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LINK Global Economic Outlook

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Introduction

This global economic forecast was prepared by staff of the Economic Monitoring and Assessment Unit, of the United Nations Department of Economic and Social Affairs based on inputs from national LINK centres and information from other sources as of 31 March 2004. The major global assumptions underlying the forecast are set out in the Box below. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the websites of both the United Nations and the University of Toronto.[1]

Major assumptions for the baseline forecast

The United States Federal Reserve is expected to keep the target interest rate at 1 per cent until the third quarter of 2004, raising it gradually into 2005; the European Central Bank is expected to maintain its current monetary stance until the end of 2004, followed by a gradual tightening in 2005; and the Bank of Japan is expected to increase the Bank's outstanding balance by about 10 per cent in 2004 from the average level of 2003, retaining the policy interest rate at zero.

The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements.

The international price of oil is assumed to be $28 per barrel of Brent crude oil in 2004 and $27 in 2005 (compared to $28.80 in 2003).

The future international prices of other major commodities are based on the forecasts contained in the World Bank publication, *Global Economic Prospects 2004*, with some adjustments to take into account more recent developments.

The United States dollar is projected to continue depreciating against the euro and the Japanese yen, reaching $1.30 per euro and Yen 105 per dollar by mid-2004, but to strengthen thereafter, reaching $1.20 per euro and Yen 110 per dollar by the end of 2005. These assumptions are based on the expectation that the pressure on the dollar arising from the large external deficit of the United States will be counter-balanced by favourable effects from the growth differential between the United States and other major economies.

[1] http://www.un.org/esa/analysis/link and http://www.chass.utoronto.ca/link.

Overview

The momentum that the world economic recovery gathered in the second half of 2003 has strengthened further in 2004. As projected and delineated in the previous LINK forecasting exercise,[2] the global economic recovery has broadened to include a growing number of economies and has strengthened across sectors. Gross world product (GWP) is forecast to grow by 3.7 per cent in 2004, slightly more than previously projected (see table 1). The accelerating phase of the expansion in most economies is, however, expected to end gradually in the second half of 2004, with the growth of GWP moderating to 3.4 per cent in 2005. The key challenge for policymakers worldwide is to achieve, to the maximum extent possible, more balanced global growth and, at the same time, to control the downside risks so as to avoid a reversal.

Notwithstanding the conspicuous differential in economic vigour among regions and individual economies, the improvement in growth prospects is almost ubiquitous. The economy of the United States continues to expand apace, with the latest indication of a long-awaited revival in employment providing the missing linchpin for a more secure continuation of economic expansion in the future. The recovery in Japan has been stronger and more tenacious than expected by most analysts, raising the probability of a turning point and the extrication of the economy from its decade-long stagnation and deflation. Economic activity in most Western European economies has been largely anaemic, but there are signs of a gradual improvement. Meanwhile, most economies in transition, which fared relatively well in the past global downturn, seem likely to increase growth further in the global upturn. For their part, developing economies in Asia have been further strengthening their performance, with the dynamism of their international trade generating growing synergies for the region and enhancing its role as a locomotive for global growth. However, emerging signs of overheating in some sectors and areas in China—the primary driver of growth for the region—have raised concerns. A noticeable increase both in the demand for and in the prices of commodities has contributed to growth in more and more economies in Latin America and Africa, but further improvements in economic policy, as well as additional structural reforms, remain crucial if these regions are to attain the higher, sustainable rates of growth necessary to achieve meaningful development progress. In Western Asia, economic prospects for many economies are still vulnerable to political instability and geopolitical tensions. Such factors also remain the main sources of uncertainty for the global economy as whole.

For many economies, the recovery was initially driven by policy stimuli and/or external demand, but has gradually developed broad strength based on domestic demand. The downturn in 2000-2001 was characterized by a beleaguered business sector, featuring a substantial decline in global capital spending, a precipitous fall in world equity prices and a significant drop in corporate profits, along with higher unemployment and larger excess capacity. The extent of the current recovery can be gauged from developments regarding each of these variables. Business profits and business investment have been recovering strongly, particularly in some major

[2] Although there was no LINK Meeting in the second half of 2003, an abridged forecast was made based on inputs from a number of national LINK centres in November 2003. The resulting outlook was published in *World Economic Situation and Prospects 2004*, (United Nations Publication, Sales No. E.04.II.C.2; www.un.org/esa/policy/index.html).

Table 1. Gross domestic product and world trade
(Annual percentage change)

