

**REPORT ON THE MEETING OF THE EXPERT GROUP
ON THE WORLD ECONOMIC SITUATION AND PROSPECTS
(PROJECT LINK)**

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INTRODUCTION

The Spring 2003 meeting of the Expert Group on the World Economic Situation and Prospects (Project LINK) was held at United Nations Headquarters, New York, from 23 to 25 April 2003. The Economic Monitoring and Assessment Unit (EMAU) of the Department for Economic and Social Affairs (DESA) hosted the meeting, and over 70 participants from some 50 countries, as well as several representatives from international agencies and the United Nations Secretariat, attended. This report summarizes key issues discussed in the meeting.

The agenda of the meeting covered three broad topics: (1) the global economic outlook, including the LINK global outlook prepared by EMAU, and the global outlook as assessed by other international institutions; (2) regional economic outlooks presented by LINK country participants and United Nations regional commissions; (3) other economic issues, such as Europe's Growth and Stability Pact, the impact of the war in Iraq, and fiscal sustainability in developing countries.

The LINK *Global Economic Outlook*, and *Regional Outlook*, prepared by EMAU for the meeting, LINK *Country Reports* prepared by country participants, and other documents presented at the meeting were available on both the United Nations website (<http://www.un.org/esa/analysis/link>) and the Project LINK Research Center website at the Institute for Policy Analysis at the University of Toronto (<http://www.chass.utoronto.ca/link>). The deliberations during the meeting have been used as an input for the *World Economic and Social Survey 2003*, prepared by the United Nations Secretariat.

Professor Lawrence Klein, University of Pennsylvania, chaired the opening session. He remarked that not since the 1997 Asian financial crisis had the world economy been facing such an unusual level of uncertainties, and believed that the meeting would produce an insightful prognosis of the world economy.

Mr. Ian Kinniburgh, Director, Development Policy and Planning Office, United Nations, delivered an opening statement on behalf of Mr. Nitin Desai, Under-Secretary-General for Economic and Social Affairs. First, he welcomed the participants to the meeting and expressed appreciation to Nobel Laureate Professor Lawrence Klein, Professor Peter Pauly and the other participants for their contribution to the work of the United Nations. He then briefed the audience on the latest developments in policy deliberations within the United Nations system on economic issues. He defined a number of issues that he hoped the meeting would focus on. He noted that the "war premium" associated with the war in Iraq seemed to have diminished, but the consequences of the war on the world economy and particularly on West Asia remained to be analyzed. He called attention to the underlying dynamics for post-war recovery, citing such factors as consumption in developed economies and business investment in information and communication technology (ICT). He questioned whether the world economy would still be able to rely on the United States as the single engine of global growth. He also

requested more analysis of issues in the areas of trade and external financing for developing countries, and macroeconomic policies. He concluded his statement by listing a number of concerns regarding the downside risks facing the world economy, particularly the impact of increased security and military spending on long-run growth. In this regard, Mr. Kinniburgh warned of the possibility for a reversal of the “peace dividend” gained in the 1990s at the conclusion of the Cold War.

GLOBAL ECONOMIC OUTLOOK

Representatives from five international institutions presented their global economic outlooks at the meeting: Mr. Ian Kinniburgh on behalf of the United Nations/LINK; Mr. James Morsink on behalf of the International Monetary Fund (IMF); Mr. Hans Timmer on behalf of the World Bank; Mr. Pete Richardson on behalf of the Organization for Economic Co-operation and Development (OECD); and Mr. Ray Barrell on behalf of the National Institute of Economic and Social Research (NIESR). Two experts presented outlooks for international commodity markets: Professor Gerard Adams of Northeastern University on non-oil commodities and Professor Robert Kaufmann of Boston University on oil markets.

All speakers on the global outlook noted the latest reports of weak world economic growth, which they argued was largely a result of the geopolitical uncertainty concerning the war in Iraq. As the military operation in Iraq was concluding, they all expected a recovery starting in the second half of 2003, although their views differed slightly on the strength and pattern of the recovery across nations.

Mr. Kinniburgh presented the highlights as documented in the *LINK Global Economic Outlook*. He argued that the heightened geopolitical uncertainties and risks that arose before the invasion of Iraq and the war itself had taken a heavy toll on the world economy. With the exception of a few countries, economic growth had decelerated substantially around the world between late 2002 and early 2003. The anticipated global economic recovery was further delayed and the period of slow growth further prolonged. Because the military action in Iraq was briefer and less extensive than widely feared, the previous downside risks associated with the conflict had been reduced substantially and the outlook for the world economy had improved accordingly. After more than two consecutive years of slow growth, the repeatedly postponed and long-awaited recovery was forecast for the second half of 2003, with gross world product (GWP) expecting to grow by 2.2 per cent for the year as a whole, compared to 1.9 per cent in 2002. In 2004, GWP was forecast to grow by 3.1 per cent.

Among the developed countries, the benefits of reduced geopolitical uncertainty would be greatest for North America, which would lead the recovery. Inherent weaknesses in Western Europe would temper its turnaround while Japan would continue to languish. The economies in transition were expected to build upon their recent strength. In the developing countries, recovery in Latin America and steady but limited growth in Africa would buttress external factors. Partially because of severe acute respiratory syndrome (SARS), growth in South and East Asia in 2003 would moderate,

while the war in Iraq would be reflected in a severe slowdown in Western Asia before a recovery forecast for 2004.

In presenting the outlook for the world economy, based on the latest IMF *World Economic Outlook*, **Mr. James Morsink** stated that the world economy in the near term would neither continue to deteriorate, nor be able to achieve a significant rebound. In his opinion, any acceleration in the near term would rely entirely on recovery in developing countries, as most developed economies would continue to languish. He reviewed a number of factors that were important for any recovery: monetary policy in the United States and United Kingdom remained accommodative, but was less so in the euro area; financing conditions in emerging markets had improved, as indicated by the narrowing of the yield spread for sovereign bonds, although the spreads remained high for a few individual countries; productivity growth in the United States was resilient, and the Information and Communications Technology (ICT) revolution would continue to stimulate investment and to spread to other economies.

He also presented some highlights of the outlook for regions and for commodity prices. He warned of a few downside risks for the world economy: the current account deficit in the United States would continue to widen, to about 5 per cent of gross domestic product (GDP), with the danger of an unruly adjustment in the future; the adjustment to equity market bubbles might not be over, which would diminish banks' ability to expand credit; vulnerability in some developed countries remained high; and housing prices in a number of countries had appreciated significantly over the past few years, increasing the risk for a burst in the property bubble.

Mr. Hans Timmer presented an outlook based partly on the latest *Global Development Finance* (GDF) publication of the World Bank. First, he addressed three possible approaches to handling the non-economic uncertainties in making forecasts for the world economy: to ignore them, to focus heavily on them, or to go beyond them and focus on broader economic issues less impacted by these uncertainties. He stated that the latest GDF took all three approaches.

Mr. Timmer's presentation covered three broad areas: he updated the Bank's global outlook, he discussed the shifts in capital flows to developing countries, and he highlighted the rising importance of workers' remittances.

He believed that the world economy would continue to recover—he stressed that the recovery had started a year earlier, but had been weakened during 2002 by a number of shocks. He expected the recovery would be moderate, relying on business-cycle dynamics, namely a gradual healing of the excesses of the 1990s, and on policy stimuli. He reviewed a number of indicators for the current state of the world economy, including improvement in the balance sheets of many companies in the United States, a turnaround in business investment, a strengthening in non-oil commodity prices, a narrowing of emerging market spreads, and, although recovery in industrial production remained hesitant, a rebound in world export volume. He warned of some risks for the recovery, notably SARS and the high level of household debt in the United States.

In addressing the shift in capital flows to developing countries, he showed the significant change in external financing for developing countries since the 1997 Asian financial crisis: this group had turned from net capital importers in 1997 to net capital exporters in 2002. Mr. Timmer explained that this reversal was partly due to the increase in oil prices, and partly because of behavioural changes brought about by the financial crises of the past few years. He claimed that capital flows across countries, unlike trade flows, were not determined by comparative advantage (that is, in the view of the note-taker, by comparative labour/capital ratios across countries). He also noted the structural change in external financing for developing countries, namely, a shift from debt financing to Foreign Direct Investment (FDI). He emphasized that FDI was not needed for financing current account deficits but for integrating the host countries into the world economy.

Mr. Timmer pointed out that workers' remittances to developing countries had increased over the past few years and the total now exceeded the amount of Official Development Assistance (ODA) to this group. Two main sources of remittances have been the United States and Saudi Arabia. The vulnerability of receiving countries to an abrupt decline in remittances had also increased in his opinion. The likelihood of such a decline had also grown due to: concerns in high-income countries about migration, driven by weak labour markets; concern about security issues; and geopolitical uncertainties, such as the war in Iraq.

