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Introduction

The present “pre-meeting” global economic forecast was prepared with inputs from national LINK centres and information from other sources (both as of 25 September 2002), using the LINK econometric modelling system to produce a global simulation. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the web sites of both the United Nations and the University of Toronto.¹

This report summarizes the main features of this exercise. The forecast presented here will be updated for publication in *World Economic Situation and Prospects 2003* (due for issuance in early 2003) by taking into account the discussions at the LINK meeting and the post-meeting forecast.

Overview

The world economy has been undergoing a gradual recovery from the sharp global slowdown of 2001—the weakest output performance in a decade, with roughly a dozen economies falling into recession. Neither the strength nor the breadth of the upturn has, however, been satisfactory: The arrival of economic recovery at full momentum forecast at the Spring 2002 meeting appears to have been delayed by at least two quarters. In other words, the peak of the economic recovery is now seen around mid-2003 rather than in the second half of 2002 as in the April forecast. Not only that, the sustainability of the ongoing recovery remains subject to a number of uncertainties.

The latest LINK forecasting exercise reconfirms the cautious outlook made at the April 2002 LINK meeting: By taking into account a confluence of factors, the LINK baseline forecast of 1.7 per cent for 2002 reconfirms the spring forecast of 1.8 per cent for gross world product (GWP), up from 1.2 per cent in 2001, but under 3 per cent for 2003, which is slightly lower than the 3.2 per cent reported in April 2002 (table 1). This momentum should push the growth of GWP approximately back to its long-run path of annual expansion of about 3 per cent. While the turning point identified earlier has thus been confirmed, the unknowns in the global economic outlook are, as they were at the time of the Spring exercise, the strength, the sustainability, and the breadth of the ongoing economic recovery, with new uncertainties having become pervasive in the interim.

The world economy at this juncture is characterized by a number of common features, albeit to varying degrees across countries: slow growth of output, benign inflation with, in fact, deflation in some economies, stagnant employment, low interest rates, worsening fiscal balances, unstable and uneven international trade, gyrating and depressed equity markets, and diverging economic performance across regions and countries.

¹ The UN website is: <http://www.un.org/esa/analysis/link>; the University of Toronto's is: <http://www.chass.utoronto.ca/link>.

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

	October 2002 forecasts a/			April 2002 forecasts b/	
	2002	2003	2004	2002	2003
Gross world product	1.7	2.9	3.5	1.8	3.2
PPP weighted	2.1	3.2	3.9	2.6	3.6
Developed market economies	1.3	2.3	3.0	1.3	2.8
Canada	3.2	3.2	3.9	2.3	4.5
France	1.6	3.0	3.0	1.6	3.0
Germany	0.3	1.5	1.7	0.9	2.4
Italy	0.9	2.3	2.9	1.3	2.6
Japan	-0.7	0.9	2.0	-1.1	1.7
United Kingdom	1.5	2.5	2.9	2.0	2.8
United States	2.3	3.2	3.9	2.4	3.4
Memo items:					
EU	1.1	2.3	2.6	1.4	2.7
Euro zone	1.0	2.2	2.6	1.3	2.7
Economies in transition	3.4	4.0	5.0	3.5	4.1
Russia	4.0	4.0	5.2	4.0	4.4
Developing countries	3.3	4.7	5.1	3.5	4.9
Latin America and the Caribbean	-0.9	2.8	4.0	0.3	3.1
Argentina	-12.0	1.0	4.0	-10.0	1.0
Brazil	1.4	2.5	3.3	2.4	3.1
Mexico	1.9	4.8	5.4	1.7	4.5
Africa	2.7	4.1	4.5	2.7	4.2
North Africa	1.9	4.1	4.6	2.1	4.4
Sub-Saharan Africa <u>c/</u>	4.1	4.9	4.8	4.1	4.9
Nigeria	4.0	4.9	4.6	3.1	3.3
South Africa	2.4	3.4	4.0	2.3	3.3
South and East Asia	4.4	5.0	5.1	4.5	5.4
India	4.7	5.5	5.8	5.7	6.4
Indonesia	4.0	5.2	4.9	3.2	5.4
Korea, Republic of	6.0	6.1	5.8	5.8	6.0
Malaysia	3.9	5.6	6.8	4.9	6.3
Philippines	4.5	4.8	5.3	4.2	5.6
Thailand	4.1	4.2	4.0	2.8	3.7
China	7.7	7.5	7.6	7.2	7.0
Western Asia	1.9	4.4	4.9	2.0	4.7
Oil-exporting countries	1.7	4.9	4.9	1.3	5.2
Oil-importing countries	2.3	3.8	4.8	2.1	3.2
World export volume	1.6	5.7	6.2	2.2	5.8
Oil price (Brent, \$/pb)	25.0	26.0	26.7	23.0	24.0

a Pre-meeting forecasts.

b Actual or revised estimates as published in *World Economic and Social Survey 2002*.

c Excluding Nigeria and South Africa.

Many economies are also increasingly constrained in their capacity to pursue further policy stimulus, either because fiscal imbalances are already large, monetary policy is already quite relaxed, or, as in the European Union (EU) countries are hitting the limits of the self-imposed policy constraints on fiscal and, for the euro-zone members, monetary policy as well.

While for most developed economies one can observe a dichotomy between resilient household consumption spending and hesitant business capital outlays, many developing countries continue to be confronted with a challenging international environment: weak external demand, prices of most non-fuel primary commodities (which are the prime export-revenue earners for many of these economies) are still hovering near their historical lows, and on the whole contracting net capital inflows to the group of developing countries and economies in transition.

At the same time, the economic recovery for a large number of economies continues to depend significantly on the health of the economy of the United States, as there is presently no other major economy that, at least in the short run, could plausibly assume the role of the United States as the locomotive of global economic buoyancy.

The sluggish pace of the global economic recovery has resulted from a confluence of competing driving forces. While many of the forces analysed in the last LINK report have been confirmed, several new factors have since come to the fore.

Among the five major supportive factors identified in the last LINK report, namely, monetary- and fiscal-policy stimuli, resilient consumer spending, inventory restocking, softening energy prices, and strengthening confidence from the low levels that crystallized in the wake of the 11 September 2001 terrorist attacks, only the first three have remained all but unchanged. Energy prices are no longer supportive of economic expansion. Rather, the recent run-up in oil prices has become a constraining factor on economic buoyancy. Business and consumer confidence has in general also reversed its course.

On the other hand, the key dragging factors on global economic growth addressed in the last LINK report, namely, tepid business capital spending; protracted consolidation in global information and communication technology (ICT); and deflated equity prices, have not improved at all; some have, in fact, deteriorated even further.

During the past six months, a few more adverse factors have come to the fore, including rising geopolitical tensions; an increasing number and an enlarged scale of revealed corporate scandals in major industrial countries, particularly in the United States; and worsening fiscal predicaments in Latin America. These new factors, plus the havoc wreaked by unusually large natural disasters such as floods and drought in a number of economies, have exacerbated the original weaknesses in the world economy. In fact, in mid-2002 these developments almost aborted the tentative global economic recovery.

Aside from non-economic factors, the far-from-buoyant global macroeconomic environment is currently principally due to the problem of excess investment in the developed

economies in the late 1990s. It is also associated with debt overhang and asset price deflation, notably in major equity markets. A marked proportion of these excesses still remains to be worked off. For example, in telecommunications as the most beleaguered sector during the present phase of the evolving global economic cycle, even after two years of consolidation, capacity utilization is estimated to be running at only 35 per cent in the United States and many European countries.² From a global perspective, the excess manufacturing capacity in developed economies reflects not only relatively lacklustre effective demand within these economies, but it also results from mediocre effective demand emanating from the rest of the world, particularly from the lower-income developing economies. In today's more globalized constellation of production, trade, and financing, capacity built in individual economies has become much more dependent on aggregate demand worldwide, rather than primarily on the state of the home economy. This holds especially for the high-technology sector with its large scope for economies of scale.

In light of the above, to resolve the overcapacity in manufacturing in core developed economies, it may be necessary for policymakers to focus on boosting their respective domestic demand in the short run. However, it will be even more crucial in the longer run to promote growth in a large number of developing countries, where potential demand remains well below satiation.