	November 2003 forecasts			April 2004 forecasts[a]		
	2003	2004	2005	2003[b]	2004	2005
Gross world product	2.5	3.3	3.3	2.6	3.7	3.4
PPP weighted	2.9	3.7	3.8	3.1	4.2	3.9
Developed market economies	2.1	2.9	2.8	2.0	3.2	2.8
Canada	1.9	2.2	3.5	1.9	2.2	3.2
France	0.5	1.7	2.3	0.2	1.7	2.5
Germany	0.0	2.0	2.2	-0.1	1.5	2.3
Italy	1.0	2.0	2.4	0.4	1.0	2.3
Japan	2.7	2.0	1.9	2.7	3.1	2.0
United Kingdom	1.9	3.0	2.6	2.4	3.3	2.7
United States	3.0	4.2	3.7	3.1	4.7	3.6
Memo items:						
EU	0.9	2.2	2.5	0.8	1.9	2.4
Euro zone	0.6	2.0	2.4	0.4	1.6	2.4
Economies in transition	4.9	4.9	4.6	5.8	6.1	5.7
Russia Federation	6.0	5.0	4.5	7.3	7.8	6.4
Developing countries	3.8	4.7	4.9	4.3	5.1	5.3
Latin America and the Caribbean	1.3	3.3	4.1	1.7	3.6	4.1
Argentina	5.5	3.5	4.0	8.4	4.0	4.0
Brazil	0.5	3.0	3.9	-0.1	3.2	4.4
Mexico	1.6	3.8	4.8	1.3	3.5	4.5
Africa	3.2	4.1	4.7	3.3	4.1	4.8
North Africa	4.1	4.3	5.6	4.2	4.0	5.2
Sub-Saharan Africa[c]	2.9	4.8	4.9	2.9	5.1	5.5
Nigeria	4.3	5.0	4.9	3.5	3.8	3.9
South Africa	2.0	3.1	3.5	1.9	3.3	3.5
South and East Asia	3.9	4.9	4.9	4.5	5.5	5.2
India	6.1	6.3	6.0	6.5	6.3	6.1
Indonesia	3.9	4.5	4.4	4.2	4.5	4.4
Korea, Republic of	2.7	4.9	5.5	3.1	5.5	5.1
Malaysia	4.2	4.5	4.4	5.2	6.1	5.2
Philippines	3.9	4.3	4.1	4.5	4.9	5.3
Thailand	5.8	5.8	4.7	6.7	5.9	4.8
China	8.7	8.0	7.5	9.1	8.5	8.2
Western Asia	3.2	3.9	4.7	3.5	3.2	4.2
Oil-exporting countries	2.6	3.5	4.3	3.5	3.1	4.2
Oil-importing countries	4.0	4.4	5.3	3.6	3.4	4.1
World export volume	4.6	6.7	7.1	4.9	6.8	7.4
Oil price (Brent, $ per barrel)	28.0	25.0	25.0	28.8	28.0	27.0

[a] Pre-meeting forecasts.
[b] Actual or most recent estimates.
[c] Excluding Nigeria and South Africa.

developed economies, but also in a number of developing countries. In the United States, for example, business investment in equipment and software has returned to the peaks of 2000 in both nominal and real terms. Meanwhile, rates of capacity utilization have also been rising steadily in a growing number of countries. Equity markets have recuperated to a large degree, but most equity prices are still lower than their previous "irrationally exuberant" peaks.

In contrast, the recovery of employment has been slow. Signs of improvement in labour markets are discernable in some economies: the number of layoffs has been declining and unemployment rates have stabilized, or even fallen, in some cases. However, employment growth remains weak. Although the recovery in the labour market usually lags the upturn in other economic indicators, the current delay seems to be much longer than in previous business cycles.

In developed economies, the weak employment growth in Western Europe, and to some extent also in Japan, could be partially attributable to the slow growth of gross domestic product (GDP), but in the United States the contrast between robust GDP growth and persistent weakness in the labour market has been puzzling.[3] Some observers have ascribed the hesitant recovery in the labour market to strong productivity growth, as businesses have continued to benefit from the rapid innovations in information and communication technology (ICT) over the past decade, allowing them to raise output without much increase in labour input. Other analysts blame the weak employment growth on increased global economic integration, arguing that the increase in imports from developing countries has led to reduced job creation in manufacturing in the United States, while outsourcing has reduced domestic job opportunities in the services sector. These explanations may be partially true at the firm or industry levels, but do not hold at the macroeconomic level where efficiency gains from either technological change or international economic integration should not harm aggregate employment as long as effective demand grows in tandem with potential output growth. The delayed recovery in economy-wide employment in the United States is not a result of the efficiency gains per se, but the consequence of a lag, or failure, in translating these gains into a sufficient effective demand. For instance, the productivity gains in the United States have so far taken the form of a higher return to capital (as reflected in the surge in corporate profits), while the gains to labour have been only a minuscule rise in wages.

Unemployment pressures in developing countries and economies in transition are even more severe. So far, only a small number of countries in Asia and in the group of economies in transition have registered cyclical recovery in unemployment rates. Even so, the unemployment rates for most Asian economies are still far above levels prior to the Asian financial crisis of the 1990s, while, despite the improvement, unemployment rates in the economies of transition are still high. Similarly, the high unemployment in many developing economies, with rates reaching 20 per cent or more in some countries in Africa and Latin America, will not be resolved by a cyclical upturn alone but requires longer-term measures.

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[3] Strong growth in payroll employment was finally registered in March 2004, but a continuation in coming months is necessary to confirm a steady recovery in the labour market of the United States. Although the unemployment rate in the United States has fallen from a peak of 6.3 per cent in mid-2003 to 5.6 per cent in March 2004, the improvement has been mainly due to a drop in the labour force participation rate, particularly for younger people; the unemployment rate would otherwise have been about 7 per cent.

The baseline forecast predicts a progressive and cyclical improvement in the employment situation in 2004-2005 as the global economic recovery solidifies further. On the other hand, the longer the delay in the recovery of employment, the higher the downside risk for a relapse in the global recovery, as consumer confidence will be eroded and household spending will falter. As part of the effort to avoid this situation, government policies should include reforming labour market rigidities and providing training and assistance to workers who are in transition as a result of technological change or global economic integration. Protectionism will not lead to an efficient solution of unemployment problems.

