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Challenges for Developing Countries during the Coming Global Recovery

THE CURRENT GLOBAL ECONOMIC SLOWdown is exceptionally deep and broad. Global growth in 2001, at 1.2 percent, was 2.7 percentage points lower than in 2000 (figure 1.1). In the last 40 years the deceleration in gross domestic product (GDP) was sharper only in 1974, during the first oil crisis. The current slowdown is also broad in that the deceleration is equally rapid for industrial countries and developing countries. The slowdown in economic activity coincides with an unprecedented 14 percentage point deceleration of world trade, from record growth of 13 percent in 2000 to a 1 percent decline in 2001 (table 1.1). However, contrary to many earlier downturns, inflationary pressures remained very subdued and this allowed monetary authorities to loosen their policies substantially.

The bursting of the high-tech bubble at the end of 2000 and the terrorist attacks in September 2001 made the deceleration of the global economy so exceptionally sharp. The unpredictable character of these events made it difficult to anticipate the depth of the downturn. Nevertheless, after the terrorist attacks the expectations—a deeper recession and a delay of the recovery by one or two quarters—appear to be materializing.[1] Several of the strong market reactions to the terrorist attacks have been reversed and signs of a recovery in the United States and the high-tech sectors have started to mount.

Even during this unusually synchronized downturn, the intensity and character of the economic malaise differ across countries, sectors, and income groups. Especially hard hit are countries dependent on commodity exports, with many commodity prices at historical lows; highly indebted emerging economies, because private investors have reduced their exposure in emerging markets in reaction to increased uncertainty, reduced value of portfolios in industrial countries, and increased default provisions; high-tech sectors, with many firms decimated after the high-tech bubble burst; and tourism industries, suffering from the aftermath of the terrorist attacks. As in every severe downturn, poor people pay a high price. Without buffers or safety nets to rely upon, their ability to satisfy basic needs is immediately at stake when incomes decline.

The current sharp deceleration in economic activity largely follows a typical investment and inventory cycle, even if it was triggered by other factors, such as the bursting of the high-tech bubble or the terrorist attacks. Likewise, the standard investment cycle is expected to play a major role in recovery. The steep decline in investment and stock building in recent quarters carries seeds for a forceful cyclical recovery. As capital stocks and inventories are adjusted downward to reflect lower growth expectations, the decline in investment and stock-building tends to become less steep and activity starts to rebound. The rebound will be further fueled by aggressive monetary and fiscal stimulus, especially in the United States. The current synchronism of the cycles in different parts of the world will likely be reflected in a strong global recovery, even if recovery in individual countries is not exceptionally vigorous.

The economic consequences of the terrorist attacks probably delayed this rebound by about two quarters, implying strong growth in the second half of 2002. Weak growth in the second half of 2001 and the first half of 2002 is expected to keep global growth in 2002 at 1.3 percent, slightly above growth rates for 2001. This outlook implies a downward adjustment since the publica-

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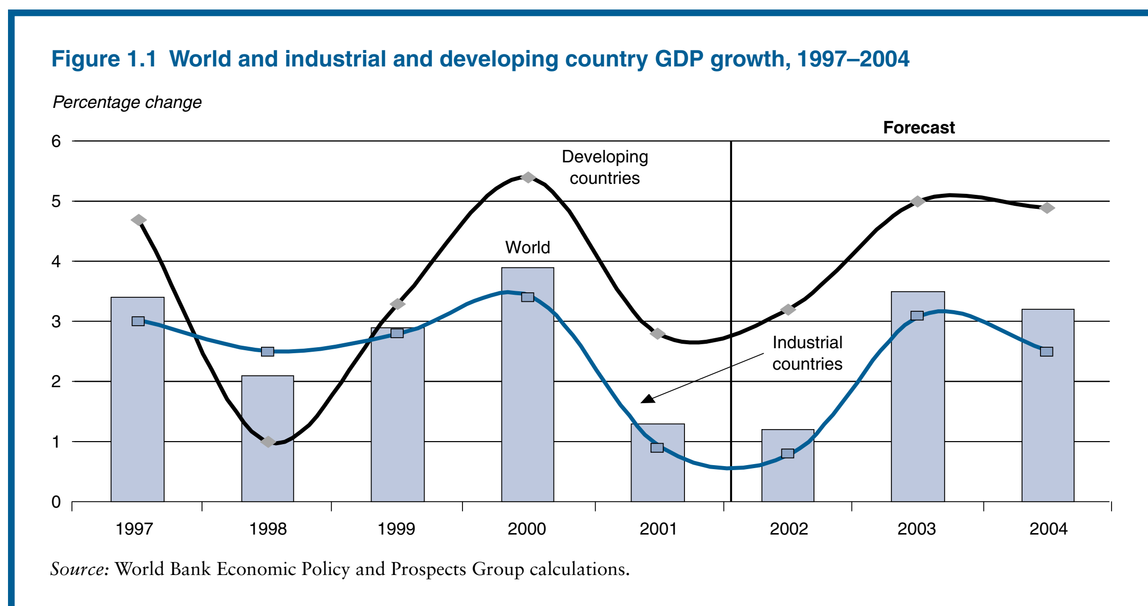
Figure 1.1 World and industrial and developing country GDP growth, 1997–2004