Mr. Pete Richardson presented the outlook based on the *OECD Outlook (73)*, and focused on OECD countries. He started by analyzing a number of underlying forces, such as oil prices, exchange rates, equity prices, confidence and policy stance, and gave his assessment of the current state of the world economy. He also analyzed some high-frequency indicators, believing that a gradual recovery was under way. He stressed the differentials across the United States, Europe and Japan. While his outlook for these three major economies were in line with previous speakers, he listed a number of separate risks for each of them: in Europe, high and rising unemployment and the poor fiscal position of key member countries (1.5 per cent of GDP, even in 2004, according to the current forecast); in the United States, a need for fiscal restraint following discretionary easing, little scope for further monetary action and the high current account deficit; in Japan, high unemployment, continued deflation, bad loans, a weakened banking system, and a continued need for structural reforms.

Mr. Ray Barrell believed that the recent fall in the dollar and the Government's fiscal stance would help raise the output growth of the United States, while growth in the euro area and Japan would be constrained by strong or appreciating exchange rates. He stated that investment appeared to be rising in the United States and in some larger euro area countries, but consumption growth risks remained in the United States, the United Kingdom and Japan. His presentation featured an in-depth analysis of a number of specific issues, including deflation risks; interest rate and policy reactions; exchange rates and realignments; oil prices and the Iraq war; and fiscal policy in the United States.

He remarked that demand-driven deflation would have a negative impact as it could lead to deeper recessions and liquidity traps. However, supply-driven deflation, as seen in China, should not be a problem. He demonstrated the deflation risks in the United States with a stochastic model simulation: in the baseline with expected inflation at 2 per cent, the chance for deflation in 2004 would be 1 in 20 but, if the expected value of inflation rate were 1 per cent, the chance for deflation would increase to 1 in 6. He commented that the recent depreciation of the United States dollar should have reduced the risk of deflation.

In discussing the impact of the realignment in the exchange rates among the major currencies, especially between the United States dollar and the euro, Mr. Barell foresaw a redistribution of global demand; however, the response in the euro area would be more inertial than in the United States. He claimed that, even though the euro/dollar exchange rate had changed significantly, the evidence of pass-through to prices was still difficult to find. In any case, he believed euro area growth would slow by over one-half per cent in 2003 because of the euro appreciation, while growth in the United States would rise a little.

In remarks from the floor, participants addressed several issues, a prime topic being remittances. **Mr. Juan-Rafael Vargas, Escuela de Economia, Costa Rica**, raised the question of their relationship with macroeconomic policy. He argued that in regions with the “wrong” or ineffective macroeconomic policies, remittances could do the work of economic policy—i.e., provide a Keynesian boost to the economy. Post-September 11 changes in the immigration policies of many states might thus impact more than just the lives of potential immigrants. **Mr. Nazem Abdalla, Senior Economist, United Nations Economic and Social Commission for Western Asia (ESCWA)** provided further details on remittance flows which, from that region, amounted to about US \$26 billion per year. Most of this money flowed out of Gulf Cooperation Council (GCC) countries but, with those states limiting immigration, remittance flows would fall. Remittances in the region were an effective way for states to bridge balance-of-payments deficits.

Mr. Andre Hofman, United Nations Economic Commission for Latin America and the Caribbean (ECLAC), noted that remittance flows to Latin America had declined for the past 3 to 4 years, while Mr. Hans Timmer contended that, given the post September-11 world, the global prospects for remittances had dimmed. Mr. Timmer also discussed the various models of remittances, singled out Mexico’s formal process (encouraging remittances). He also addressed the question of whether remittances (and the outflow of workers behind them) was a result of structural imbalances or successful policy; he argued that it was a function of comparative advantage and the perennial surplus of labour in many developing countries.

Several participants raised the issue of FDI and the surprising resiliency of FDI, even amidst economic decline. However, in many countries, as Mr. Timmer noted, FDI was relatively small compared with total capital flows, and the reversal of capital flows other than FDI had been significant.

Mr. Richardson and Mr. Barrel contributed their views on the role of the European Central Bank (ECB). According to Mr. Richardson, the inflation-targeting objective of the ECB might be wrong; compared with the US Federal Reserve, the ECB had considerably less freedom of action. The ECB could cut rates as a market signal, but only at the risk of missing its inflation policy targets. Mr. Barrel argued that the ECB was likely to achieve its target range and, given the structures, there was no case for weakening the interest rate.

GLOBAL ECONOMIC OUTLOOK: COMMODITIES

Non-oil commodities

Mr. Gerard Adams, Northeastern University, Boston, argued that commodity prices were largely dependent on the world economic cycle, and that they were also sensitive to the degree of synchronization among the world's economies: a synchronized global upturn thus could be expected to have a larger impact on commodity prices.

Most prices had shown only a small cyclical recovery, with price levels still considerably depressed from historical highs. For some commodities, such as oil and gold, the war premium seemed to have already receded. The prices of agricultural commodities were up a little more than that of metals. However, world demand was still far from exhausting supply capacity, so that a significant recovery in generalized non-oil commodity prices would take longer than the 2003-04 horizon.

The depreciation of the United States dollar vis-à-vis the euro meant that real prices of commodities, measured in euros, were lower than their dollar prices suggested. On the other hand, currency depreciations against the dollar in some developing producer countries had increased the prices in local currencies, providing a stimulus for production and exports.

The short-run outlook for world oil prices

Mr. Robert Kaufmann, Boston University, began his presentation by examining the recent large fluctuations in world oil prices, and based the remainder of his talk on two questions raised by the price movements concurrent with the Iraq war, namely why had oil prices been so high prior to the war and why had the war forecast been too high?

In response to the first query, Mr. Kaufmann argued that prices had been elevated for three reasons. First, world oil stocks, and especially those in the United States, had declined precipitously. Second, strikes in the oil industry in Venezuela had almost shut down the petroleum sector, further exacerbating the oil stock fears. Finally, from January 2003 until the Iraq war in March 2003, the price of oil had included an implicit "war premium," based in part on the experiences of the oil markets during the first Persian

Gulf war. In all, prior to the Iraq war, oil prices in the first quarter of 2003 had risen by \$5.50 per barrel, of which \$1.75 was attributed to stock reductions, \$1.25 to the problems in Venezuela, and \$2.50 to the threat of war in the Middle East.

Mr. Kaufmann then turned to the oil forecasts made by analysts (including himself) prior to the Iraq war. Almost without exception analysts had suggested that oil prices would be much higher during and after the war than they actually were. Why were the projections so inaccurate? The problem, argued Mr. Kaufmann, was that the assumptions of many analysts had failed to materialize; most observers had predicted a loss of 700,000 barrels a day of Kuwaiti crude and a six-month loss of all Iraqi oil exports. As it turned out, Kuwaiti oil production had been only marginally impacted by the hostilities and oil fields in both northern and southern Iraq had escaped the war relatively unharmed and were projected to return to their full pre-war capacity within about two months. Additionally, the lifting of the UN sanctions on Iraq would further ease Iraqi oil exports. Furthermore, oil analysts failed to project the speed with which the Venezuelan strike would be lifted and the country would return to full production; in less than three months (January-March 2003), the country's production had gone from 500,000 barrels a day to 2.5 million barrels a day, approaching the pre-strike levels.

Regarding a post-war forecast, Mr. Kaufmann contended that Iraqi production would return in full by the third quarter of 2003. Further, recent difficulties in both Venezuelan and Nigerian production would continue to be overcome, allowing oil stocks to recover to "normal" levels. Oil prices would also be more depressed due to the continuing softness of the global economy, with the relatively slow growth dampening the demand for oil.

REGIONAL ECONOMIC OUTLOOK

Several sessions were devoted to the outlook for different regions in the world economy.

United States

Professor Klein, University of Pennsylvania, presented his view on the short-term outlook for the United States, based on the High Frequency Model maintained at the University of Pennsylvania.

He started with a chart to illustrate the budget cost of the war in Iraq together with a projected cost of the Ballistic Missile Shield, which, while still under debate, would cost about \$1 trillion in fifteen years. Echoing the question raised by Mr. Kinniburgh in his opening statement regarding the reversal of the “peace dividend”, Professor Klein attested that lower military spending in the 1990s, after the “Cold War”, had generated a measurable dividend for the economy of the United States, as well as for the world economy; conversely, the current rise in military spending would be costly.