Over the past several months, the international economic environment for developing countries and economies in transition has become more favourable. A growing number of these economies are benefiting from the revival of international trade, rising prices of commodities and increased capital inflows. A further strengthening of this environment will, however, require more progress in international cooperation. For example, with the volume of world exports projected to grow by about 7 per cent in 2004-2005, the ratio of the growth of trade to that of GWP will be less than the average of the 1990s. Without a significant breakthrough in the Doha Round, it will probably be difficult for the growth of international trade to maintain its dynamism beyond the current cyclical recovery.

External financing conditions for many developing countries and economies in transition improved in 2003. Net capital flows to emerging market economies have increased significantly since mid-2003,[4] reversing the downward trend since the Asian financial crisis of 1997-1998. Encouraged by the improved prospects for the world economy, low interest rates in the developed countries, a recovery in global equity prices and the efforts to improve policies in a number of emerging economies, all types of net private capital flows to this group of countries are on the rise. Foreign direct investment (FDI) is expected to rebound in 2004 after several years of downward drift, while portfolio investment has rebounded over the past year, as most emerging stock markets have outperformed equity markets in developed countries recently. The recovery in private credit flows has also been significant: increased global liquidity and improved investor confidence have been beneficial for bond issuances by emerging economies, while financing costs, as measured by the yield spreads of emerging market bonds over the United States Treasuries, have declined to their lowest levels since the Asian financial crisis (see figure 1). Net commercial bank lending has turned positive for the first time in seven years and will likely continue to increase in 2004.

The international prices of many commodities have risen strongly in the past year. Some, such as the prices of petroleum, metals, fats and oils, have surged very recently, rising 50 per cent or more over a year to reach their highest levels in several years. Rising global demand is a common factor behind the recovery of these prices, particularly the strong growth in China's demand for raw materials and energy. For instance, in 2003, China's GDP elasticity reached 1.7 for electricity, 2 for iron and steel and above 2 for nonferrous metals, compared to a world average of around 0.5. The substantial depreciation of the United States dollar vis-à-vis other major currencies may also have contributed to the higher prices of commodities: historically,

[4] The group of emerging market economies refers to some 30 large developing countries and economies in transition that have largely integrated into the global trade and capital markets. Most other developing countries, the large majority, can barely access global capital markets.

these prices, since they are mostly quoted in United States dollars, tend to move inversely with the exchange rate of the dollar.[5] At the same time, supply constraints, such as the poor soybean harvest and labour disturbances at some mineral sites, have also pushed up the prices of specific commodities. The outlook for the prices of most non-fuel commodities remains firm in the short run, but the long-term secular trend continues to be downward, particularly if measured in terms of real purchasing power. Meanwhile, the high volatility of these prices is expected to persist.

Petroleum prices have remained high for the past year, recently surging to the highest level in a decade. Despite the fact that the price of petroleum has been significantly above the OPEC target range of $22-$28 per barrel, the cartel has continued to announce production cuts, partly in an attempt to adjust the target to take account of the depreciation of the United States dollar. At the same time, global demand for oil has been on the rise due to accelerating world economic growth. In addition, geopolitical concerns have increased pressure for many countries to build or replenish strategic petroleum reserves, adding to global oil demand. Since the forecast is that the depreciation of the United States dollar may have bottomed out, OPEC is expected to be less aggressive in reducing production, but global oil demand will continue to be strong. The prices of petroleum in 2004-2005 are therefore expected to be at the upper level of the OPEC target, moderately lower than the current level.

Rising commodity prices have benefited many commodity-exporting countries, improving their growth outlook, but concern about the implications for global inflation has also been growing. The pass-through of higher commodity prices to overall inflation has so far been negligible, suggesting that a large proportion of the rise in the prices of commodities has been absorbed by producers and distributors, instead of being passed on as higher prices to consumers. Headline inflation has edged up in a large number of countries, but "core" inflation measures—excluding such volatile components as food and energy prices—remains tame, and some economies that previously had rapidly increasing price levels, such as a few Latin American countries and economies in transition, have reduced inflation further. In some other economies, deflationary pressures have been dissipating; in China, mild deflation for the past few years has been replaced by moderate inflation.

In addition to higher commodity prices, other potential inflationary factors include: for dollar-related economies the depreciation of the United States dollar, in which a large part of international tradables are invoiced, and the associated unsterilized foreign exchange interventions by central banks in a number of economies; the relatively high and growing fiscal deficits in many countries; and overheating, or exuberance, in some economies. If not carefully managed well, any of these factors could trigger a rise in global inflation. Overall, however, while the risk of global inflation in rising, it is not seen as a major threat in the baseline forecast. Whereas the former risk of global deflation has been significantly reduced.

[5] While a precise relationship between the prices of commodities and the exchange rates of the dollar may be difficult to establish, two factors can explain the connection. First, investors may use commodity markets to hedge against the depreciation of the dollar and, second, some commodity producers may be able to take into account a change in the exchange rates of the dollar in their pricing, even if their pricing power is limited.

On the other hand, there are several counterforces to inflation. The monetary policy of many central banks is focused on controlling inflation, with prevailing policy rules in a number of central banks inherently engineered to be more aggressive in fighting inflation than on handling deflation. Macroeconomic management in many developing countries has improved. Global integration has increased international competition and thus curbed monopoly power.[6] Technological innovations have raised productivity growth. Various economic reforms, in domestic markets as well as in international trade and financial systems, have reduced rigidities and barriers. As long as these factors persist and firmly anchor low inflationary expectations, global inflation should remain under control.