For many developing economies, the weakness of global demand has also exerted downward pressures on prices of many commodities that form the backbone of their export earnings and it has tended to shrink private capital flows, which has proven once again to be highly pro-cyclical. As a result, many developing countries with a high external debt burden have experienced either pressure on their exchange rates when adhering to a fixed-rate regime or weaker exchange rates when adhering to floating rates, and deteriorating debt-to-GDP and, for many economies, debt-to-export revenue ratios. Especially vulnerable have been countries with large current-account and fiscal deficits. The diminution in capital inflows into these countries has necessitated a contraction in economic activity, which in turn has entailed a deterioration in the fiscal outlook, eroded investor confidence, and led to further shrinkage in capital flows and a rise in the cost of external financing. A number of economies in Latin America were mired in such a vicious cycle in 2002, and remain quite vulnerable. Though the dynamics of public debt in Argentina and Brazil are not quite the same, in both countries it had major adverse impact on the health of public finances in general.

The current LINK baseline outlook shows that the economy of the United States will continue to lead the global recovery, but with not much momentum. Economic recovery in Japan and Western Europe continues to rely chiefly on external demand. With domestic demand lacking vigour, recovery in these economies will remain fragile. While the economy of Japan continues to be dragged down by fiscal and debt difficulties, most economies in Western Europe will be tightly constrained, on both the fiscal and monetary sides, by their adopted policy frameworks, leaving little scope for expansionary macroeconomic policies.

² For details, see a special report in *Business Week*, 7 October 2002, pp. 66-74. At the extreme end, capacity utilization of the fibre-optics infrastructure built in the late 1990s is reported to be at only 3 per cent (New York Times, 3 October 2002, p. A26).

The economic rebound in several Asian developing economies is expected to continue, but it remains vulnerable to any relapse in the pace of the economic recovery sustained by major developed economies. On average, GDP for Latin America is expected to decline in 2002 and the outlook for 2003 remains cautious. While an increasing number of countries in Africa are expected to grow by 4 per cent or higher due mainly to strengthened domestic economic factors, many economies in the region are still not expected to gain any tangible growth in per capita income. Despite a significant rebound in oil prices, the benefit for most oil-exporting developing economies in West Asia and elsewhere has been confined at best. However, the group of economies in transition is likely to continue to exhibit fairly stable growth.

The key downside risks for the global economic outlook are rooted in the rising geopolitical tensions and the rise in deflationary pressures due to the protracted decline in equity prices. In such an inauspicious environment, macroeconomic policies are expected to remain accommodative. The current stance on economic stimuli may well fail to be sufficiently strong, however.

Anaemic global economic recovery

Developed economies

Following the mild recession of 2001,³ *The United States* has been on a path of economic recovery, but the strength of the mending process has remained anaemic. The pace of the recovery has also been unstable, with considerable fluctuations in quarterly growth performances. The baseline outlook predicts continuing recovery at 2.3 per cent for 2002 with further strengthening of the economy to 3.2 per cent in 2003. Whereas the risk of a relapse into another economic downturn—the so-called double dip or W scenario—cannot be completely ruled out, it is presently not large.

The economic recovery in the United States has so far been driven mainly by substantial policy stimuli, including the lowest interest rates in four decades; tax reductions; and rising government spending. Consumer spending has continued to be resilient, supported by a number of factors such as a stable rise in real income, low inflation, large cash-outs from mortgage refinancing, and various discount and financing incentives offered by vendors. By contrast, the business sector, manufacturing in particular, continues to be weak. Firms are still hesitant about bolstering their capital spending and hiring employees because they are confronted with a plethora of uncertainties and depressing factors: mounting geopolitical tensions, a series of corporate financial chicaneries of mega magnitudes, unclear prospects for the recovery of corporate profits, a nebulous outlook for the next upturn in the demand for ICT products, and a further precipitous fall in equity prices.

A good sign is that business spending on equipment and software, which had been one core dynamic force driving the economic cycle in recent years, after a protracted decline of more than one year, has finally regained some growth, albeit at still low intensity. Without a full

³ The latest revision in national account statistics found a contraction of GDP for three consecutive quarters in 2001, instead of just one quarter as previously reported.

recovery in business spending and a significant improvement in the labour market, the current strength in household spending will sooner or later peter out, which in turn could lead to a prolonged period of slow growth, possibly even a repeat contraction in GDP levels.

The outlook for *Western Europe* has recently become more cautious. Economic performance in the region has been weaker than projected in the April 2002 LINK Outlook. Although the current baseline scenario does not foresee a repeat of the downturn, growth in the region is expected to remain slow for the rest of 2002. In other words, the acceleration in the second half of 2002 anticipated in the April 2002 global outlook has, as per the new outlook, been postponed by at least two quarters, until the first half of 2003. On a year-over-year basis, GDP growth for the EU is expected to decelerate from 1.5 per cent in 2001 to 1.1 per cent in 2002, but to recover to 2.3 per cent in 2003.

Economic activity has been particularly tepid in Germany and Italy, but also in Austria, Finland, and the Netherlands. On the other hand, the economic performances of France, Spain, and the United Kingdom have been relatively less worrisome. Business investment, especially in the manufacturing sector, remains a drag for many economies in the region as a result of continuing excess capacity, high levels of corporate debt, falling profits, and the rising cost of capital from both the sharp fall in equity prices and the widening of corporate bond spreads. Consumption has maintained positive growth. However, consumer confidence in most Western European economies has been subdued since the economic downturn in 2001, dampened by weaker labour markets and contracting equity wealth. A rebound in exports in the early part of this year provided the main impetus to the recovery in economic activity, lacklustre as it turned out to be, but the momentum of exports tapered off in the middle of the year.

In the outlook, exports are still expected to lead the continuing economic recovery. However, the recent appreciation of the euro against the U.S. dollar may, to some extent, curb the strength of exports. Although macroeconomic policies in the region have been stimulatory, the policy stance has been not as strong as in the United States. Especially in the euro area, inflation concerns and the Stability and Growth Pact have prevented the enactment of broader and larger stimulus.

Ending the contraction in economic output recorded in 2001, the economy of *Japan* stabilized in the first half of 2002. GDP growth for 2002 as a whole, however, is still estimated to decline by 0.7 per cent from 2001 and only a low rate of growth, under 1 per cent, is forecast for 2003 as a whole. The tentative strength in the economy has so far been mainly propelled by a stronger-than-expected upturn in exports, attributable largely to the economic recovery in the United States and in a few Asian economies. Domestic demand, by contrast, has remained weak. Despite the gradual rise in industrial production, business fixed investment continued to decline in the first half of 2002, albeit with a moderating downward momentum. Government investment continued to shrink, and this is expected to prevail also into 2003, as the large budget deficit and the mounting public debt restrain any sizeable increase in fiscal spending that might otherwise have been contemplated. Meanwhile, consumer spending stagnates and the housing sector remains sluggish, as consumer sentiment is depressed due to rising unemployment, deteriorating income conditions, and further falling equity prices.⁴

⁴ The Nikkei index of 225 stocks fell in early September 2002 to its lowest level in 19 years.

While the newly-announced policy initiative for the Central Bank to purchase listed stocks at market value is expected to stabilize the equity market in the short run, tackling the root of financial fragility in the economy, including the growing magnitude of non-performing loans, remains a formidable task on the way to bringing about a more robust economic recovery.

The prospects for other developed economies are relatively brighter. The economy of *Canada* has been recovering at a much stronger pace than that observed in other major developed economies, driven by robust gains in export volume, resilient household demand, and large inventory restocking. GDP is expected to grow by 3.2 per cent for 2002 and to sustain that pace through 2003.

The economies of *Australia* and *New Zealand* weathered the global slowdown of 2001 fairly well and have continued to register good performance in 2002. Domestic demand has been strong across a wide spectrum of goods and services in both economies, with the housing sector in Australia being particularly vigorous. GDP growth is expected to be around 3.5 per cent for both economies in 2002 and to moderate slightly in 2003, owing to the gradual emergence of some capacity limits and some cyclical factors.

Economies in transition

Most economies of *Central and Eastern Europe* (CEE) have continued to perform at variance from global economic trends, in the sense that they fared relatively well during the global downturn in 2001 and are experiencing only somewhat more moderate growth in 2002. GDP growth in the region is estimated to average around 2.5 per cent for 2002, with acceleration due for 2003.

Because of their increasing dependence on the economic strength of the EU, sluggish demand emanating from within the EU was responsible for the marked deceleration in the pace of exports of many CEE economies. On the other hand, strengthened domestic demand, resulting from fiscal-policy stimuli and, to some degree, the cumulative benefits of the structural reforms enacted in recent years, has offset some of the external weakness. Meanwhile, foreign direct investment (FDI) has on a cumulative basis been conducive to lifting productivity and improving the international competitiveness of a number of activities in these economies. But there probably was a decline in FDI inflows in 2002.