He went over some thirty economic indicators to show the current state of the economy of the United States and the possible trajectory in the short-run outlook. In his view, most indicators confirmed that the economy had performed weakly during the first quarter of 2003: labour markets were fragile as non-farm payroll employment continued to decline; inflation had surged to nearly 4 per cent as a result of higher energy prices; and various indices pointed to weakening consumer and business confidence. He also noted some resilience in the economy, particularly with such heightened uncertainties: housing starts remained strong and mortgage rates were at low levels, so it was too early to say that strong support from the residential sector had gone. He predicted continued weak growth in the second quarter of 2003, with GDP growing by only 0.5 per cent. He emphasized that, if the economy continued in the 2 to 3 per cent growth range, it would be too slow to generate jobs. He noted the re-emergence of the “twin deficits” in the United States, namely the deficit in the current account and the deficit in the government budget, and foresaw no signs of a turn-around in the deficits at any time soon. He criticized the current fiscal policy as “misguided” but considered that it was not all bad; for example, he believed that the removal of taxes on dividends would generate investment, as anticipated by the Bush Administration. He warned that the fiscal predicament facing most states and local governments would lead to a reduction in spending on many public goods and services, such as education and public infrastructure, and called for a balance between federal financing and state financing.

In the discussion, answering a question about the impact of the weak dollar on the twin deficits, Professor Klein stated that the lower dollar would not lead to an immediate reduction in the trade deficit because of the “J-curve” effect. Asked about his view on the relatively high projection of GDP growth for the United States in 2004, 3.9 per cent, he commented that the number was on the optimistic side but it would not be impossible.

Replying to questions about the cost of the war in Iraq and post-war reconstruction, he believed the war cost more than a twenty-year extended stay for UN inspectors in Iraq. He derided the favouritism given to contractors involved in the post-war reconstruction of Iraq. He also commented on the importance of FDI to developing countries, stating that developing countries, such as China, linked FDI to technology in the long run, while portfolio investment was often only transitory, going in and out quickly.

Japan

Professor Kanemi Ban, Osaka University, presented the outlook for the Japanese economy. He emphasized that deflation in Japan continued in 2003, and that nominal GDP fell by 1.4 per cent in the first quarter. In analyzing aggregate demand, he pointed out that business investment, which had rebounded in 2002, would decline again in 2003, while household consumption would be flat. He noted the most recent improvements in business conditions—as indicated by business surveys, particularly for manufacturing—but he believed that the sustainability of the recovery would be largely dependent on a recovery in exports.

He listed several challenges facing the Japanese economy: unemployment continued to deteriorate, non-performing loans kept increasing, and banks' capital valuations had declined relentlessly, as stock market declined to the levels of twenty years ago. He also reviewed various policies that had been enacted to reduce shareholdings by banks and to reduce non-performing loans. In his opinion, all these policies seemed to be too small in stance and too late in timing to resolve the grave financial problems in the economy.

In answering a question regarding the possibility for a policy to draw more foreign banks into Japan, Professor Ban believed that the yen should depreciate; otherwise it would be too expensive for foreign banks to enter. Elaborating on the question of demand- or supply-driven deflation, he argued that there had been a structural change in the economy, with the household saving rate dropping to 6 per cent from 20 per cent two decades ago.

Western Europe

Mr. André Drama is, European Commission, presented the outlook for Western Europe. He contended that the eurozone was expected to grow by less than 1 per cent in 2003 and 2.25 per cent in 2004. On the positive side, inflation had fallen, the exchange rate was appreciating, employment growth was still resilient (which meant that structural reforms had had some effect) and unemployment had gone up less than it might have, given the slow growth. He concentrated on three issues, leaving fiscal issues to the session on the Stabilization and Growth Pact (see below).

First, he was not optimistic about exchange rate stability, noting its volatility in the past. In 1980, the ecu (the predecessor of the euro) had been valued at 1.4 (to the United States dollar) and by 1985 it was 0.78; volatility had been very common.

Currently, both Europe and the United States were pursuing monetary policy that neglected exchange rates, so more volatility would be likely. Exporters would have to learn to adjust. The degree of openness of the EU had increased since the 1960s but this had occurred only within the EU. The extra trade share had remained constant over period (10 per cent of GDP), especially if oil were netted out, and most trade was invoiced in euros, with only oil in US dollars. This meant that changes in exchange rates would not affect exports significantly.

Second, inflation had remained stubbornly above 2 per cent and was expected to average 2.2 per cent in 2003 and below 2 per cent in 2004. Why? Oil was one reason, but he pointed to service price inflation, which had been stable at 3 per cent and had only recently gone below 2 per cent, as a prime culprit. Competition in services was less than in manufacturing, as many prices were regulated, and productivity was lower than in manufacturing. Consequently, according to the Bellassa-Samuelson effect, with similar rates of wage growth, inflation would be higher (than if the service sector were more efficient).

Finally, employment growth had continued despite the slowdown. Over the past year, unemployment had fallen from 10 to 8 per cent. It was now increasing, but the labour market appeared to be more flexible than before. In particular, hours had decreased rather than employment. He noted that, in comparing labour markets in the EU with the United States, GDP per employed person in the EU was approximately equal to that in the United States, but GDP per capita was only 70 per cent of the United States level. This meant that the number of hours worked in the EU were less than in the United States and raised the question of whether more leisure was good or bad.

Several country participants from the floor added to Mr. Dramaïs' presentation.

Germany: **Mr. Ulrich Heilemann, RWI Institute, Essen, Germany**, commented on the reforms under way in Germany, noting that they would have no effect until 2004/05, and that there could be modifications to the timetable, so that 2003/04 would not be affected. He said that nothing could be done about the current situation. Chancellor Schroeder's plan was to reduce social expenditures and press more people into the labour market, but many people thought that it was a bad time for such an approach.

France: **Mr. Arnaud Buisse, French Ministry of Finance**, said that the budget deficit in his country was expected to be 3.4 per cent in 2003 and that the planned tax cuts would go through, so there should be some stimulus. By 2004, the government would be past mid-term elections so it was expected that the deficit would be brought down to 2.9 per cent. After the current round, there would be no more tax cuts in the foreseeable future.

Mr. Pete Richardson, OECD, asked if the good behaviour in the labour markets until then was a sign of more flexibility or labour hoarding by firms. If the latter, then there could be a major shakeout if growth continued to be slow. Mr. Dramaïs replied that, until more data were obtained, it was not possible to tell how much structural change there had been.

Central and Eastern Europe

Mr. Rumen Dobrinski, United Nations Economic Commission for Europe (ECE), made a presentation. He said that the countries of Central and Eastern Europe (CEE) had exhibited some resilience to the global economic slowdown in 2002; most of the slowdown in their economic growth, in response to a weaker external environment, occurred in 2001. Deceleration of growth, however, continued in 2002, with the growth in the Commonwealth of Independent States countries (see below) decelerating more than in the CEE region.

There had been a divergence in economic performance in the CEE in 2002, especially among different sub-regions, including Central Europe and South-Eastern Europe. In particular, there had been a shift in the strength of growth from Central to South-Eastern Europe. In Central Europe, GDP growth in 2002 had remained below average, reflecting continuing economic weakness in Poland, while in South-Eastern Europe the recovery had continued. This was not only because the former had stronger trade links to the EU (and was thus impacted by slow EU growth), but also because these regions were at different stages of structural reforms. The initial strong growth of the immediate post-reform era in Central Europe had petered out so that South-Eastern Europe had become the fastest growing subregion.

One common feature for all subregions in 2002 had been a shift from export-driven growth to growth driven by domestic demand. The sustainability of this domestic demand was questionable because this was not a sustainable pattern of growth for small open economies and because these countries needed to keep both their external imbalances and fiscal deficits in check.

The outlook for all CEE countries was optimistic for 2003, with positive growth, and a shift from stable inflation to disinflation, explained by, among other factors, nominal appreciations of the exchange rates. However, structural fiscal deficits posed a risk to this outlook. Because of the second stage of structural changes, and the recapitalization of the banking sector in particular, there were additional sources of fiscal deficit. A further risk to the outlook was posed by the current-account deficits of CEE states.

The fiscal costs of EU accession might be high for the new members for the initial years and there was a considerable need for public infrastructure investment and other expenditure in the accession countries. At the same time, EU fiscal policy rules required a significant tightening of fiscal expenditures and were therefore an impediment to economic expansion.

Special European Topic: Two Europes Merging

European Union enlargement

A presentation on this topic was made by **Franjo Stiblar, Ekonomski Inštitut Pravne Fakultete, Ljubljana, Slovenia**, began by updating the meeting on the state of EU enlargement. EU enlargement would take place in May 2004 and, following the accession, new member states would participate in the EU parliamentary elections in June 2004 and would start to operate in the European Commission from November 2004. They would join the euro zone, however, not earlier than 2007.

The total GDP of the candidate countries was only 8 per cent of the GDP of the EU, their total population was 18 per cent, and their land area was 23 per cent. The importance of these two regions for each other in the trade of goods and services and the provision of banking services was asymmetric. At the same time, there was diversity among candidate countries by size of population, GDP, macroeconomic performance, and transfers received from the EU. The level of development of the financial sector, in particular, was three times higher in the EU than in the accession countries, measured by assets-to-GDP ratio, ratio of credit (to public and private sectors) to GDP, and market capitalization-to-GDP ratio.