Given this generally benign inflation environment, global monetary policy has remained accommodative, with only a few exceptions (see table 2). While it appears that the three-year cycle of global monetary easing is about to end, a number of central banks have indicated that they will show restraint in raising interest rates. The baseline forecast assumes a gradual increase in policy interest rates by major central banks in late 2004, but a number of economies that are behind in the recovery cycle could maintain low interest rates for a longer period. The challenge is to judge the uncertain lag between the activation of monetary policy and its effects on the economy; this will require finesse by central banks, in addition to a sound policy framework.

The challenge for fiscal policy in many economies is even greater. Current fiscal policy stances vary substantially from country to country. Among the developed countries, fiscal policy remains the most expansionary in the United States, modestly stimulatory to neutral in most West European economies and restrictive in Japan. Fiscal policy has been stimulatory in most Asian developing economies, mainly restrictive in Latin America, and mixed in other developing regions and in economies in transition. However, one common trend throughout the world is the widening of government deficits, accompanied by rising public debt. The exceptions are few, one being as the Russia Federation, with its large budget surplus from increased oil revenues. Several Latin American economies have also made notable progress in achieving a surplus in their primary balances as a result of more disciplined fiscal policy in recent years. Most economies are expected to have to undertake fiscal consolidation in the next few years. Although few have started this process, fiscal policy in general will become less stimulatory around the world in 2004-2005.

While the deteriorating fiscal position has led to increasing debate in many countries, the situation in the United States has drawn special attention. The fiscal position of the United States has eroded rapidly over the past few years, with the budget balance swinging from a surplus of above 2 per cent of GDP in 2000 to a deficit of about 4 per cent of GDP in 2003. Even the most optimistic projections show that large deficits are likely to persist for a considerable period of time if there is no major change in the policy framework.

It is estimated that about half of the change in the United States' budget balance was due to the recession of 2001 and the response to it of the built-in "automatic stabilizers"—reduced tax receipts due to a smaller base of income and capital gains (the latter resulting from the

[6] Increased exports from China, for example, have prevented international prices of manufactured goods from rising. At the same time, China has played a dual role in the global inflation environment because its strong growth has contributed to higher commodity prices.

Table 2. Changes in policy interest rates

	Level at 2 Apr 2004 (per cent)	Change from Dec 2000 (basis points)
Developed Countries		
Canada	2.25	-350
United States	1.00	-550
Japan	0.00	-25
Euro zone	2.00	-275
United Kingdom	4.00	-200
Norway	1.75	-525
Sweden	2.00	-200
Switzerland	0.25	-325
Australia	5.25	-100
New Zealand	5.25	-125
Economies in transition		
Czech Republic	2.00	-325
Hungary	12.25	50
Poland	5.25	-1375
Developing countries		
Brazil	16.25	50
Chile	1.75	-625
Mexico	6.05	-1112
China	5.31	-54
Hong Kong [a]	2.50	-550
India	6.00	-200
Indonesia	7.42	-700
Korea, Republic of	3.75	-150
Philippines	6.75	-675
South Africa	8.00	-400
Taiwan Province of China	1.38	-325
Thailand	1.25	-25

Source: JP Morgan.
[a] Special Administrative Region of China.

decline in equity prices) and increased expenditures for income support and related programmes. The other half of the deterioration was due, roughly equally, to two other factors: increased discretionary spending, mainly on defense and homeland security; and changes in tax policy, including the tax cuts enacted during the past few years. Both the automatic and discretionary measures have provided useful stimuli to the economy, preventing it from slipping into an otherwise deeper recession and boosting a recovery, but concerns are rising regarding the fiscal sustainability of the United States.

There are different views regarding the implications of the tax cuts made in the United States, including whether they should become permanent and the consequences of the resulting budget deficits both for economic growth in the medium- and long-run and for the solvency of the country's social security systems. Proponents argue that the tax cuts will improve economic efficiency by stimulating supply-side incentives for workers and firms, thus leading to higher growth. Opponents, however, contend that any efficiency gains will eventually be outweighed by the costs associated with the large deficits, which will crowd out private business investment and lead to lower productivity in the longer run.

The United States' fiscal deficit also has implications for global economic growth and stability. The fiscal stimuli adopted in the United States have played an important role in the recent global economic recovery, but international concerns are growing that the country's large government deficit might lead to higher long-term interest rates in global capital markets and to a consequential dampening of global investment and growth in the longer run. Moreover, the inextricable linkages among the fiscal deficit, the external deficit and the exchange rates of the dollar vis-à-vis other currencies mean that the fiscal deficit has direct and significant risks for the stability of the world economy.[7]

In this sense, the notion of the United States as the locomotive for global growth becomes more complex. The United States has contributed about 30-40 per cent of the growth of the world economy in the past few years and the recovery of many economies has been dependent on their exports to the United States. This "locomotive" has, however, been powered by resources borrowed from the rest of the world: the current account deficit of the United States, a measure of how much of the spending by the United States is financed by borrowing from abroad, is more than 5 per cent of GDP. The sustainability of the United States economic expansion is therefore crucially dependent on the willingness of the rest of the world to continue to lend the United States by accumulating United States' assets, mostly United States Treasury Bonds.[8] Such a cycle of interdependency between the United States and the rest of the world is unlikely to prove sustainable.