The clear laggard in this group has recently been the economy of Poland, the largest in the region. Tight monetary policy combined with severe structural problems in some industrial sectors has led to a protracted stagnation of output in Poland. While the floods in mid-2002 severely devastated the economy of the Czech Republic and exerted negative repercussions also on some other economies, reconstruction of damaged facilities may stimulate GDP growth in 2003 and thereby ease the budget strain with which notably the Czech Republic has recently been grappling.

In general, the economic outlook for most economies in the region depends on the strength of the economic recovery in the EU as well as on the ability of policymakers to meet the challenges posed notably by large budget deficits and by any sustained rise in oil prices.

Since the turnaround observed in 1999, economic expansion in the majority of the members of the *Commonwealth of Independent States* (CIS) has proceeded. Although the momentum has recently moderated, GDP growth for the group in 2002 is still expected to be at about 4 per cent, the same as projected in the last LINK exercise. About the same pace is anticipated for 2003 as external demand improves. However, without further restructuring and substantial increase in investment, growth in the medium run will be constrained by emerging supply bottlenecks, especially in a few large economies of the group.

A substantial slowdown in GDP growth was witnessed in both the Russian Federation and Ukraine in the first half of 2002, as external demand eased but consumer demand continued to expand at a fairly stable pace. Several hydrocarbon-exporting economies in the group such as Azerbaijan, Kazakhstan, and Turkmenistan continue to enjoy sizeable GDP expansion, bolstered by comparatively high prices for their energy exports and rising volumes, and increased capital inflows for the construction of oil- and gas-related investment projects. Also the agricultural sector for the group on average registered positive growth, with the Russian Federation reporting a near-record grain output due to favourable weather conditions and improved productivity.

The pace of economic reform has, however, slowed down notably in quite a few countries and the prospects of any substantial progress in the near term currently appear to be dim.

Heightened geopolitical conflicts and uncertainties had, and will continue to have, a mixed impact on many economies in the group. The military operations in Afghanistan allowed the Central Asian countries to extend their economic and political cooperation with the United States and other economies. The rebuilding of Afghanistan will provide additional export markets for these economies. The recent surge in the prices of oil, in response to the increasing probability of another military conflict in the Gulf, may benefit oil-exporting CIS economies. However, the potential benefits from higher export prices might be offset by lower investor confidence and shrinking external demand.

Growth in three *Baltic* economies has been stronger than anticipated in the early part of the year, with a robust rate of 4.9 per cent in 2002, accelerating to 5.4 per cent in 2003. Buoyant domestic demand and stronger trade with the CIS countries have offset weaker demand from the EU.⁵ Also the pace of expansion in the CEE region has partially compensated the weak demand prevailing in the EU. Increased wages, credit expansion, and declining unemployment have bolstered private consumption. On the other hand, external deficits and fiscal constraints are major policy concerns in the economic outlook for these economies.

⁵ For example, Estonia's exports to the EU declined at a double-digit annual pace in the first half of 2002.

Developing countries

The near-term outlook for GDP growth in *Africa* remains the same as presented at the last LINK forecast, namely, an aggregate pace of output expansion of 2.7 per cent for 2002 with an acceleration to about 4 per cent in 2003. The baseline outlook is conditioned on a continuation of improvements in the external environment; a modest recovery in the prices of some commodities; and, on the domestic front, no major outbreaks in the types of natural or man-made disasters that have plagued African countries in recent years.

Most countries of the region have maintained a steady pace of economic growth, but output performance has become more diverse across the region. Some 20 countries are growing at respectable rates of 4 per cent or higher—with a few exceptions of spectacular double-digit rates in countries such as Angola, Chad, Equatorial Guinea, and Mozambique. However, sluggish growth in five of the largest economies accounting for roughly two thirds of Africa's GDP—Algeria, Egypt, Libya, Nigeria, and South Africa—depressed the pace of aggregate output performance for Africa as a whole. On the downside, Zimbabwe faces a third year of economic contraction amidst continuing controversy over its land redistribution policy, widening fiscal deficits, excessive money-supply growth, rising inflation, drought, famine, severe fuel shortages, inadequate foreign exchange for financing essential food and fuel imports, and growing isolation from donors and international financial institutions.

GDP growth in most African countries can be attributed to a significant degree to increased agricultural output. Drought in several countries in southern Africa, however, caused widespread crop failures that have led to palpable food shortages and the most severe threat of famine in over a decade: An estimated 14 million people in Angola, Lesotho, Malawi, Mozambique, Swaziland, Zambia and Zimbabwe, as well as several other countries, face the highest risk of famine, starvation, and malnutrition.

Manufacturing output also expanded as a result of moderate increases in consumer demand and improvements in supply-side factors. For example, Kenya and Nigeria reported higher capacity utilization in manufacturing as a result of improvements in power supply.

Better macroeconomic management in many African countries has resulted in greater stability in the economic environment and an abatement of inflationary pressures. Poverty-reduction strategies—inspired by the preparation of poverty-reduction strategy papers (PRSPs) for development assistance lending and support of donor countries—have increasingly been adopted as essential components for national development plans.

Furthermore, a number of African countries continue to benefit from improved political and economic governance. Significant progress in peace negotiations for the resolution of conflicts in Burundi, the Democratic Republic of the Congo, Somalia, and Sudan in 2002, together with the resolution of some of the more obdurate conflict situations in Angola, Eritrea, Ethiopia, Madagascar, and Sierra Leone during the year, have greatly improved the prospects for economic growth in those countries. However, civil unrest of the type witnessed in Côte d'Ivoire in September 2002 and the uncertainties associated with upcoming election campaigns in Kenya,

Nigeria, and several other countries in late 2002 and early 2003 are only two examples of the many downside risks to the near-term outlook for the region.

The economic recovery in *East Asia* strengthened during the first half of 2002, with a number of economies in the region registering a rate of output growth exceeding 5 per cent. Despite some weakening signs in the middle of the year, growth prospects for the region remain encouraging. The economies of these countries continue to outperform those of other regions, sometimes by a significant margin.

Although the strength of the economic recovery varies noticeably across economies in the region—with China and the Republic of Korea clearly leading, and Hong Kong Special Administrative Region (SAR) lagging—the upturn has gradually been spreading to more economies and has been affecting more sectors. Supported by policy stimuli, a rebound in domestic demand, particularly strong consumption spending, played an important role in initiating the economic recovery. A quick turnaround in exports, due both to the recovery of demand from the United States and on buoyant intraregional trade, provided further synergy and bolstered the economic momentum in the region. Meanwhile, the recovery in domestic demand and in exports has lifted industrial production, particularly in the ICT sector, which was severely depressed in the global downturn of 2001.

While growth in the services sector has been stable, the performance of the agricultural sector varies across economies: Floods, droughts, and other natural disasters have wreaked havoc on a number of economies in the region.

However, weaknesses in the region remain and may constrain growth prospects for 2003 for some of these economies: Except for China, where double-digit growth in investment continues, business investment generally continues to lack impetus; the employment situation remains under pressure, as unemployment rates are at their historical highs in a few economies, and even for those economies where unemployment rates have recently improved, the rates still exceed the levels that prevailed prior to the Asian crisis of 1997-1998; falling equity and property prices in some economies may drag down consumer spending in the future; and while exports are expected to strengthen further in 2003, the growth prospects of many economies in the region can be substantially eroded by any relapse of weakness in the economies of major industrial countries.

Growth in *South Asia* improved notably in the first half of 2002. It may continue for some economies, but a few large economies in the region are expected to experience moderation in the second half. The aggregate pace of GDP growth for the region in 2002 is estimated to remain nearly identical to that of 2001—4.5 per cent—and to improve in 2003 to 5.5 per cent.

The rebound in early 2002 was led by India, Pakistan, and Sri Lanka, bolstered by rising exports and improving domestic factors such as better harvests, expansionary policies, as well as increased international aid (Pakistan) and the end of domestic conflict (Sri Lanka). The near-term outlook for the region, however, has deteriorated somewhat since mid-2002 because of unfavourable monsoon rains, weakening external demand, heightened geopolitical uncertainties, and rising oil prices. The upturn in the pace of GDP growth for India is expected to reverse as the

summer drought will likely compress agricultural output and business confidence continues to be eroded by renewed tensions in the region. Growth in Nepal is also likely to decelerate due to adverse weather and domestic insurgency. Improved prospects are, on the other hand, found for such countries as Bangladesh, Pakistan, and Sri Lanka.