The level of development and the role of small and medium-sized enterprises were also much higher in the EU, and the process of starting-up such enterprises in the candidate countries remained too complicated. Most of the candidate countries were still very far from meeting the euro zone entry criteria. At the same time, some of the accession countries met the criteria of optimum currency area better than some current member States.

Overall, the enlargement would bring additional problems of non-homogeneity to the EU.

One participant was asked if the currency boards in the CEE could become a source of financial crises. The speaker believed not, as only Bulgaria among the candidate countries had a high level of external debt, which it had managed to reschedule and thus reduce its payments. Another participant asked if EU assistance would boost the economies of CEE countries following accession, as had occurred in a number of current EU countries. Again the speaker believed not, given that the increased growth enjoyed by some current EU countries upon their accession had been due largely to their economic situations, which had originally been in better condition than those of the present candidates.

Eastern Europe and the Commonwealth of Independent States

In the second part of this presentation, **Rumen Dobrinski** was moderately optimistic about the outlook for the Commonwealth of Independent States (CIS). Most

countries were expected to sustain their momentum in 2003 or even record a moderate upturn. The region as a whole was expected to grow by over 5 per cent, with Central Asian and Caucasian countries enjoying higher than average rates of growth.

The fiscal and current-account deficits were mentioned as risks to the outlook. The fiscal situation in the CIS, however, was better than in the Eastern European (EE) states because CIS countries were behind EE countries in terms of reforms with fiscal consequences. Some countries still had large current account deficits, but Russia and Ukraine had enjoyed large current-account surpluses in 2002.

Mr. Dobrinski said that Russia, the largest economy of the region, was experiencing a remarkable recovery, which had not been fully anticipated after the Russian crisis of 1998, and that it had the potential to become the engine of growth for the CIS region because of its size, extensive trade links with the CIS countries, and steady economic growth.

Two major factors initially responsible for the Russian recovery after its financial crisis were the depreciation of its currency and high the prices of oil. Although the effects of the first factor had already been exhausted, high prices of energy continued to benefit the country's economy. Russia had succeeded in increasing its oil output and exports and there was a strong correlation between oil revenues and GDP growth. By some estimates, a \$1 increase in the price of oil raised the GDP growth rate by 0.4 to 0.6 per cent and fiscal revenues by 0.8 to 0.9 billion rubles.

Growth in Russia was being driven by private consumption, which was expected to expand by about 10 per cent in 2003. Business investment had also started recovering at the beginning of 2003. In the short term, Russia should be able to maintain or improve on the higher GDP growth rates it achieved in 2002; during the first quarter of 2003, the economy had grown by 6.4 per cent. Growth in the long run, however, would depend on progress in reforms.

Special Topic: The Russian Economy

Empirical regularities in the Russian economy

Mr. Vladimir Eskin and Mr. Andrei Rudoi, Global Insight, Boston, presented their high-frequency model for forecasting the national accounts variables for the Russian economy.

They started by reviewing the economic situation in Russia in 2002 and presented an outlook for 2003. In 2002, Russian economic growth had slowed to 4.3 per cent from 5 per cent in 2001. A further slowdown had often been predicted as a result of an expected decline in oil prices; for example, the IMF had projected 4 per cent GDP growth for 2003 and 3.5 per cent for 2004. However, the speakers thought that Russian short-term economic prospects were better than many economists believed. Growth had accelerated to more than 6 per cent in the first quarter of 2003; but although slowing, it

was still expected to be 5 per cent in the second quarter. For 2003 as a whole, economic expansion would exceed the previous year's rate. There was particularly strong growth in construction in the first quarter of 2003—14 per cent, as compared to 3 per cent in 2002. Growth in services had exceeded growth in the production of goods.

In the second part of their presentation, Mr. Eskin and Mr. Rudoi presented their model. The model calculated principal components from monthly indicators derived from over one hundred data series. National account variables were then regressed on principal components and ARMA terms. The model measured the same-quarter impact of exogenous shocks, such as a change in world oil prices, on the national account variables.

Africa

Mr. Adam Smith and Mr. Carl Gray, United Nations, presented a summary of the outlook for Africa. Africa's overall GDP growth was expected to reach 3.5 per cent in 2003, a slight increase from the 2.9 per cent in both 2001 and 2002. Growth was projected to continue accelerating, albeit slowly, to 4.1 per cent in 2004.

For the first time in many years, 2002 had seen sub-Saharan Africa surpass the continent's average growth, as the large economies of North Africa had been hampered by low OPEC quotas and/or decreased demand from trading partners. Despite reduced growth in Nigeria, and only a slight increase in South Africa, more than twenty countries—almost all sub-Saharan—had grown in excess of 3 per cent. Only four countries—Côte d'Ivoire, Madagascar, Malawi and Zimbabwe—had suffered contraction. Other than Malawi, which had endured a severe drought, contraction had been a result of conflicts, protracted in Côte d'Ivoire and Zimbabwe, and stabilizing in Madagascar.

The external economic climate in 2002 had become more negative for Africa as the year concluded, and had been marked by continued tentative recoveries in the continent's trading partners and increased uncertainties over potential military engagement in Iraq. This uncertainty had been exacerbated by the depreciation of the US dollar against the euro. African commodities were sold in dollars, but the majority of imports were priced in euros, which meant that the continent was increasingly hurt as the dollar declined.

The last quarter of 2002 had presented significant challenges for Africa. Impending combat in Iraq had further hampered tourism in North Africa, and political instability had increased in many states in which citizens had expressed violent disapproval of the war. States such as Egypt had been severely impacted, facing losses in tourism earnings and currency value, which, combined with its designation as being in a war zone, had constrained growth during the final months of the year. The other major trial for the continent had come about due to the increasingly intractable crisis in Côte d'Ivoire, which had begun to take on region-wide tendencies. With the mass repatriation of its foreign workers, Côte d'Ivoire had lost the backbone of its cocoa economy and the region had lost remittance flows, the locus of substantial FDI, and a prime engine of

growth. The contagion effects of this crisis had been considerable; especially affected have been the landlocked countries of Burkina Faso, Mali, and Niger, whose economies had had to absorb not just reduced remittances and increased unemployment, but also substantially higher transshipment costs. Continued tensions in Zimbabwe and the Democratic Republic of the Congo, and between Ethiopia and Eritrea, had also served to depress end-of-year growth in other parts of the continent.

In 2003, the poles of African growth would start returning to their norms, with North African states again growing more vigorously. Algeria and Libya, in response to higher OPEC quotas and momentary price spikes, were expected to achieve higher growth, while Morocco and Tunisia would continue their recovery from the terrorist attacks of 2001. Though continent-wide growth would improve slightly and African inflation was expected to decline to 6.3 per cent, the outlook for many African states remained clouded by events in the Middle East and the continued instability in several countries.

The fallout of the Iraqi engagement, and questionable growth in Europe and North America, added to the uncertainty. In West Africa, in addition to the Côte d'Ivoire situation, further instability had visited the region during the first quarter of 2003, with a coup in the Central African Republic, increased fighting and political volatility in the Mano River region, and sustained tensions due to an unsettled dispute over the Bakassi Peninsula between Cameroon and Nigeria. Despite this uncertainty, however, exports should increase if global economic growth picked up in the second half of 2003. Projected price increases for almost all categories of export commodities would additionally strengthen export revenues and GDP growth in many countries.

Global and subregional uncertainty might affect official financial flows to the continent. Though African states continued to benefit from the Heavily Indebted Poor Countries (HIPC) Initiative, the war in Iraq and the continued rebuilding of Afghanistan placed some of the promised ODA for Africa—and, in particular, those funds pledged under the United States Millennium Challenge Account—in jeopardy. The administrators of these funds might not commit the money elsewhere, but their attention to Africa might be dulled by seemingly more pressing issues elsewhere.

Average inflation rates in Africa had increased slightly from 2001 to 2002, to 7 per cent, a figure which masked continuing difficulties in maintaining low price growth in Ghana, Malawi, Nigeria, Zambia and Zimbabwe, all of which recorded double digit inflation during the year. Other states, however, notably Botswana, Tanzania and many CFA countries, had managed to reduce inflation, in many cases as a result of tight monetary and fiscal policies and increased domestic food supplies.

Asia

Mr. David Choi, United Nations, provided the regional outlook on Asia. The main features of the outlook for both South and East Asia were an immediate moderation

of the economic recovery under way, a slow return to robust growth in the second half of 2003, and accelerated growth—still restrained by several factors—into 2004.

Mr. Choi remarked that growth in East Asia, had rebounded markedly in 2002 from the slowdown in 2001. This performance was a reflection of specific domestic and international factors. In general, the recovery had been led by increasingly strong exports to the United States, continued strong domestic consumption patterns, and accommodative fiscal and monetary policies in the region. In late 2002, the external environment had deteriorated, but export growth had remained strong, as downward pressures had been offset by strong intraregional trade, particularly a surge in imports from China.