In addition to the risks mentioned above, there are other caveats to the baseline forecast. In addition to public debt, private debt is also rising in many economies and this may expose a

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[7] A detailed discussion of the risks associated with global imbalances and exchange rates can be found in *World Economic Situation and Prospects 2004* (United Nations publication, Sales No. E.04.II.C2; www.un.org/esa/policy/index.html).

[8] Asian central banks are estimated to finance about half of the United States annual external imbalance by accumulating dollar-denominated reserves.

vulnerability if interest rates rise in the future. There are also periodic reminders of the risks that terrorism and geopolitical uncertainties continue to pose to the health of the world economy.

Developed economies

After exceptionally strong growth in the second half of 2003, the outlook for the economy of the *United States* remains robust in 2004. Leading the way has been the acceleration in business investment in equipment and software. Growing at a double-digit pace, business capital spending has fully recovered to the peak level of 2000, buttressed by a solid improvement in corporate profits and historically low interest rates. Meanwhile, despite a slight moderation, consumer spending continues to grow robustly and exports, which have also been sluggish for the past few years, have revived. On the supply side, labour productivity has risen at an exceptionally strong rate, and continues to improve. While monetary policy remains accommodative as a result of the benign inflation environment, fiscal policy continues to be stimulative, though less than in the previous year.

A patent weakness in the economy has been the slower-than-anticipated recovery of employment. Although the layoffs have declined, there was almost no growth in new hirings of workers until March 2004. Gains in productivity from technological innovations and other structural changes may have delayed hiring to date, but it is expected that the employment situation will improve over the course of 2004. A further delay in employment growth, however, could cause consumption to falter. Another downside risk, described above, is the deteriorating fiscal position, and the closely related widening external deficit and weakening of the dollar vis-à-vis other major currencies.

Economic activity in *Western Europe*, with the exception of the *United Kingdom*, has been sluggish to date but the baseline forecast is for a continuation of the gradual recovery. The weak growth so far has been primarily supported by net exports, along with an increase in inventories and some recovery in fixed investment; consumer spending has been dragging. Across sectors, industrial production rose significantly in late 2003, although weakening slightly at the beginning of 2004, with most of the strength being in the intermediate, energy and capital goods sectors. The service sector was much weaker. Survey results indicate that, after a sharp improvement in industrial confidence over the past several months, there have been some signs of relapse lately, reflecting wavering views about future business conditions. The gradual rebound will continue to rely on an expansion of exports and investment spending. Consumption is expected to pick up, but not to the extent that it plays a major role in generating growth. The slow improvement in labour market conditions, coupled with the uncertainties stemming from the outlook for reforms regarding pensions, health care and labour market, could cause consumers to raise savings rates, dampening consumption.

Despite appreciation of the euro, which negatively affects European exports to those countries whose exchange rates have moved with the United States dollar, the strength of world activity is expected to be sufficient to generate a significant acceleration in exports.

Inflation in the area remains close to 2 per cent, the upper limit set by the European Central Bank (ECB), but there have been significant differences across countries. For example, there is a difference of more than one percentage point between inflation in France and in Germany. Such across-country inflation differentials pose a challenge for the single monetary policy in the euro area. In the forecast, inflationary pressures are expected to continue to subside and the ECB is expected to maintain its current policy stance for a considerable period; the United Kingdom, on the other hand, has already raised interest rates and further tightening is expected.

With few exceptions, 2003 saw a major deterioration in budgetary conditions across the region. France and Germany exceeded by wide margins the 3 per cent limit for the deficit-to-GDP ratio embodied in the rules of the Stability and Growth Pact (SGP), and a few other countries also came close to missing this target. Fiscal policy is expected to become moderately restrictive in many countries over the course of 2004-2005 as governments attempt to consolidate budgets, although the consolidation is not expected to be so abrupt as to stall the recovery. On the other hand, there are major downside risks associated with the path of exchange rates: appreciation of the euro beyond a certain point could precipitate a reversal in a number of countries in the region.

With GDP increasing at 7 per cent rate at the end of 2003, its best quarterly performance in 15 years, the economy of *Japan* is expected to grow by about 3 per cent in 2004. The resurgence has been driven mainly by exports: exports to China, for example, surged by 44 per cent during 2003. The external-demand-led recovery has gradually been feeding through to the domestic sector, with an increasing number of companies showing positive domestic earnings. Business capital spending is growing at a brisk pace as corporate profits grow strongly, and the latest surveys show that the improvement in corporate investment conditions is broadly based. For economic growth to become more self-sustained, the strength of the business sector needs to be transferred to the household sector through increases in wages and employment.

Although the protracted deflationary pressure has abated with a rise in the prices of domestically produced goods, elimination of the possibility of deflation requires action to be taken with regard to a number of structural problems, such as the large volume of non-performing loans, the fragile financial positions of both the public and the private sectors and the need for corporate restructuring. While monetary policy is expected to be accommodative, with the zero interest rate being maintained for a long period, the effectiveness of this policy will continue to be hampered by the fragility of the banking system. Fiscal policy will remain restrictive, focusing on reducing the heavy government indebtedness.