While macroeconomic policies in the region are expected to remain broadly supportive in general, the outlook for the region as a whole continues to be subject to a number of downside risks, including weather conditions, external demand, and regional and domestic conflicts.

Uncertainties surrounding the economic outlook for many economies in *West Asia* have been mounting as a result of the heightened risks associated with rising oil prices and the still-evolving state of geopolitical and military tensions. Except for Turkey, GDP growth in 2002 for most economies in this group is expected to decelerate from the previous year. The growth prospects for 2003 are anticipated to improve, but only if the geopolitical situation remains benign and oil prices are contained.

Because of the escalated conflict between Israel and the Palestinian Authority, the economy of Israel is expected to register another decline in its GDP in 2002, while the Palestinian economy has all but collapsed. The outlook for the economy of Turkey has improved. After the deep contraction experienced in 2001, Turkey's domestic economy is expected to grow by 4 per cent in 2002 and to strengthen further in 2003. Buttressed by the IMF-supported economic stabilization programme, the local currency has stabilized, inflation is decelerating, and the real economic sector has been recovering. Political stability remains key to sustaining this economic recovery, however.

Despite rising oil prices, GDP growth in 2002 for most oil-exporting economies in the region is expected to be lower than that of 2001, partly due to the reduction in the volume of oil production, but partly also because of the lagged effects from the weak oil prices in the earlier part of the year. Given the firm outlook on the prices of oil and continued fiscal stimulus in these economies, some improvement is on the horizon for 2003, but only if the geopolitical environment does not erode into open protracted conflict.

Since the last LINK meeting, the prospects for the economies in *Latin America and the Caribbean* have deteriorated further. GDP growth for the group is expected to register a decline of about 0.9 per cent in 2002, worse than the near-stagnation of 2001. The outlook for 2003 indicates cautious optimism, with GDP growth expecting to recover to just under 3 per cent. The dismal economic situation in the region has resulted from a combination of dire fiscal predicaments in a number of economies and worsening external conditions.

The largest drag to the region's GDP has been the precipitous contraction in Argentina—estimated at about 12 per cent in 2002. In consequence of the default on sovereign debt declared in late 2001, the country's banking system was paralysed and depressed real economic activity. Uncertainties regarding the country's debt restructuring, gaining financial support from the international financial institutions, and recovery in the real economy remain palpable in the outlook for Argentina.

The spillover effects of the Argentine crisis have, over time, been more significant than was originally expected. This holds in particular for its neighbouring countries such as Paraguay and Uruguay, with GDP in the latter likely to register another decline for the fourth consecutive year.

Another impetus for the downturn in the region came from Brazil, the largest economy in the group. Increased uncertainties associated with the upcoming presidential election substantially eroded the confidence of international investors over the sustainability of the country's large debt, forcing the economy to the brink of a debt crisis during the summer of 2002. With prompt support from the IMF, the economic situation has since been stabilized, but the currency's exchange rate deteriorated significantly and risks remain in the outlook.

A few other economies in the group are also expected to register either a decline or a noticeable deceleration in GDP, including Venezuela—where the higher price of oil could not prevent the economy from falling into a recession.

Mexico is expected to recover from a recession year, though its pace of output growth at 1.9 per cent in 2002 will remain far from robust. A further improvement in 2003 will largely depend on the strength of the economic recovery in the United States. Most Central American and Caribbean economies, whose tourism receipts fell markedly in the aftermath of the terrorist incidents in September 2001, are in a similar situation.

Unfavourable international economic environment for developing countries

After a decline in the volume of *world trade* by 1.6 per cent in 2001⁶—the worst performance in two decades—the pace of expansion of international trade has been recovering. However, this recovery has been volatile and its strength has been markedly uneven across regions and countries.

The expansion of world trade rebounded strongly in early 2002 under impetus of economic stabilization and recovery in the pace of GDP growth in a number of economies, particularly the United States and some Asian economies. Continued growth in consumer demand, restocking of inventory, and stabilization in business investment, however tentative, brought about a turnaround in global industrial production as well as in world trade.

Leading the recovery in world trade was the robust import demand of the United States, running at an annual rate of more than 20 per cent in the first half of 2002, despite a softening in the exchange rate of the U.S. dollar vis-à-vis major currencies. As a result, several Asian developing economies, as well as Japan, experienced a brisk rebound in their exports, with many of them registering more than 20 per cent growth in the same period. The rapid recovery of exports in these economies reflected both their high dependence on the market of the United States and their specialization in ICT products. The intensified intraregional and intra-industrial trade for the Asian economies also contributed to this dynamism.

⁶ Measured by the volume of merchandise exports.

The recovery in exports was also noticeable, but far less powerful, for other economies. In fact, exports of some economies in Western Europe and Latin America continued to decline. In Africa, large currency depreciations and the improved competitiveness of South Africa and several North African countries led to improvements in manufacturing exports. African exports of textiles and apparel and of a wide range of other manufactured goods to the United States also rose under duty-free arrangements and other market-access privileges of the African Growth and Opportunity Act (AGOA).

The outlook for further recovery in world trade remains worrisome, however. Except for a few economies such as China and the United States, import demand in the majority of economies remains weak; in effect, many economies continue to experience shrinking imports. Contracting net capital inflows have forced a number of developing economies to adjust their external deficits by severely constraining their import demand. For example, imports of some Latin American economies dropped at a double-digit rate in the first half of 2002, with Argentina being an extreme case as its imports fell by 60 per cent in the same period.⁷

Most recent statistics reveal a loss of momentum in world trade in mid-2002, along with the observed deterioration in the prospects for the recovery of world output.

With so many weaknesses and uncertainties in the world economy, as discussed elsewhere in this report, the pace of growth in export volume registered for many economies in the early part of the year is not expected to be sustained in the second half of 2002. The annual growth of world trade is estimated to be only below 1.6 per cent for 2002; it should rise to just under 6 per cent in 2003, however.

Trade in services has also been recovering from the traumatic shock of the 11 September 2001 terrorist attacks. But internationally traded travel-related services remain depressed.

The uneven recovery in the growth of international trade is expected to worsen the already large external imbalances across regions and countries. Imbalances in trade and current accounts across the world economies, most notably, the large deficits in the United States and the corresponding surpluses in Asia and the EU, were accumulating rapidly in the late 1990s and posed an increasing risk for the stability of the world economy. The global downturn of 2000-2001 did narrow these imbalances, but only marginally, with the external deficit of the United States declining from 4.2 per cent of GDP in 2000 to about 3.9 per cent in 2001. There was also some decline in the surplus of Japan.

Given the recovery pattern in world trade in 2002, however, the deficits of the United States are bound to widen again, as forecast, to exceed 4.5 per cent of GDP in 2002 and 2003. However, among developing economies, external deficits in Latin America are expected to narrow in consequence of the reduced levels of capital inflows to finance imports. The surpluses in Asia are likely to decline.

⁷ Unlike during the debt crisis of the early 1980s, the moratorium on debt-servicing declared in late 2001 closed down nearly all credit lines, including for regular merchandise imports.

In the medium run, stable and balanced growth of world trade of such a magnitude as to contribute to robust expansion in world income will be predicated on further trade liberalization and improvements in the world trading system. Among other measures, a reduction of trade barriers and subsidies imposed by developed economies on the goods and services for which developing economies have an intrinsic comparative advantage that so far has not translated into commensurate exports will be particularly beneficial for sustaining the pace of world economic development and the welfare of all nations.

The incipient rebound in the prices of a broad range of commodities in early 2002 proved to be brief. While the prices of oil and a few agricultural commodities have continued to move upward, the prices of many other commodities have retreated since the middle of the year. In the baseline outlook, a mild upturn is expected for the prices of most commodities, along with the further strengthening in global demand. However, the typical features of secular downturn in the long run and high volatility in the short run will continue to be associated with the prices of these commodities.

The *prices of oil* have risen by more than 50 per cent, from a level below \$20 per barrel (pb) at the beginning of 2002 to about \$30 pb by the end of September. A large proportion of the surge was, however, caused by marked uncertainty, hence speculation, due to heightened geopolitical tensions rather than changes in economic fundamentals. In the earlier part of the year, however, concerns about OPEC quotas played a role as well.

With weak GDP growth in the world economy, global demand for oil is estimated to expand by about 0.7 per cent in 2002, primarily driven by rising demand in North America and, to a lesser extent, in Asia. On the supply side, after the cumulative reduction of about 5 million barrels per day (bpd) in 2001, the Organization of Petroleum Exporting Countries (OPEC) decided to keep the production quotas unchanged for most of 2002. However, world output of oil has actually been rising during 2002, due partly to an increase in output by non-OPEC oil producers and partly to above-quota production by some OPEC members.