Despite this growth, private investment in East Asia remained weak in most economies, and unemployment was a mounting problem, largely a function of an ongoing “rebalancing” process in the subregion. Inflation, however, remained benign, but there was a concern that deflation might be imminent in some countries. An additional concern had been the outbreak of severe acute respiratory syndrome (SARS), which would weigh down growth for some time. Tourism economies would be particularly vulnerable. However, if SARS was effectively controlled within the next month or so, growth would pick up in the second half of 2003.

In South Asia, growth in 2002 had only slightly improved from 2001. Performance remained uneven across countries, largely a result of different climatic and security conditions. Fiscal policies would probably remain accommodative in most of the region’s countries, but a mounting concern about the large public debt burden might restrain fiscal stimuli. Growth in the region would strengthen in the second half of 2003 and become more even across South Asia as world demand improved and climatic and security conditions were ameliorated. In 2004, growth would accelerate further, but its pace would still be below the targets set by regional states, constrained by structural impediments, including large fiscal deficits. Some countries, including Bangladesh, Nepal and Sri Lanka would also have to contend with intense competition in their garment industries, their main export sector.

The positive outlook for both South and East Asia was predicated on the ability of states to control SARS, retain flexible/accommodative macroeconomic policies and sustain the strength of intraregional trade (particularly vis-à-vis China). Improved demand in major developed countries and, especially important for agriculture-dominated economies, a return to “normal” climatic conditions would also be pivotal. Risks, however, were many and included the unknown side effects of a potential failure in negotiations with the Democratic People’s Republic of Korea regarding their nuclear ambitions, the tense political situation in the aftermath of the Iraq war (especially in largely Muslim states), the possibility of a worsening “el Niño” phenomenon, and an unfavorable monsoon season.

China

Mr. Wang Tongsan, Chinese Academy of Social Sciences, presented the outlook for the Chinese economy. He remarked that his projection was finalized before the large outbreak of SARS, so some quantitative adjustments would be necessary. He indicated that China's economy had started the year at a very strong pace, as GDP had grown by 9.9 per cent in the first quarter of 2003 and investment had soared. Even with the disruption of SARS, he believed GDP growth could still reach 8.5 per cent or higher for the year as a whole. He was cautious about the impact of SARS on growth because it was uncertain how long it would take for China to contain the disease. Instead, he focused on some economic fundamentals. He believed that the strong performance in the first quarter of 2003 marked a turning point for the Chinese economy, ending a period of "slowdown" since 1996: general prices had rebounded noticeably in the first quarter, lifting the deflationary pressure that had haunted the economy for three or four years, and the trade balance had turned to deficit for the first time in several years. Commending the role of proactive fiscal policy in the past few years in stimulating domestic demand, he also pointed to the negative effects of the policy: the ratio of investment to GDP had been pushed to above 40 per cent. In his opinion, policies in the future should focus more on stimulation of household consumption.

In responding to a question about the possibility that the Chinese currency, the yuan, might appreciate, Mr. Wang believed that in the near term the government would not shift the targeted band for a managed floating exchange rate vis-à-vis the United States dollar. He mentioned that, because the policymakers' highest priority was to reduce unemployment and underemployment, the government would not revalue the currency to avoid hurting exports and jobs.

Latin America and the Caribbean

According to **Mr. Andre Hoffman, Economic Commission for Latin America and the Caribbean (ECLAC), Santiago**, close to 2 per cent growth was expected for the region in 2003. The most salient feature of this outlook was the fact that Argentina was again on a growth path after its disastrous performance in 2002. The basic assumptions in ECLAC's outlook were:

- Slow growth in the industrial countries;
- Continued improvement in commodity prices, but still sluggish export volumes;
- Oil priced at \$27.50 per barrel.

There had recently been some improvements in the external sector, mostly linked to better export prices since volumes remained sluggish. Additionally, there had been improvements in access to international capital, and foreign exchange markets were becoming more stable. Inflation in the region was expected to come down to the range of 6 to 7 per cent, though it had been 11 per cent in 2002, after 10 per cent in 2001.

For 2003, export growth of 5 per cent was expected, along with a recovery of imports after the 2002 recession. The region's current-account deficits would contract. Internally, inflation was expected to moderate as currencies regained stability, with the exception of Venezuela. Interest rates were expected to be lower and in some countries there had already been some growing dynamism in monetary aggregates. There would remain little room for expansionary fiscal policies, although some monetary easing might take place.

Ecuador was a difficult case: there was a problem with the external sector, and external debt was rising. The surge in oil prices, however, had provided much needed support and growth in 2003 was expected to be 2 per cent.

Relatively stable growth of about 2.8 per cent was expected in the Caribbean, largely as a result of strong growth in Trinidad and Tobago

The region faced serious economic and political problems of an internal nature. In several countries the situation might worsen. In Venezuela, a contraction of around 10 per cent was expected for 2003, although some viewed this as optimistic. Additionally, further economic weakening in the United States would have a strong impact in Mexico and Central America.

Mr. Hofman also commented on the balance of payments of the region. Workers' remittances had become an item of significant magnitude. In some countries, such as El Salvador and the Dominican Republic, they represented as much as 10 per cent of GDP. In others, such as Bolivia and Ecuador, remittances represented 5 to 10 per cent of GDP.

As to capital markets, country risk, as measured by the EMBI index of sovereign debt spreads for the regional aggregate, had reached extremely high levels in October 2002. From levels of 1400 basis points, however, they had come down to around 900. On the other hand, bond issuance had picked up in the region since January 2003, although there were signs of renewed sluggishness.

Several comments on Mr. Hoffman's presentation were made from the floor. **Mr. Alfredo Coutiño, CEFM, Mexico**, identified two factors behind the meager 2.5 per cent growth forecast for Mexico, which was well below its potential rate of 4 to 4.5 per cent: the first was the strong correlation between the business cycles of Mexico and the US as a result of NAFTA; the second was the marked drop in Mexico's domestic saving rate during the previous three years –a loss of 5 percentage points of GDP, which would constrain economic growth rate over the medium term.

In addition, the present administration had proved unable to carry forward key economic reforms in the electricity and oil sectors due to strong opposition in Congress. There was a high likelihood that the opposition would retain control of Congress in legislative elections later in 2003, with the result that the chances for a deepening of structural reforms would be diminished, which in turn would compromise the growth in savings and investment rates that was needed.

Mr. Eustaquio Reis, IPEA, Brazil, commented on policy issues in Brazil. There had been a great deal of speculation regarding Brazil in financial markets during 2002 that had influenced its economic performance. The Central Bank had been slow in reacting to speculation, and had failed to show a willingness to actively address the issue initially. The new Central Bank President who took office after the elections, however, had been quick to raise interest rates, which had increased from 21 per cent in September 2002 to 26.5 per cent in April 2003.

The new Government had proved sound in its macroeconomic approach, even more so than anticipated by optimists. It had raised the primary surplus target from 3.75 to 4.25 per cent of GDP, passed only a 1 per cent pay rise for civil servants, and seemed to be according great importance to acting by the rules. Financial markets had reacted very positively to the new government's policies, as shown by the prevailing stability in the exchange rate and interest rates spreads. The key challenges were the structural reforms, in the areas of social security and the tax system, to be submitted to the Congress in June 2003.

Ms. Cristina Rodriguez, Metroeconomica, Venezuela, drew a somber picture of current developments in Venezuela, stressing political instability and the uncertainties affecting economic activity, in addition to the increase in unemployment. The Government's suppression of the free foreign exchange market had resulted in the development of a large black market in currency. **Mr. Pedro Palma**, also from Metroeconomica, pointed to the impoverishment undergone by Venezuelans: there had been a 25 per cent decline in per capita income during the past three years.

Western Asia

Mr. Nazem Abdalla, Senior Economist, United Nations Economic and Social Commission for Western Asia (ESCWA), discussed economic performance and the prospects in ESCWA member countries. Growth in the Gulf Cooperation Council (GCC) countries as a group was expected to accelerate to about 3.9 per cent in 2003 from 1.4 per cent in 2002, mainly thanks to increased oil production. Meanwhile, growth in the non-oil exporting countries would decelerate from 2.4 per cent in 2002 to 1.9 per cent in 2003. For the ESCWA region as a whole, growth was expected to be around 3.3 per cent in 2003 following 1.7 per cent in 2002. Mr. Abdalla pointed out that these figures could not be compared with DESA's figures owing to differences in country groupings.