The substantial appreciation of their currencies vis-à-vis the United States dollar has had an adverse impact on *Australia, Canada, and New Zealand*, making monetary conditions in these economies more restrictive than indicated by their domestic interest rates. After a slowdown in 2003, GDP growth in Canada is expected to recover in 2004. While the Central Bank of Canada is expected to reduce interest rates further to strengthen domestic demand, exports are forecast to pick up as demand from the United States increases and offsets the negative price effects from the appreciated Canadian dollar. In Australia, the momentum that has been gathering since the middle of 2003 has strengthened further in 2004. This strength has been broadly based, with consumption, residential construction and business investment all growing robustly. Meanwhile, net exports, which had dragged for the past few years and offset strong domestic demand, have also started to show some improvement, due to the more conducive international economic climate. Some moderation in GDP growth is expected in late 2004, as the rise in household debt, housing prices and the external deficit all seem to be unsustainable. In New Zealand, after growth averaging 3.7 per cent annually for the past five years, the strength of the economy is expected to moderate in 2004-2005. A decline in the saving rate, which has reached -10 per cent of current disposable income, threatens to slow the economy, particularly if housing prices reverse when net immigration eventually moderates.

Developing countries

GDP growth in *Africa* is expected to accelerate in 2004-2005 as many countries achieve an increase in agricultural and industrial output. Higher consumer spending, increasing investment, including more FDI in several countries, and expanded, though cautious, government expenditure in a growing number of countries are expected to support rising domestic demand. Meanwhile, a more auspicious external environment, including higher prices of commodities and increased demand for Africa's exports, should improve the prospects of a large number of countries in the region.

In North Africa, GDP growth is forecast to be sustained at around 4 per cent in 2004. Increased oil revenues will support the growth of both private and public consumption in Algeria, Egypt and Libya. Improved relations between Libya and the United States, as well as the thawing of political relations between Libya and the United Kingdom, are expected to spur inflows of foreign investment into Libya for infrastructure development and for repair and modernization of oil-production facilities. Rising industrial output and an increase in services related to tourism in Egypt, Morocco and Tunisia are also expected to improve North Africa's overall growth. The anticipated recovery in the European Union (EU) will be an additional factor contributing to enhanced economic growth in the sub-region.

GDP growth for sub-Saharan Africa, excluding Nigeria and South Africa, is forecast to accelerate to 5 per cent in 2004 from 3 per cent in 2003; including Nigeria and South Africa, the regional average is expected to be 4 per cent in 2004, up from 2.6 per cent in 2003.

Growth in 2003 varied widely across sub-Saharan countries. South Africa registered only 1.9 per cent GDP growth, against forecasts of 3 per cent earlier in the year. South Africa's export gains in 2003 were severely eroded by the loss of competitiveness stemming from the sustained appreciation of the rand vis-à-vis the dollar. Overall, growth is expected to rebound to over 3 per cent in 2004 on the basis of consumer demand driven by lower inflation and lower interest rates, increased investment spending and an expansionary fiscal stance targeted at poverty reduction, employment creation and the fight against human immunodeficiency virus/acquired immunodificiency syndrome (HIV/AIDS). In Nigeria, higher oil-export revenues, increased public and private consumption and a moderate increase in agricultural output sustained GDP growth in 2003 and are expected to persist in 2004.

Elsewhere in sub-Saharan Africa, oil-producing countries will continue to benefit from increased oil prices: GDP in new oil-producing countries, such as Chad and Equatorial Guinea, is growing at a double-digit pace. The same is true in Angola where new production facilities have boosted output significantly. Several countries that have made progress in political and economic reforms, such as Benin, Botswana, Ghana, Mauritius, Mozambique, the United Republic of Tanzania and Uganda, are expected to sustain growth rates in the range of 4-6 per cent in 2004. Countries that have recently emerged from conflicts, such as the Democratic Republic of the Congo, Liberia and Madagascar, are also expected to register high rates of growth. Increased South African investment in infrastructure development and increased industrial capacity in minerals and metals processing for export markets will continue to underpin growth in several countries in southern Africa, particularly Mozambique and Namibia.

Cote d'Ivoire, Ethiopia and Zimbabwe suffered economic contraction in 2003, but a recovery is anticipated for both Cote d'Ivoire and Ethiopia in 2004. Conversely, Zimbabwe's severe economic decline, which has resulted in a cumulative contraction of output of over 50 per cent over the past five years, is expected to continue into 2004, although the contraction will likely be less severe than in the past three years.

Fiscal and monetary policies in most African countries were generally cautious in 2003, reflecting the gains that some countries have made in recent years in improving political governance and economic management. This trend also reflects the need for several recipient countries to adhere to performance criteria established by multilateral lending institutions and donor countries as underlying conditions for external financial assistance and debt relief. Inflation was contained at single-digit levels in most African countries, but larger increases in consumer prices were recorded in countries suffering from food shortages, higher costs of imported oil and petroleum products, currency depreciation and excessive liquidity.

The short-term outlook for Africa is favourable in the absence of any major supply-side shocks to domestic output, such as adverse weather conditions that would disrupt agricultural output. Expectations of a more favourable external environment in 2005 have improved the prospects for export revenues from oil and non-oil commodity exports, as well as for exports of manufactured goods to the EU and the United States under improved market-access agreements. However, several countries—most prominently Algeria, Ghana and Niger—are considered vulnerable to political tensions and a loss of fiscal discipline in view of presidential and parliamentary elections scheduled in 2004.