In the near term, the prices of oil will likely continue to be dominated by the still-evolving geopolitical pressures. At current price levels, the market may have already discounted the possibility of a military operation in the Gulf; however, it is impossible to price in completely a wide range of various plausible scenarios. Therefore, high volatility with upward risk remains in the near-term outlook for the prices of oil.

In the LINK baseline, the annual average prices of oil are expected to be near the upper bound of the \$22-28 target set by OPEC for the rest of 2002 and for 2003.

The movement of the prices of non-oil commodities varied in 2002, but these prices generally remained weak, with most them bouncing not far from their historical lows registered in the years after the 1997-1998 Asian crisis. On the upside has been the noticeable gain in the prices of grains, particularly *wheat*, because of lower-than-expected yields from crops planted in Canada, the Russian Federation, and the United States, and drought conditions in key growing areas. The prices of *coffee* have experienced another year of large swings, by more than 30 per cent between highs and lows, but ended at the level near historical lows because of the increase

in supply. The new future coffee options recently offered by the Brazilian Government, which prospectively allows its customers to buy part of the country's future crop at fixed prices, may have imparted some stability for the market in the outlook. The prices of *base metals* fell in the second quarter after rising earlier in the year. The general weakness in the prices of base metals reflects the lacklustre buoyancy of world industrial production. Meanwhile, the price of *gold* has registered substantial gain, about 10 per cent from the level of a year ago, due largely to increased demand for hedging, and also speculation, on heightened risks associated with depressed equity prices and possible military operations in the Gulf.⁸

External financing conditions for most developing countries and economies in transition became more restrictive in the course of 2002 and near-term prospects are not very encouraging.

Despite the brief improvement in early 2002, *net capital flows* to developing countries and economies in transition are estimated to have contracted for the year as a whole below the level of 2001, thus continuing the general downturn in the trend of net capital flows to this group of economies since the 1997-1998 Asian financial crisis. With the recent decline, total net capital flows to these economies have reverted to the level of a decade ago, and the ratio of net capital flows to GDP is now much lower than what prevailed in the early 1990s.⁹

Foreign direct investment (FDI) continues to be the major source of external financing for developing countries and economies in transition. Although it has on the whole remained quite stable in comparison with other types of capital inflows, net FDI inflows also diminished in 2002, partly due to a slower pace of privatization in some of these economies. The lion share of FDI continues to be concentrated in a few large economies in Asia and Latin America, however. While FDI to economies in transition in Europe has continued, albeit at a lower pace than observed in recent years, the net flows to Africa remain negligible.

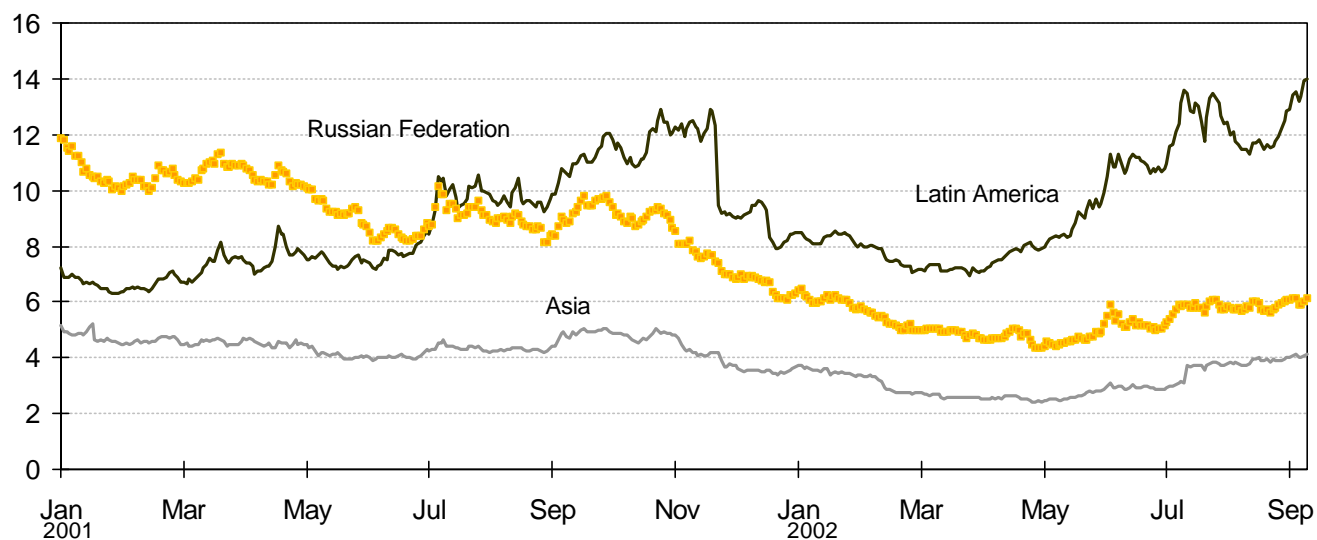
Other components of net capital flows to developing countries and economies in transition all dwindled to small levels, with flows from commercial banks registering another year of net outflows as net repayments continue the post-Asian-crisis trend of the past several years.

During 2002, country-specific risks heightened for a number of developing economies, partly contributing to the deterioration in external financing conditions. Argentina's debt moratorium; Brazil's fiscal predicament; some contagion from Argentina as foreign investors panicked, thus feeding the vicious cycle of higher spreads, lower value of the real, and increased public debt; and political uncertainties related to the upcoming elections in several countries all contributed to raising the risk premium for these countries. Nevertheless, one could also witness a rise in overall market risk, that is, the risk not confined to any particular emerging financial market, in mid-2002, with a general deterioration in international investor confidence. As indicated by figure 1, the spreads of sovereign bond yields for a group of developing countries and economies in transition over the United States Treasury bonds widened noticeably in the second half of 2002. Intensified volatility in major equity markets, a grimmer outlook for the global recovery, and mounting geopolitical tensions since mid-2002 all contributed to broadly rising risk aversion. Given this cautious global environment, only a marginal increase, if any, of net private capital flows is expected for 2003.

⁸ Note that the price of gold is not among the prices of the group of commodities usually covered in the LINK system.

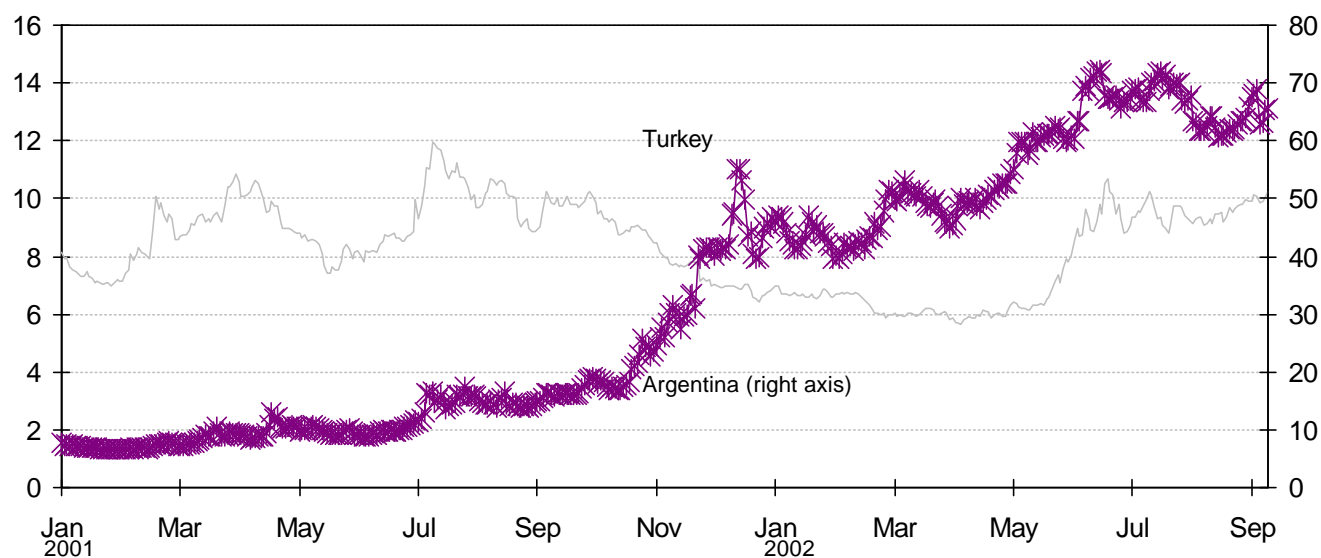
⁹ For a detailed analysis of a decade of capital flows to emerging economies, see The Institute of International Finance, *Capital flows to emerging market economies* (Washington, DC: The Institute of International Finance, September 2002), p. 4.