He also indicated that ten out of thirteen ESCWA members produced and exported oil. Oil prices (OPEC basket crude) had averaged \$24.4 per barrel in 2002, slightly up from \$23.1 in 2001. Oil production had averaged 16.7 millions of barrels per day and accounted for 25.6 per cent of the world total in 2002. However, oil production was 6.3 per cent below its 2001 level. He then described the Oil-for-Food Programme, which had started in December 1996 and was funded exclusively with Iraqi oil revenues. Initially, Iraq had been allowed to export oil worth \$2 billion every six months, two-thirds of the proceeds being used for Iraq's humanitarian needs (food and medicine). In

1998, the ceiling had been increased to \$5.2 billion every six months and, in 1999, the ceiling had been removed and the categories increased to 24 items. The programme benefited not only Iraq, but also countries exporting to Iraq under the programme, including other Arab countries (Egypt, Jordan, Lebanon and Syria), as well as non-Arab countries; about 75 countries exported goods to Iraq under the Oil-for-Food Programme.

Finally, Mr. Abdalla addressed the external debt of Iraq. He estimated the total external debt of Iraq for the first Gulf War to be around \$383 billion, of which \$199 billion was for compensation (\$172 billion owed to companies, governments and institutions and the remaining \$27 billion to individuals); \$127 billion was accrued interest and \$57 billion was owed on pending contracts, such as for energy and communications deals, mostly owed to Russia. Iraq's main creditors were the GCC countries (\$30 billion), Russia (\$12 billion) and France (\$8 billion).

Middle East

Mr. Suleyman Ozmucur, University of Pennsylvania, gave an overview of the Middle East region, a region much larger than ESCWA's and DESA's coverage, as it included North African countries and the Sudan. He identified common features of the region: population growth and literacy rates were much higher than the world average; the region was poor in water resources; unemployment was uniformly high, between 25 and 30 per cent, especially among the young; and the public sector was the biggest sector in the economy and remained the driving force behind economic growth. Additionally, government spending as a ratio to GDP was high and largely allocated to military spending. The region did not attract foreign direct investment, with less than 2 per cent of world FDI flowing to the Middle East. Finally, regional integration was limited.

SPECIAL ECONOMIC TOPICS

Global consequences of the war in Iraq

Mr. Josh Bivens, Economic Policy Institute, Washington, made a presentation on the global consequences of the war in Iraq. His main argument was that the global economy was weak due to insufficient aggregate demand. He claimed that uncertainty due to the war was a marginal factor in explaining current economic conditions. Therefore, the war effort, either by removing uncertainties or by its potential Keynesian effects via increased military expenditures (in any case not significant as a share of GDP), would not be enough to promote faster growth. In the United States, increased unemployment, households' high indebtedness and the slow growth of personal disposable income were the reasons for the anaemic growth of consumer demand. In his view, diminishing consumer confidence could be largely explained by increasing unemployment. Meanwhile, investment was constrained by excess capacities. Unemployment was also a dampening factor in Western Europe: having recovered somewhat towards the end of the 1990s, employment had deteriorated once again and prospects for recovery were dim. In Japan, demand was negatively affected by debt deflation, high unemployment and a high savings ratio. Finally, some of the larger

emerging economies, Latin American countries being prime examples, were still vulnerable to financial crises and very dependent on growth conditions in developed countries. Asian countries were in a stronger situation but their growing dependency on industrialized economies' markets, the United States in particular, would not warrant much autonomous growth.

As global economic weaknesses did not originate in uncertainties related to the war in Iraq, it was not clear, in Mr. Biven's view, how the end of the war would help boost global economic recovery. The major impact of the war was in undermining the necessary conditions to enhance increased cooperation and coordination among policy makers of the major economic powers. Coordination and cooperation were even more pressing in globalized and integrated economies. In such countries, policy stimuli quickly translated into increased imports, benefiting other economies as well but also implying limited net benefits for the economy adopting expansionary policies unless other economies adopted similar measures in concert.

Mr. Biven's presentation generated several interventions from the floor. Participants expressed their concerns about the narrow focus of the presentation in terms both of its short-term horizon and of the issues addressed (largely economic and centered on developed countries). For instance, it was said that a major positive impact of the war for the United States would be a relaxation of long-term constraints on the global oil supply as Iraq re-entered the global oil market as a major player: world oil supply in ten to fifteen years was expected to be significantly larger than would have been the case with the continuation of the status quo in Iraq. Moreover, the removal of economic sanctions would allow for increased investments in Iraq with beneficial spillover effects for its neighbours. Other participants highlighted such issues as the implication of the war for political developments in the Middle East, the ways and means to mobilize funds for the reconstruction of Iraq, and the impact of the latter on the global economy. Comments were also made on the limits of expansionary policies in Western Europe to foster growth, as the current output gap in the region was considered relatively small and closing the gap would not necessarily provide much of a boost for the global economy.

Fiscal policy in Europe – The Stability and Growth Pact: A Roundtable

Mr. Andre Drama is, European Commission, began by noting that the Stability and Growth Pact (SGP) was secondary legislation and just as hard to modify as the Maastricht Treaty itself. Theo Waigel was the “father” of the SGP; it was the price paid to Germany for giving up the deutsche mark for the euro. The original proposal was even harsher, as it would have had automatic sanctions. He argued that the current SGP was more flexible than generally thought. There were two criteria —a 3 per cent limit on the fiscal deficit-to-GDP ratio and a 60 per cent limit on the public debt to-GDP ratio. If a deficit exceeded 3 per cent, the EC had to submit a recommendation to the European Council and the Council had to decide whether a fine should be levied.

There were a number of proposals for reform, but they were on the modalities of the framework not the substance. One possibility was to take account of cyclical positions

by looking at structural budget deficits. Another possibility was to give the early warnings more force. However, Charles Bean had noted that the framework was all sticks and no carrots. For example, currently all small countries had correct positions vis-à-vis the SGP, but there was no reward for this virtue. One proposal would be to have tradable deficit permits similar to the pollution permits in the environmental arena, whereby surplus countries could sell permits to deficit countries. This would be of little help in the current circumstances, however, because the small countries could not offset the imbalance when Germany, France and Italy were all in deficit.

Mr. Adolfo Castilla, Autonomous University, Madrid, noted that there was a difference between the interpretation of the present situation and the actual content of the SGP. Originally, there were three proposals. The first laid out the five convergence criteria for entry into the European Monetary Union (EMU): exchange rates, interest rates, deficits, debt, and inflation. The second was a time frame for compliance. The third set limits on the deficit in the post-EMU period. Germany wanted fines for breaching the deficit target, which was the core of the SGP. So there were two key variables: inflation and the fiscal deficit. The European Central Bank (ECB) argued that, if the deficit was a problem, countries should improve labour markets and make other structural reforms. Spain had had trouble with inflation due to high growth in the previous three years, with its inflation running 1.5 per cent higher than euro zone averages. The SGP had been successful, however, in that it had introduced a stability culture across the EU. As a case in point, it had been a great success in Spain.

However, was the SGP system too rigid? There was some flexibility in that the Council of Ministers had to approve the fines. The EMU was too young to tell if it was too rigid. It was necessary to separate the difficulties of the SGP and current world economic conditions. The current problem was low growth, not the dictates of the SGP.

Mr. Stephen Hall, Imperial College, London, discussed the theoretical foundations of the SGP. He argued that it derived from the Barro/Gordon discretion-versus-rules debate. In such a model, the policy maker chooses a policy to maximize a utility function, which depends on deviations of output from potential and deviations of inflation from target. A problem arises because output moves quickly while inflation is more persistent. This gives an incentive to the policy maker to boost output in the short run, because inflation will only increase later. Thus there is a need for a rules-based policy to constrain this opportunistic behaviour, but it comes at a cost: the ability to stabilize the economy is reduced, so that there is also a need to allow some flexibility.

This argument was the rationale for making Central Banks independent. However, the policy story was more complicated, because there were monetary authorities and fiscal authorities, and a game theoretic situation between the two. The Central Bank controls inflation through interest rates, but the fiscal authorities can then use policy to boost output, knowing that the Central Bank would take care of the inflationary consequences. The Nash solution to such a policy game resulted in interest rates being higher than they should be, and thus there was a need for a fiscal policy rule as well. Again, the question was: how could these be designed to allow for sufficient flexibility?

In the euro zone, there was one money and no fiscal transfer system between countries. Therefore the SGP needed to both allow flexibility and control the bias resulting from opportunistic fiscal behaviour. The SGP calls for long-term balanced budgets and, if there was a deficit, policy must react, regardless of the economic situation. This arrangement was not able to deal with a situation where Germany was in recession and Ireland was overheating. In the UK, the policy rule was the Golden Rule; budgets were balanced over the cycle, so stabilization policy was allowed. However, practically, one did not know where one was in the cycle, so there was no constraint. This had led to the current situation, where fiscal policy was too expansionary and interest rates were higher than they should be, in addition to the exchange rate being too high and exports depressed.

How could the framework be improved, especially to deal with differences across countries? It might be possible to link the rule to individual country inflation performance so that, if inflation was high, deficits would need to be reduced and vice versa. Unless there were fiscal transfers across countries, some action would clearly be required.