Economic growth is accelerating in *Eastern Asia*, fueled by the region's traditional dynamism—trade. A recovery in the second half of 2003 was initiated by strengthening demand from the United States and an upturn in global ICT product markets. While the impetus from powerful growth in China continues to increase, a better-than-anticipated recovery in Japan has added new strength to the region's growth, engendering a rapid expansion of intraregional trade. Meanwhile, supported by expansionary policies, rebounding equity prices and increased confidence, private consumption and business investment have strengthened further, with a broad-based recovery in both the service and manufacturing sectors. Moreover, imports in a growing number of Asian economies have recently begun to outpace exports, suggesting an increasing contribution to the recovery in the rest of the world. At the same time, the improvement in labour markets has been relatively weak. Although unemployment rates have tentatively declined in some economies, they are still well above the levels prior to the Asian financial crisis of 1997 for most economies. Inflation remains subdued in the region, and the small number of economies that experienced deflation in the past have either reversed it or improved the situation. The surge in the prices of commodities and the policy interventions in foreign exchange markets seem to have increased inflationary pressure in some economies, presaging a gradual removal of policy stimuli.

China continues to lead the region's economic strength. After growing by 9.1 per cent in 2003, GDP in China is expected to register another year of strong growth in 2004. A major challenge is how to deal with an apparent overheating in some sectors of the economy and, at the same time, a large labour surplus. Meanwhile, several other economies in the region, particularly those tightly linked to China, such as Hong Kong SAR, the Republic of Korea, Malaysia, Singapore and Taiwan Province of China are expected to see a marked acceleration in growth in 2004. The uncertainties and downside risks for the economic prospects of the region include persistently higher prices of petroleum and other commodities and the possibility of political instability associated with forthcoming elections in a number of economies.

After a rebound in 2003, growth in *South Asia* is expected to solidify further in 2004, with more balance across countries and sectors. The external sector of the region has been strong: while the extraordinary surge in Pakistan's exports in 2003 has moderated as the one-off effects of increased textile quotas wane, India's exports and imports are both increasing sharply, with exports being driven by ICT-related products and services. The appreciation of local currencies in the region against the United States dollar does not seem to have led so far to any significant dampening effects on the region's exports, but it has joined with the rebound in domestic demand to raise the demand for imports. International tourism to the region has also been improving, which is especially important for the economies of Sri Lanka and Nepal. Meanwhile, a recovery in the agricultural sector, contributing to higher incomes, has been a common trend in the region, with the sole exception of Sri Lanka, where a prolonged drought is expected to affect harvests in 2004.

While monetary policy is expected to remain accommodative in 2004, despite increasing inflationary pressures in some countries, fiscal policies are expected to become more prudent, or even restrictive, as most economies in the region are still having unsustainably large budget deficits. Structural reforms, including privatization programmes, will continue in a number of countries in the region. Trade policies are becoming more liberal and include a further reduction and simplification of tariffs, the accession of Nepal to the World Trade Organization (WTO), and agreement on a South Asian Free Trade Area (SAFTA). The phasing-out of the Multi-fibre Arrangement (MFA) at the beginning of 2005 will, however, have a mixed impact on the region: India and Pakistan may be positioned to face the challenges of increased international competition but Bangladesh and Sri Lanka may suffer from their loss of preferential quotas. Progress has been made in reducing cross-country tensions, but domestic conflicts and uncertainties about political stability and geopolitical security will continue to pose downside risks for the economic growth of the region.

The economic prospects for *Western Asia* are still critically conditioned by geopolitical developments in the region, particularly the situation in Iraq and relations between Israel and Palestine. Since mid-2003, the economic improvement in Iraq has been dilatory, with oil production and exports increasing gradually, but remaining below their pre-invasion levels.

A plethora of difficulties and uncertainties remain and the attainment of economic and political normalcy in Iraq is likely to require both a longer time than some participants anticipated and more resources for reconstruction. Meanwhile, the conflicts between Israel and Palestine seem to have escalated. The only propitious sign for the region, specifically for the oil exporting economies, is the higher price of petroleum and even this benefit has to be discounted because of the depreciation of the United States dollar—in which the international prices of petroleum are quoted—and the reduction in oil production in these economies to support a firm petroleum price in the future. All in all, GDP growth for the region as a whole in 2004 is expected to maintain the 3.5 per cent pace of previous years, accelerating slightly in 2005.

Despite the higher petroleum price, growth in the oil-exporting countries in the region, already dampened by concerns about the security situation, will likely be dragged down by fiscal consolidation, which will reduce both public consumption and investment spending in 2004. Among oil-importing countries, growth is forecast to moderate slightly in Turkey for 2004: a strong rebound starting in the second half of 2003 seems to be petering out as a protracted weakness in the labour market is hampering household spending, but the outlook for 2005 remains strong. Meanwhile, Jordan and Lebanon are expected to achieve modest improvements. The conflict between Israel and Palestine has had negative spillover effects on the region as both tourism receipts and transit-trade revenues continue to decline. External balances are expected to deteriorate in 2004 in most countries. The depreciation of the United States dollar (to which most currencies in the region are pegged) will contribute to inflationary pressures. After several years of decline, inflation is expected to pick up in 2004 in response to the increased cost of imports priced in euros. Unemployment has been increasing throughout the region and is expected to rise again in 2004.

The short-term economic outlook for *Latin America and the Caribbean* (LAC) continues to improve. After a recession in 2001-2002, the momentum of a recovery in the second half of 2003 has carried over into 2004. The global cyclical upturn has led to more favorable external conditions for the region. Stronger demand from North America and Japan, as well as from China, and the substantial rise in the prices of commodities[9] have boosted the growth of exports from the region. At the same time, the depreciation of the United States dollar, along with more flexible exchange-rate regimes, has allowed most countries to ease monetary policy: interest rates in many economies are now at multi-year lows. Meanwhile, investor confidence continues to improve, as reflected by the rebound in asset prices and the narrowing of sovereign debt spreads.