**Figure 1a. Yield Spreads on Emerging Market Bonds,
2 January 2001 to 30 September 2002**
(Percentage points)



Source: Data of JPMorgan Co., New York.

**Figure 1b. Yield Spreads on Emerging Market Bonds,
2 January 2001 to 30 September 2002**
(Percentage points)



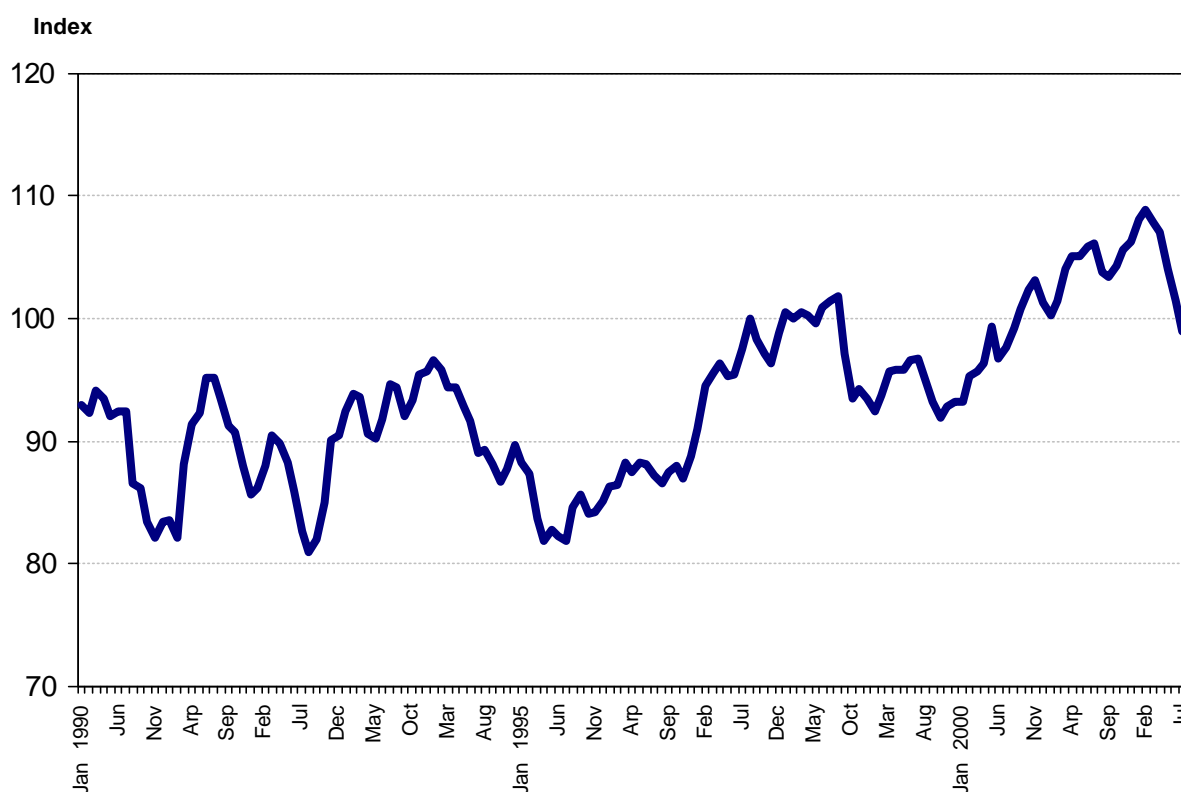
Source: Data of JPMorgan Co., New York.

Since the last LINK meeting, large fluctuations have also been observed in foreign exchange markets. The long anticipated reversal of the exchange rate of the U.S. dollar against other major currencies finally seems to have begun. Sentiment towards the U.S. dollar deteriorated further over the summer, with the trade-weighted value of the currency falling to levels that are about 8 per cent below the peak of January 2002 (see figure 2).

Several factors contributed to the weakness of the U.S. dollar, including the continued contraction in equity values; the insidious corporate scandals; heightened geopolitical uncertainties; and the perennial concerns about the sustainability of the country's external deficits.

The recent fall in the value of the U.S. dollar in terms of major currencies has been significant, but it reverses only part of the very strong rise experienced during the second half of the 1990s, when the above-cited dollar index appreciated by more than 20 per cent. The decline in the U.S. dollar was broad-based vis-à-vis major currencies. It fell 8 per cent against the euro; for a while, the euro returned to parity against the U.S. dollar for the first time since February 2000. The fall against the yen prompted significant intervention by the Japanese authorities during the summer. Most Asian currencies also strengthened against the U.S. dollar.

Figure 2. Trade weighted index of the U.S. dollar
(March 1973=100)



On the other hand, the value of currencies of many Latin American economies generally eroded in consequence of the economic and political uncertainties in the region. Argentina's peso has lost three quarters of its value against the U.S. dollar since the currency board was abandoned in early 2002, while Brazil's real fell by more than 30 per cent in the wake of the uncertainties of the forthcoming election and worries about the sustainability of its external debt, which depends to a large extent on the country's ability to generate a trade surplus, which it has recently, but it remains uncertain whether this can be sustained.

In the outlook, the exchange rates of the euro is assumed to drift upwards against the U.S. dollar, regaining parity by the fourth quarter of 2003 and slowly inching up thereafter to reach 1.04 by the end of 2005. On the other hand, the yen is assumed to remain stable at ¥120 to the U.S. dollar throughout the forecast period. The assumptions on the exchange rates of other currencies can be found in the *LINK Tables*.

Benign inflation outlook versus stagnant labour markets

As expected in the last LINK forecast, inflation edged up in a large number of economies during the first part of 2002, driven by various factors, including a rise in the prices of food and energy in some countries; weaker currencies in others; and large wage increases in some others. In spite of these developments, excepting just a few countries, inflation remains tame throughout the global economy.

Despite a risen probability of an oil shock resulting from the geopolitical tension around the Gulf, the baseline inflation outlook continues to be benign for the majority of economies. While a few developing economies that have recently experienced large currency devaluation need to bring inflation under control, further disinflation is expected in several economies in transition. In the Baltic and CEE economies inflation has already been compressed to low single-digit levels. Further reductions will therefore be marginal. However, in several CIS and south-east European economies annual inflation rates remain around 20 per cent and further progress with reducing that pace of inflation is anticipated.

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

The employment situation in most economies is not encouraging. In the recovery phase of the business cycle, improvements in labour market normally lag the rebound of output. As a rule, an economy needs to grow above its potential rate of GDP growth for a few quarters before its businesses can absorb the workers laid off during the downturn phase. Given the weak pace of recovery in GWP observed so far and what is in the forecast for the near term, with many economies still growing at far less than their potential, employment stagnates for most economies at best and continues to decline in some.

Except for a few economies such as Australia, Canada, and New Zealand, most developed economies have continued to experience a loss of employment in their manufacturing

sector. In the United States, for example, factory employment is down 10 per cent from the peak of 2000; the same percentage is also found in Japan and smaller losses are witnessed in some EU economies. Recovery in industrial production has not yet been sufficiently strong and of a sufficiently long duration to stanch the employment losses incurred in these economies during the downturn. After rising to near 6 per cent at the beginning of 2002 from below 4 per cent in the halcyon days of 2000, the unemployment rate in the United States has since stagnated. Although the rate is far from the high levels observed in the postwar period, the number of long-term unemployed—those in the unemployment queue for 6 months or longer—has proportionately risen.

While the unemployment rate in Japan is rising to a record high, the rates for most economies in Western Europe have continued to hover around their 2001 level, but have recently marginally surpassed that threshold. A new feature, associated closely with the deep consolidation in the ICT sector, is that the number of unemployed with high skills has risen faster than that for low-skilled labour in a number of developed economies.

Among developing economies, high unemployment and large underemployment rooted in the structure of many economies, notably many African economies, remain a long-term policy challenge—a key hurdle on the way to substantial poverty reduction. Rising unemployment rates have also become worrisome in some Latin American economies, particularly Argentina, where the debt crisis has driven open urban unemployment to above 20 per cent. While a number of Asian economies have managed to lower their unemployment rates somewhat, the rates are in general still higher than those observed prior to the Asian crisis of 1997-1998. In China, sizeable surplus labour in rural areas combined with the large number of laid-off workers in the cities continues to be a key policy concern. Only a number of economies in transition have continued to reduce their unemployment rates, but from high levels of the earlier years of the transition, and the rates are still relatively high. In some, such as Poland, unemployment, especially among young people, has recently surged to very high levels indeed.