Mr. Ulrich Heilemann, RWI Institute, Essen, discussed Germany's situation within the SGP, noting that the SGP together with the EMU had eliminated any possibility for business cycle policy. At this point, even to allow the automatic stabilizers to work required going to the Commission and currently Germany was in one of the worst economic crises in its history. The problem was political: the Government was committed to a zero deficit, so the Pact could not be changed. One year previously the French had made an initiative to amend it, but Germany had rejected it. If the Germans followed the rules rigorously and brought the deficit down to zero, growth would be seriously affected, and the whole EU would slow down. Six institutes (of which the RWI was one) had suggested that a better policy would be to emphasize the expenditure path; that is, the government should choose a stable expenditure path and then let taxes swing with output. Mr. Heilemann said that it was not possible to get to a zero deficit in four years. In the pre-EMU days, if fiscal policy had been set to reduce the deficit, the Bundesbank would have lowered interest rates. He concluded that probably there would be no change to the SGP, but that it would not be enforced rigorously.

Several questions were raised from the floor. **Mr. Reis** asked whether the SGP would inhibit investment in infrastructure, particularly for the accession countries. **Mr. Dramais** replied that the current definition of expenditure included everything and already there were a lot of problems identifying expenditure items. If there was also a distinction between current expenditure and investment, there would be even more games played. **Mr. Stephen Hall** noted that in the UK they had redefined many expenditure items as public/private partnerships so that they would not be included in the deficit measure. There was a lot of skill involved in such creative accounting. **Mr. Terry Quinn, Bank of Ireland**, discussed the case of Ireland. During its recent period of high growth, infrastructure bottlenecks had required higher government investment but had also led to higher inflation. Now, with lower growth, these infrastructure projects were still needed, so it made sense to borrow in order to finance investment in infrastructure.

He noted that Ireland was also using public/private partnerships but not for good reasons; the only reason it was doing so was to bend EU rules.

Mr. Rumen Dobrinsky asked about linking the deficit criterion to inflation performance. In the case of the accession countries, there would be high inflation as a result of the Bellassa-Samuelson effect, so they would be forced to tighten policy; but then how would they catch up? **Mr. Stephen Hall** replied that this was an issue of getting the correct value of the exchange rate at entry. Only if this was wrong would there be an inflation problem.

Mr. Per Rasmussen, Ministry of Economics, Denmark, argued that there was significant legal flexibility in the SGP and that if a country was on the correct structural path, the probability of hitting the 3 per cent limit was zero. The problem in Germany was that they were not on the correct structural path.

Mr. Ulrich Heilemann agreed that there was a post-reunification problem. The Germans had not anticipated that trend growth would fall to 1.25 per cent and that construction would deteriorate for four consecutive years; consequently, mistakes had been made. But it was too late now; simply because these shocks were unanticipated did not mean that Germany could risk discussing its problems on the EU stage politically. After all, the SGP was a German idea.

Mr. Pete Richardson argued that transition problems were a separate issue. If these issues were eliminated, Mr. Hall's ideas were very similar to Andrew Sentence's. Giving more attention to the economic position within the cycle was akin to taking account of inflation.

Mr. Andre Dramais noted that the EC had been looking at the cyclically-adjusted balance for a long time, but only unofficially; officially, Germany opposed the idea. He also noted that, if an economy ran a balanced budget over the cycle, the probability of the deficit going beyond 3 per cent was zero, as Mr. Rasmussen had said.

Mr. Ulrich Heileman argued that the distinction between "cyclical" and "structural" was very delicate and that a bad *cyclical* situation could lead to a bad *structural* situation at some point. Additionally defining the two could be very political.

Trade and production in the global economy

Mr. Dan Trefler, University of Toronto, presented his views on trade and production in the global economy. He noted that about one third of global trade was intra-firm trade and that international trade was dominated by multinational companies, either as buyers or sellers. Trade liberalization and lower transportation and communication costs had facilitated this process. Nonetheless, Mr. Trefler argued that the wave of mergers and acquisitions and the increase in FDI flows had been one of the main factors underlying the expansion of trade. Developing countries had benefited from these

processes, although developed countries had been the main destination of foreign investment.

He reviewed the major “pull” factors attracting FDI to developing countries: inexpensive and skilled labour, systems to promote knowledge, and innovations and institutions guaranteeing a sound business environment. He argued that although cheap and disciplined labour might be a factor when multinationals were deciding where to invest, it was not the most relevant one. In global production networks, very little value-added was accrued via production; the lion’s share of added value came from product development, sales and post-sales services. Thus, the growth potential for developing countries resided not in being cheap sources of labour, but in exploring the advantages they might have in controlling and generating knowledge of the productive processes, (or parts of them), including supply chains and sources, required for any given finished product. Mr. Treffer admitted that creation and control of knowledge by developing countries was a long-term process, but a feasible one, a contention demonstrated by the garment industry in Hong Kong. He also admitted the importance of institutional arrangements, including legislative protection regarding expropriation and compliance with contractual arrangements. International trade could play a catalytic role in this process. Nonetheless, he insisted that institutions should not be imposed on developing countries and that the process of institution-building and transformation should be initiated within these countries, which would occur as the need to limit rent-seeking behaviour became increasingly apparent.

In the question-and-answer session, one participant remarked that most African developing countries could not participate effectively in international trade because they lacked the appropriate institutional arrangements; on the other hand, the lack of participation in trade meant that these countries did not have the right incentives to promote required reforms to develop their institutions.

Global disequilibria in perspective

Professor Peter Pauly, University of Toronto, presented a paper on “Global Disequilibria in Perspective,” which analyzed such issues as the global implications of current-account imbalances. The paper argued that the United States current-account deficit was unsustainable and more than likely would have to be unwound through a significant real depreciation of the dollar. The real exchange rate adjustment would result in several years of growth falling below potential output. Current fiscal policy and debt-service obligations would make it unlikely that the Federal Reserve would be able to halt the depreciation of the dollar through fiscal stimulus.

Developments over the past year indicated a worsening of current account deficits due to falling private foreign investment flows into the United States. This trend had been partly offset by the increased purchase of treasury notes by Asian Governments. However, at the same time, a growing number of central banks have been rebalancing their foreign exchange reserves by switching from the dollar to the euro. The decline in

foreign investment had been largely attributed to loss of profitability in the ICT industry, which had been the driving force behind private investment inflows into the United States in recent years. It was also unlikely that profit expectations in that industry, described as unrealistic, would rise to levels of previous years.

Attractive investment opportunities in emerging markets, at the same time, would also dim the prospects for a significant resurgence of capital flows to the United States. The United States could also experience a significant outflow of European-owned, dollar-denominated equity holdings, a significant proportion of which had sought safe haven in North America during the Asian financial crisis. There was the growing prospect that these funds could be reallocated to emerging markets in developing countries or repatriated to Europe because of equally attractive investment opportunities that were expected to become available in countries undergoing structural reforms. The strengthening of the euro also gave additional impetus to the repatriation of European funds.

Another development that would contribute to increased capital outflows from the United States was growing domestic financing needs in such countries as China, Japan and others undergoing rapid industrial development, with large current account surpluses. Japan's financial problems, ageing population and lower savings rates could also trigger a large-scale repatriation of financial assets. Shifts in financial resources away from dollars could also result from political strife or a decision by OPEC to change the unit of account in the oil trade from dollars to euros, although those factors were not yet on the horizon.

The United States large current-account deficit reflected the country's fundamental savings-investment imbalance, which would only worsen as public savings declined at the federal, state and local levels. The debt/GDP ratio was currently a little more than 20 per cent but would climb to 60 per cent in 2010 under current policies. This would mean annual debt-service costs of around \$200 billion, even if interest rates were as low as 3 per cent.

The required adjustment to correct the current-account deficit, currently running at 5 per cent of GDP, would be a sustained real depreciation of the dollar similar to the steep depreciation that occurred in the second half of the 1980s. The strengthening of the euro over the past two years indicated a step in that direction. The price that the United States (and the global economy) would have to pay for this adjustment would be a combination of higher imported inflation, a contraction of real output, a decline in consumption, and an increase in the savings rate.

The following issues were addressed during the discussion period:

- There was general agreement that any significant reduction in holdings of United States treasury bills by Japan would entail an appreciation of the yen. It would be better if domestic demand increased in response to various stimulative policies. An appreciated yen would also put less emphasis on the need for export-oriented growth as the driving force in the Japanese economy.

