to reverse the deflationary process that has been under way for more than a decade. Action should thus simultaneously focus on financial and corporate restructuring in order to remove the structural impediments to revitalizing the economy. The EU, by contrast, has much greater scope for expansionary monetary and fiscal action, which can supplement and support the United States recovery and play a significant role in reviving the global economy.

Deflation is a global problem, with too many goods chasing too few buyers and too many workers chasing too few jobs. Under such circumstances currency movements only serve to redistribute the deflationary gap and unemployment among countries without bringing much support to global recovery. For the same reason, without a coordinated expansionary action the international monetary and financial system is likely to remain highly unstable, resulting in sharp and unexpected movements in capital flows and exchange rates, thereby straining trade relations. Monetary policy coordination can play an important role in bringing about stability to capital flows and an orderly realignment of exchange rates if it is combined with coordinated fiscal expansion.

Global deflation constitutes a serious problem for developing countries. Many successful exporters now face excess capacity in sectors supplying foreign markets, and this tends to intensify price and exchange rate competition, thereby adding to global deflationary forces. Others, particularly those with serious foreign debt problems, face stringent external conditions and are forced to cut imports at a time when there is a glut in global markets. Action on the external debt of developing countries, particularly on their official debt, in order to provide them with more breathing space, as well as a rapid expansion of international liquidity through various means – including a sizeable allocation of SDR to countries facing stringent external financial conditions – should be an integral component of an international strategy for fighting global deflation. ■

Action on the external debt of developing countries as well as a rapid expansion of international liquidity should be an integral component of an international strategy for fighting global deflation.

Notes

1 Bank of Mexico Press Release "La Balanza de Pagos en 2002", 27 February 2003, p. 4. In its Press Release "Trayectoria Reciente de las Principales Variables Económicas y Financieras", 23 May 2003 the Bank notes that investment declined by nearly 3 per cent in real terms in February 2003, year-on-year, and that investment growth was negative in 18 of the last 23 months.

2 "SARS and Asia's Economy: Impacts and Policy Recommendations", speech by Ifzal Ali, Chief Economist, Asian Development Bank, 13 May 2003, Beijing (www.adb.org).

3 Somewhat paradoxically, given the increased financial fragility that the substitution of short-term for long-term flows represents, and the continued deterioration in prospects for a global economic recovery, the international credit rating agencies have upgraded the debt of some economies such as Brazil. In early 2003 Brazil returned to the capital markets with a sovereign issue and Mexico has retired all of its remaining Brady debt.

4 The Major Currency Index contains the currencies of seven industrialized countries which, together, have a 55 per cent weighting in the Broad Index. The weight of the Euro area in the Broad Index is 17 per cent. The Other Important Trading Partner Index is designed to capture movements of the dollar against key United States trading partners in the developing world. The share of East Asian countries in this index is 62 per cent and that of Mexico is 20 per cent. For these exchange rate indexes see *Federal Reserve Bulletin*, 1998: 811–818.

5 This was most explicitly stated and discussed by Ben S. Bernanke, Governor of the Federal Reserve System, in a discourse before the National Economists Club, Washington, DC, 21 November 2002: "Deflation: making sure 'It' doesn't happen here".

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