Beyond the external catalyst, domestic economic fundamentals in many of these economies have also shown improvement. Disciplined fiscal policies in the past few years—in some countries, induced by stringent external financing conditions after the most recent debt crisis in Argentina—have led to better fiscal positions. Inflation has, in general, been under control, or even on a downward trend. For the first time in decades, the region has broken its pro-cyclical pattern of a high correlation between GDP growth and current account deficit: current account balances have improved and foreign exchange reserves are on the rise, making the region less vulnerable to capital flow shocks. All these improvements suggest continued, but

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[9] Commodities still account for more than 30 per cent of the region's total exports and for more than 50 per cent in some countries.

relatively modest, growth in 2004-2005. The region, however, faces downside risks, including susceptibility to the vicissitudes of commodity prices, a tightening of monetary policy in the United States, high external indebtedness and political tensions in some countries.

Economies in transition

After acceleration in 2003, the outlook for the economies of the *Commonwealth of Independent States (CIS)* remains robust for 2004-2005. The economic vigour of the region is bolstered by a confluence of improved domestic fundamentals, higher production, exports and prices of petroleum and gas and increased foreign investment. Improved consumer and investor confidence, due to progress in policy reforms, also continues to support growth. Household consumption has been recovering strongly, boosted by increases in real wages and pensions. Investment has also accelerated, although it is still concentrated in the energy sector. Monetary policy in most CIS countries has shifted to a more relaxed stance, except in a few of economies, such as Belarus and the Republic of Moldova, where stringent monetary and fiscal policies are still crucial for managing public debt and inflation. At the same time, fiscal positions in many countries have improved, providing a better foundation for support of economic growth in the longer run. The downside risks in the region include the vulnerability to petroleum price fluctuations, excessive wage increases and sluggish investment in the non-energy sectors. Striking a balance between macroeconomic stability and implementing reforms to achieve longer-term growth remains the major challenge.

The Russian Federation continues to be the engine of growth for the region. Increases in both investment and consumption, accompanied by export expansion, are underpinning its strength. If the prices of petroleum weaken, however, growth may moderate in 2004 from the rate of over 7 per cent in 2003. The diversification of economic growth away from the present heavy reliance on oil and gas will require steady progress in other sectors.

Through increased intraregional trade, the enduring economic buoyancy in the Russian Federation provides strong support for other CIS countries. This role has recently been reinforced by the initiative to create a single economic space (SES) among Belarus, Kazakhstan, the Russian Federation and Ukraine.

The economic prospects for *Central and Eastern Europe* (CEE) continue to improve. Growth in the region accelerated in 2003, mostly due to the improved performance of the Polish economy, with the momentum of growth shifting to the countries of South-eastern Europe. Further acceleration is expected in 2004 as external demand increases. Stronger growth in South-eastern Europe is expected to be supported by high rates of investment associated with on-going privatization and the upgrading of production facilities; a recovery in investment is also expected in Central Europe, especially in Poland, where financial conditions in the corporate sector are improving. Monetary policy has been eased in a number of countries over the past year, partly in response to currency appreciations, but room for further monetary expansion seems to be limited as inflationary pressures are building. As most economies in the region have large budget deficits, fiscal policies will continue to focus on consolidation. The region's downside risks include the impact of weak business confidence in the EU which, however, may be mitigated if it causes some EU firms to relocate some production to the region as a cost-cutting measure.

Five CEE countries will join the EU in May 2004, but this is not expected to have a significant impact on the growth prospects for these economies in the short run, since most of the gains from the integration of trade and production have already taken place. On the other hand, the new members may face difficulties in absorbing some of the EU public funds to which they are entitled and may have to comply with stricter standards in various areas. A major policy challenge for each of these economies is to work out a comprehensive post-enlargement strategy that minimizes any adverse impact from the application of EU rules and regulations.

In South-eastern Europe, Bulgaria and Romania will likely proceed with further privatization and make other improvements in the business environment in order to be admitted into the EU in 2007. Most of the other countries in South-eastern Europe need substantial upgrading of their industries before they can join the EU; this will require active support on the part of the EU, including increased assistance and more sympathetic trade policies.

After 7 per cent in 2003, growth in the *Baltic States* will remain robust in 2004-2005, despite the economic sluggishness in the EU. Their recent strength has been marked by growing employment, resulting from the success in broad-based structural policies and gains in macroeconomic stability in recent years. Rapid wage growth and expansion of consumer credit has contributed to strong growth in private consumption, and gross fixed capital formation is also booming. In contrast, the growth of exports has accelerated only in Estonia, but has slowed down in Latvia and Lithuania. Their accession to the EU in May 2004 should be beneficial for these economies in the long run, but the uncertainties about the recovery in the EU may pose some short-term risks. External balances have already deteriorated, most notably in Estonia and Latvia. Despite continued FDI flows, the rise in external deficits may increase vulnerability to external shocks. A shift to a more restrictive policy stance is anticipated to balance economic activity in these countries while the continuing depreciation of the dollar against the euro, to which the currencies of Estonia and Lithuania are fixed,[10] poses further risk.

[10] Latvia's currency is fixed to the special drawing rights (SDRs) of the International Monetary Fund (IMF).