- The envisioned period for unwinding the US current-account imbalance, which was estimated at five or six years, was based on past adjustment episodes, but would ultimately depend on how precipitous the decline in the dollar was.
- Policy coordination among the major industrialized countries during the adjustment period would most likely be ineffective because there had only been one successful case of such policy coordination in over 20 years.
- There would be no specific policy instrument to guide the adjustment, other than United States acceptance of real growth contraction and the required reduction in consumption and increase in savings.
- The growth in knowledge-based industries in the United States (which was characterized as “unbounded”) and the role of innovations in opening up new investment opportunities to offset the decline in ICT profit growth might have been underestimated in the analysis. If this were taken into consideration, the assessment of future availability of attractive investment opportunities in the United States (and corresponding foreign investment inflows) would be less pessimistic.
- The emergence of other engines of growth in the world economy could reduce the adjustment burden on the United States, i.e., the United States might not have to suffer a growth contraction in order to improve its current account balance.
- The adjustment process could, or should, be viewed in a longer-term perspective that would take into account structural shifts in the global economy. Some manufacturing processes had left the United States for other countries that were more competitive. Real exchange-rate adjustments would not reverse that process.

Fiscal sustainability in developing countries: recent experiences

Dr. Ernesto Talvi, CERES, Uruguay, made a presentation on sudden stops in capital inflows, the subsequent large macroeconomic adjustments, the domestic financial vulnerabilities that have magnified the impacts, and the specific impact on fiscal sustainability.

Since the end of the 1990s, there had been a dramatic and sudden collapse of non-FDI capital flows to emerging markets—a stark reversal of the strong flows received during the decade. The sudden stop had been accompanied by a large, persistent rise in the cost of external financing in emerging markets.

The collapse in capital flows had been followed in Latin America by a sharp surge in interest rates, a severe domestic crunch and a large current account adjustment. Trend

levels of economic growth had declined by about a half, even in favourably-regarded countries like Chile.

How countries dealt with the shock had depended principally on domestic factors and different degrees of vulnerability. Pervasive liability dollarization, in both the private and public sectors, had been a major source of vulnerability. This had resulted in a collateral problem: the value of bank loans' collateral relative to the amounts owed had plummeted as real exchange rates had to adjust sharply. The banks' response in these cases had been to try recalling the collateral, which led to a credit crunch. A major factor in the response had also been the degree of openness of the economy, in terms of the relative size of the tradables sector.

The latter had been particularly relevant in Argentina, where 78 per cent of economic activity was linked to the peso-non-tradables, whereas liabilities were highly dollarized: the balance-sheet mismatch of the private sector alone could have caused the collapse. The public sector, on the other hand, could not act as a cushion since it had itself been part of the problem. The magnitude of the fiscal adjustment needed to prevent a collapse following the external shock, estimated at an increase of the primary surplus equal to 3.4 percentage points of GDP, would have required a 23 per cent reduction of fiscal expenditure in real terms, which was politically and socially unviable, particularly given the structure of the budget. In turn, depositors became aware that banks would end up bearing the brunt of the fiscal adjustment, due to their balance-sheet exposure to public finances, prompting a run on the banking system.

Dr. Talvi stressed that it was structural characteristics of the economies, such as liability dollarization or degree of openness, rather than the specific type of exchange-rate regime in a country, that determined the magnitude and impact of the adjustment required when a sudden stop in capital inflows occurred.

During the discussion, **Mr. Juan Carlos Moreno, ECLAC, Mexico**, pointed out that there were lessons to be drawn for International Financial Institutions (IFIs) from this experience. The international financial architecture should go through some rethinking as to how to manage international liquidity in a way that would prevent huge surges and drops of financial flows.

There was also discussion as to whether, in the case of Argentina, the currency board created an incentive structure that strongly favoured liability dollarization, to which Dr. Talvi responded that he believed the causality was the opposite: a history of misbehaving governments, along with liberalized capital accounts, created incentives for dollarization, which led to the so-called "fear of floating;" or, in other words, strong political pressures to adopt and maintain fixed exchange regimes.

According to **Mr. Eustaquio Reis**, Argentina's mistake was to fix its currency to the dollar despite being a relatively closed economy. Thus the problem was its resulting incapacity to deal with the problem of real exchange-rate misalignment.

ANNEXES

Project LINK Spring Meeting

April 23-25, 2003
United Nations Headquarters, New York
Conference Room 4

Agenda

Wednesday 23 April

10:00-10:15

Opening

Chair : Lawrence Klein
University of Pennsylvania

10:15-1:00

Global Outlook

Chair : Lawrence Klein

United Nations Project LINK
Ian Kinniburgh, United Nations, New York

International Monetary Fund
James Morsink, IMF , Washington

World Bank
Hans Timmer, The World Bank, Washington

OECD
Pete Richardson, OECD, Paris

National Institute of Economic and Social Research
Ray Barrell, NIESR, London

General discussion

1:00-2:30

Lunch

2:30-3:30

Global Outlook (cont.)

Chair : Bert Hickman

Non-oil commodities
F. Gerard Adams, Northeastern University, Boston

The world oil market
Robert Kaufmann , Boston University
General discussion

3:30-4:30

Current Policy Issues I

Chair : Bert Hickman

Global consequences of the war in Iraq
Josh Bivens, Economic Policy Institute, Washington

General discussion

4:30-5:30

Regional Economic Outlook

Chair : Bert Hickman

United States
Lawrence R. Klein, University of Pennsylvania

General discussion

6:00-7:30

Reception
Ex-Press Bar, Secretariat Building

Thursday 24 April

10:00-12:00

Regional Economic Outlook

Chair : Delia Nilles

West Asia
Nazem Abdalle, UNESCWA

Western Europe
André Dramais, European Commission
Brussels

Eastern Europe and the CIS
Rumen Dobrinsky, ECE , Geneva

Two Europes merging
Franjo Stiblar, University of Ljubljana

General discussion

12:00-1:00

Current Policy Issues II

Chair : Delia Nilles

Roundtable discussion :
Fiscal policy in Europe – The Stability Pact

Adolfo Castilla, Autonomous University, Madrid
André Dramais, European Commission, Brussels
Stephen Hall, Imperial College, London
Ulrich Heilemann, RWI, Essen

General discussion

1:00-2:30

Lunch

2:30-3:30

Current Policy Issues III

Chair : Stephen Hall

Trade and production in the global economy
Dan Trefler, University of Toronto, CIAR / NBER, Boston

General discussion

3:30-5:00

Regional Economic Outlook

Chair : Stephen Hall

Empirical regularities in the Russian economy
Vladimir Eskin and Andrei Roudoi, Global Insight, Boston

Japan
Kanemi Ban, Osaka University

China
Wang Tongshan, Chinese Academy of Social Sciences, Beijing

General discussion

5:00-5.30

Current Policy Issues I

Chair : Stephen Hall

Global disequilibria in perspective
Peter Pauly, University of Toronto

General discussion

Friday 25 April

10:00-12:00

Regional Economic Outlook

Chair : Sam Olofin

Asia
David Choi, United Nations, New York

Latin America and the Caribbean
André Hoffman, ECLAC, Santiago

12:00-1:00

Current Policy Issues IV

Chair : Sam Olofin

Fiscal sustainability in developing countries:
recent experiences
Ernesto Talvi, CERES, Montevideo

1:00-2:30

Lunch

2:30-4:30

Regional Outlook

Chair : Peter Pauly

Africa
Adam Smith, United Nations, New York

Middle East
Suleyman Ozmucur, University of Pennsylvania

General discussion

4:30-5:00

LINK Business Meeting

Chair : Peter Pauly

Annex 2: List of Country Reports

NO.	NAME OF THE COUNTRY	AUTHOR
1	Singapore	Toh Mun-Heng
2	Nepal	D.R. Khanal
3	Ghana	Cletus Dordunoo
4	Ireland	Terry Quinn
5	Norway	T. Eika & M. Rolland
6	Slovenia	F. Stiblar & Joe Mencinger
7	France	Arnaud Buisse
8	Switzerland	Delia Nilles
9	Russian Federation	E. Gavrilencov
10	Belgium	Simon Erlich
11	Poland	Wadysaw Welfe
12	Austria	Ulrich Schuh
13	Venezuela	Cristina Rodriguez
14	Hungary	Andras Simon
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16	Ukraine	V. Heyets & M. Skrypnychenko
17	Mexico	Alfredo Coutino
18	Denmark	Rasmus H. Madsen
19	Slovak Republic	J. Haluska & M. Olexa
20	Hong Kong SAR	Win Lin Chou
21	Togo	Kodjo Evlo
22	Colombia	Luis García
23	Nigeria	S. Olofin
24	China	Liping Tao
25	Romania	C. Ciupagea
26	Republic of Korea	Sukha Shin
27	Greece	S. Belfoussias

Annex 3: List of Country Forecasts

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21	Israel	Rachel
22	Taiwan Province	Jin-Lung Lin
23	Malaysia	Muthi Samudram
24	Slovenia	F. Stiblar & Joe Mencinger
25	Ireland	Quinn Terry
26	China	Tao Liping
27	Australia	Duncan Ironmonger
28	Russian Federation	E. Gavrilencov
29	Denmark	E.J. Reis
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