Challenges for macroeconomic policies

The April 2002 LINK global outlook was predicated on the view, among others, that the global monetary easing cycle, which began in early 2001, would soon end. While a few central banks such as those of Australia, Canada, New Zealand, and Sweden raised interest rates somewhat, the majority of central banks decided to leave interest rates at low levels. Not only that, several central banks in developing countries and economies in transition continued to reduce their policy interest rates (see table 2).

Expansionary monetary policies have pumped excess liquidity into the global economy: nominal money supply grew on average by 7-8 per cent in 2002 for the world economy and at double-digit rates in some developed economies.

Table 2. Changes in policy interest rates

	Level at 25 Sept 2002 (per cent)	Change from Dec 2000 (basis points)
<i>Developed Countries</i>		
Canada	2.75	-300
United States	1.75	-475
Japan	0.00	-25
Euro	3.25	-150
United Kingdom	4.00	-200
Denmark	3.45	-195
Norway	7.00	0
Sweden	4.25	25
Switzerland	0.75	-275
Australia	4.75	-150
New Zealand	5.75	-75
<i>Economies in Transition</i>		
Czech Republic	3.00	-225
Hungary	9.50	-225
Poland	8.00	-1100
<i>Developing Countries</i>		
Brazil	18.00	225
Chile	3.00	-500
Mexico	7.36	-981
China	5.31	-54
Hong Kong SAR	3.25	-475
India	6.50	-150
Indonesia	13.50	-92
Philippines	7.00	-650
Republic of Korea	4.25	-100
South Africa	13.50	150
Taiwan Province of China	1.88	-275
Thailand	2.00	50

Source: JP Morgan.

Low interest rates so far seem to have had more salutary effects on the household sector than on businesses. The observed strong housing market and resilient consumption of durable goods in a large number of economies owe much to low interest rates. However, business capital spending has on the whole remained insensitive to the monetary easing, although low interest rates have, of course, also ameliorated corporate financial conditions. Excess capacity, depressed equity prices, rising risk premia for corporate borrowing due to heightened uncertainties, the lacklustre outlook for profit growth, and financial scandals may have offset the beneficial effect that the monetary stimulus for the business sector, particularly in major developed economies, would otherwise have imparted.

On the other hand, fragility in banking and non-banking financial systems such as large non-performing loans in a number of economies, developed as well as developing, may have dampened the effects of monetary easing from being properly channelled into the real sector.¹⁰ At the same time, inflation-targeting policy rules adopted by a number of economies may have prevented some central banks from reducing interest rates low enough to generate, given the prevailing circumstances, adequate stimulus for the real economic growth.

In the outlook, most central banks are expected to maintain an accommodative stance at the current level until mid-2003. Room for further monetary easing remains in many economies should the recovery turn sour.

Fiscal policy in the world economy is at a subtle juncture. While the sluggish economic recovery definitely calls for more fiscal stimulus, the majority of world economies are facing growing difficulties in strengthening their policy stance. The recent global slowdown worsened budget balances in almost all economies, albeit to varying degrees, due to the diminution in tax revenues or the rise in government expenditures or both.

Government accounts in most developed economies have turned from surplus registered in 2000 to deficits. In the United States, fiscal stimulus has been a major driver for the economic recovery, amounting in all to an estimated 1.5 to 2 per cent of GDP, taking the form of a combination of tax reduction and increased spending since the 11 September 2001 events. Real government spending is estimated to grow by 7 per cent in 2002. Although another extra stimulus package is not expected in 2003, the lagged multiplier effects of the pro-growth measures enacted since early 2001 are likely to continue to work through the economy into 2003. The balance of the government budget is estimated to register a deficit of more than \$100 billion in 2002 and about \$200 billion in 2003, compared with a surplus of more than \$200 billion in 2000.

In Western Europe, the automatic stabilizers, in a few cases combined with moderate discretionary stimulus, has functioned in such a way as to generate broad deterioration in budget deficits; only a few countries such as Austria, Finland, and Spain are exceptions. Portugal was the first country to exceed the Stability and Growth Pact limit of 3 per cent deficit-to-GDP, while France, Germany, and Italy risk such an outcome over the next year or so. As a result, the budget

¹⁰ The most quoted example is the economy of Japan, where the policy of zero interest rate has boosted double-digit growth in base money, but has left broad money growing at a very low rate.

goals embodied in the most recent revised stability programmes for all EU countries to achieve budget balance by 2004 are no longer within reach and measures are currently being contemplated to defer that deadline until 2006. Meanwhile, political pressure for further tax reduction remains in many European economies. The outlook assumes no major fiscal consolidation in 2003, but a gradual fiscal tightening in the farther horizon is reckoned with.

In Japan, any further government stimulus is limited by the already large fiscal deficit and high public debt level.

Fiscal deficits and government debts in many developing countries and economies in transition have worsened substantially—with Argentina being the extreme case when it declared sovereign default and some others near the brink of a debt crisis. In the past year, only a few developing economies in Asia have been able to adopt expansionary fiscal policy to counter the global slowdown and to stimulate the recovery. Most other developing countries and economies in transition are already facing a tight fiscal constraint. The fiscal situation for these economies will remain severe in the outlook, and for some it may even worsen further.

Uncertainties and forecasting risks

The baseline outlook is subject to a plethora of uncertainties and encompasses a number of risks, mostly on the downside. Major caveats include: (1) any military operation in the Middle East might lead to a disruption in oil supply, thus provoking an oil-supply shock to the world economy or exacerbating the effect of the run-up in oil prices recently experienced; (2) a further prolonged depression in major equity markets may send the global economy into another downturn or trap it into a protracted period of low growth well below the potential pace; (3) an abrupt adjustment in large trade imbalances across the world economies with a sharp reversal of the United States external deficits and accompanied by a substantial devaluation of the U.S. dollar could trigger financial and real economic shocks in the rest of the world; and (4) financial and fiscal fragility in a number of economies could set off further debt crises.

Military confrontation in the Gulf

No specific military operation in the Middle East is included in the basic assumptions for the LINK baseline forecast—it is not prudent to do so even if it were possible. Some “war-danger premium” is, however, implicitly built into the baseline, such as higher prices of oil and lower business and consumer confidence than posited in the previous forecast. Risks do exist for a lingering standoff or a military operation with much higher costs than those subsumed under the premium included here.

The economic consequences of any military operation in the Gulf will depend on the kind of open confrontation that will materialize. It could have a wide range of plausible outcomes of substantially different magnitudes. Not only that, opinions are also widely split on the impact on the world economy of even a well-defined scenario of a military operation. For example, some commentators believe that a repeat of “Desert Storm” could boost economic growth of the United States, as well as of the world

economy, by lifting consumer and investor confidence, propping up equity markets, and lowering the prices of oil. Dissenters argue, however, that new uncertainties will continue to depress confidence and that the financial costs of such a military operation will crowd out business investment, leading to lower potential growth. Nevertheless, the outcome could be well outside any presently conceivable scenario, rendering any serious configuration of its economic impact too complicated or beyond the realm of the plausible.

With simple assumptions on the outcome of a military operation in the Middle East, an analysis of the global economic impact would focus, in addition to human casualties; capital destruction; and infrastructure disruptions for the countries and regions directly involved, on the prices and supply of oil, the attendant changes in consumer and business confidence, and the modifications in macroeconomic policies. In this case, some of the earlier simulation exercises done with the LINK system may shed some light on the analysis. For example, a study executed two years ago¹¹ indicated that a rise in the prices of oil will normally have a limited impact on the world economy, in terms of welfare losses, but an “oil shock,” that is, a higher price of oil sustained for six months or longer, will be recessionary for the world economy, not only through welfare losses, but also through the erosion of consumer and business confidence.

In general, a military operation in the Middle East should be considered as a net drag to the world economy, no matter its merits or demerits on other grounds. It could have a substantial impact on the pace of economic activity in many countries of the Middle East, even if not directly involved in military operations.

Longer-term consequences of the protracted and severe contraction in equity prices

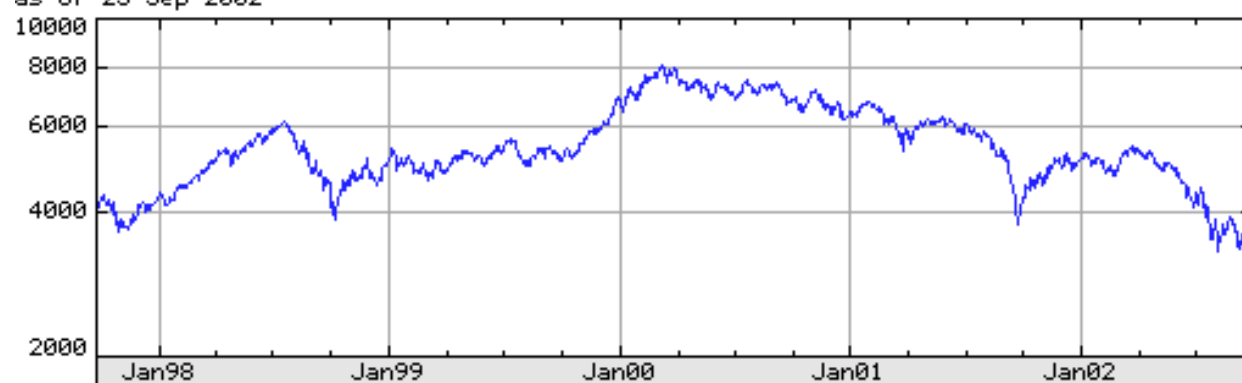
As a second major downside risk, the protracted fall in world equity markets over the past several years has increasingly inflicted downward pressure on world economic growth. After the incipient recovery following the 11 September 2001 terrorist attacks petered out in the second quarter of 2002, volatility in and downward pressure on equity markets have once again taken centre-stage since mid-2002 in all major economies. For example, this is the third year in a row of marked declines in broad indices of shares in the United States. Such a drawn-out contraction has been rare; in fact, it has occurred only twice in stock-market history. Not only that, the cumulative falls have been large: The S&P 500 was down by 45 per cent in September 2002 from its peak of 2000, the largest fall since the Great Depression. Moreover, the erosion has continued despite the very substantial easing of monetary policy.

Equity markets elsewhere have also weakened considerably in a high degree of synchronicity. As shown by figure 3, all major indices have completely reversed to the levels of five years ago, with the core Japanese stock index having fallen to a 19-year low.

¹¹ As presented at the Oslo meeting in October 2000.

Figure 3. Stock Market Indices

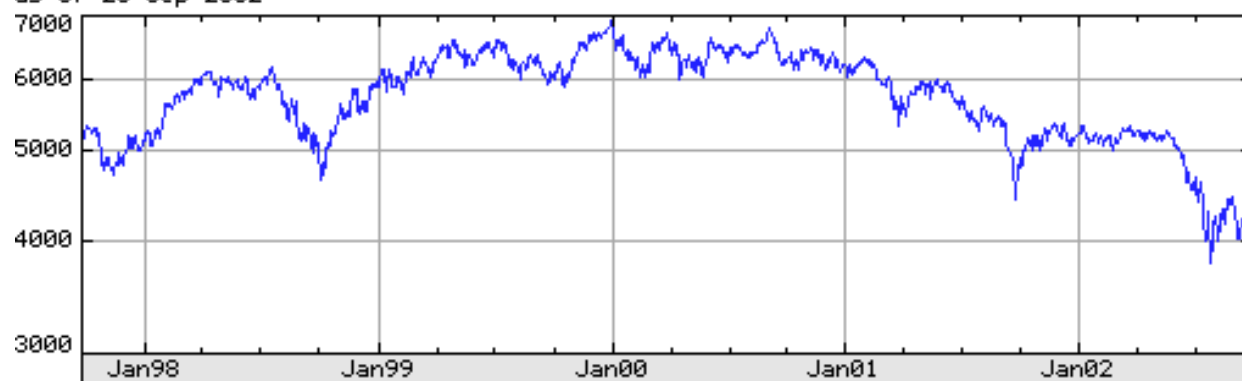
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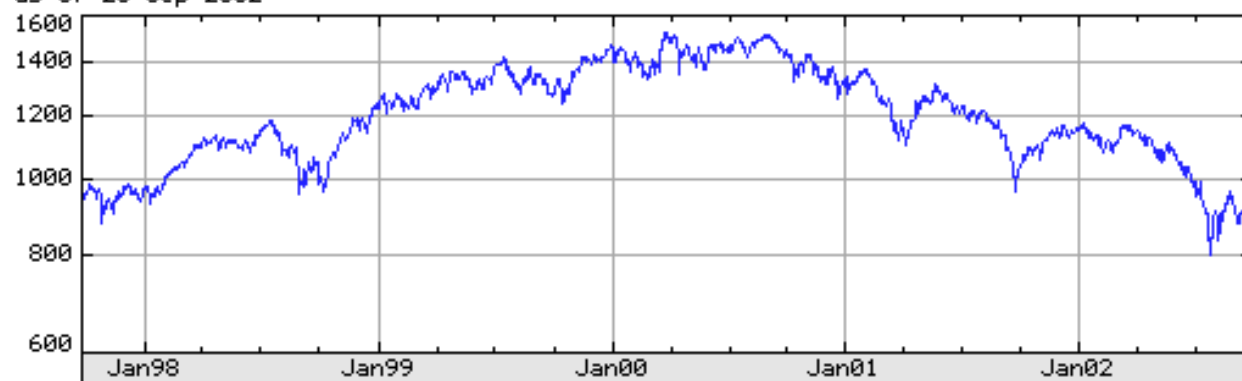
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The impact of depressed equity prices on the buoyancy of the global economy has also been previously studied in LINK exercises and elsewhere over the past few years. A LINK simulation study reported in *World Economic and Social Survey 1999*¹² showed that a 40 per cent drop in major equity markets of the United States and of Western Europe would lead to a decline of GWP by 1.7 percentage points from the baseline in two years. This simulation result coincides well with what has since materialized in the global economy in 2001-2002, with the actual growth in GWP remaining below its potential rate by about 1.5 to 2 percentage points.

One should contemplate whether, if equity markets continue to be depressed for even longer, the recovery in the pace of global growth to potential forecast in the baseline for 2003 will be feasible at all.

The sustainability of the external deficits of the United States

Another downside risk for the world economy is associated with the sustainability of the large trade deficit in the United States and the value of the U.S. dollar. This issue too has been repeatedly discussed in previous LINK meetings and other studies.¹³ The threat of a marked reversal in the external deficits of the United States in conjunction with a sharp erosion in the value of U.S. dollar against major currencies cannot be ruled out in what lingers on the horizon.

There seems to be a dilemma about the United States external deficits. It is well understood that the more the deficits expand, the higher the probability of an abrupt correction later, which will lead to larger shocks for both the financial markets and the real sectors of the world economy. Yet, paradoxically, for the sake of the global economic recovery in the short run, strong import demand from the United States, thus a further widening of the country's trade and current-account deficits, remains desirable.

As considered in the cited past study, there are a myriad of scenarios by which the trade deficit can be reversed. Three typical approaches are: (1) an abrupt adjustment driven by sentimental plunge in the value of the U.S. dollar; (2) structural adjustment in the economy of the United States, with a rise of domestic savings to narrow the saving-investment gap; and (3) structural adjustment in the world economy, with new growth engines coming to the fore and taking the relay of that of the United States, and more balanced investment portfolio across countries. The most perilous one would be an abrupt adjustment—the earlier simulation, as already noted, showed that halving the trade deficit in the United States within two years would lead to a drop in GWP by 1.7 percentage points. Therefore, it remains a challenge for policymakers worldwide to ensure a gradual and orderly adjustment. The recent return of the twin deficits in the United States, namely, a government deficit and a trade deficit, may, however, render the adjustment process more complicated than what was earlier considered.

¹² *World Economic and Social Survey 1999* (New York: United Nations Publication, Sales No. E.99.II.C.1), pp. 12-13.

¹³ *World Economic and Social Survey 2001* (New York: United Nations Publication, Sales No. E.01.II.C.1), p. 23.

Other risks

Other risks may arise from the financial fragility and the debt overhang in a number of economies. The latest debt crisis in Argentina has already underlined the severity of the issue. The probability of other countries falling into such a situation is by no means nil.

Conclusion

A global environment of low growth, low inflation, low interest rates, and worsened fiscal balances, combined with depressed equity prices and heightened geopolitical uncertainties, poses new challenges for macroeconomic policymakers. Bringing about a robust and sustained recovery in world economic growth should be the top priority for macroeconomic policies in most economies in 2002-2003. Further structural reforms, in some cases quite incisive ones, will, however, be needed for both national economies and international trade and financial systems to be able to support more balanced growth in the longer run.