Source: World Bank Economic Policy and Prospects Group calculations.

tion of *Global Economic Prospects 2002* (World Bank 2001), mainly reflecting more pessimistic views on Japan and Latin America. World trade could very well decline in 2002 for a second year in a row. However, an anticipated acceleration in the second half of 2002 will likely result in a strong recovery in annual growth for 2003. Although global GDP growth in 2003 of 3.6 percent would fall short of the strong 3.9 percent performance of 2000, advances in world trade are expected to breach 8 percent.

Not all economies will benefit immediately from the robust global rebound. Argentina's financial strains have resulted in defaults and devaluation, heralding a protracted period of painful adjustment; but there is also hope that a new base can be created for resumption of long-term growth. As financial weakness in Japan has worsened during the global downturn, a recovery of the external environment can probably not avert, but only alleviate, structural adjustments. Commodity exporters, including oil producers, have experienced large terms-of-trade losses that will limit their short-term ability to rebound. The speed of recovery toward normal trends in tourism is uncertain, leaving the prospects cloudy for many of the developing countries that are heavily dependent on this revenue source.

On average, however, developing countries' growth is expected to be robust in 2003 and 2004, reaching 5 percent per year. A strong recovery seems achievable in the absence of additional adverse shocks to the global economy. Such a recovery would be supported by modest inflation—median inflation in the developing world is around 5.5 percent, only half the average rate during the 1990s—relatively low interest rates after the recent easing of U.S. monetary policy, rapidly growing import demand in the industrial countries, and a slight rebound in real commodity prices. Exporters of high-tech products are likely to benefit more than average from this recovery. The main risks to this favorable outlook are to be found in financial markets. The fragile Japanese banking sector may trigger more adverse developments than is currently assumed, and the full complement of ramifications stemming from financial crises in Argentina and Turkey remains uncertain.

Many developing countries, even those that currently do not have large financial imbalances, face difficult challenges. The global downturn and country-based policy responses to slowing growth have reversed the trend of declining fiscal deficits in many countries, and deterioration of deficits tend to persist well after economic growth has returned to normal levels. Some oil exporters—such as Nigeria, the República Bolivariana de Venezuela, and Indonesia—are particularly vulnerable, as oil prices are expected to continue their downward trend. Furthermore, the global downturn implies a deterioration of the current account for

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Table 1.1 Global conditions affecting growth in developing countries and world GDP growth
(percentage change from previous year, except interest rates and oil prices)

		Current Estimate	Current Forecasts			GEP 2002 forecasts		
	2000	2001	2002	2003	2004	2001	2002	2003
Global conditions								
World trade (volume)	13.1	–0.8	1.8	8.3	7.3	1.0	4.0	10.2
Inflation (consumer prices)								
G-7 OECD countries[ab]	1.9	1.7	0.9	1.6	1.8	1.8	1.4	1.5
United States	3.4	2.8	1.5	2.4	2.6	2.8	2.2	2.3
Commodity prices (nominal dollars)								
Commodity prices, except oil (dollars)	–1.3	–9.1	1.3	7.3	6.4	–8.9	1.6	8.1
Oil price (dollars, weighted average), dollars a barrel	28.2	24.4	20.0	21.0	19.0	25.0	21.0	20.0
Oil price, percent change	56.2	–13.7	–17.9	5.0	–9.5	–11.3	–16.0	–4.8
Manufactures export unit value (dollars)[c]	–2.0	–1.4	–0.5	3.6	3.7	–4.6	4.0	4.4
Interest rates								
LIBOR, 6 months (dollars, percent)[c]	6.7	3.3	2.3	4.0	4.6	3.6	2.8	3.0
EURIBOR, 6 months (euro, percent)[d]	4.5	4.0	3.0	4.0	4.2	4.1	3.3	3.3
World GDP (growth)	3.9	1.2	1.3	3.6	3.1	1.3	1.6	3.9
High-income countries	3.5	0.8	0.8	3.2	2.6	0.9	1.1	3.5
OECD countries	3.4	0.9	0.8	3.1	2.5	0.9	1.0	3.4
United States	4.1	1.1	1.3	3.7	3.1	1.1	1.0	3.9
Japan	2.2	–0.8	–1.5	1.7	1.1	–0.8	0.1	2.4
Euro Area	3.5	1.4	1.2	3.3	2.7	1.5	1.3	3.6
Non-OECD countries	6.6	–1.0	1.7	4.4	4.0	0.6	3.2	5.7
Developing countries	5.4	2.8	3.2	5.0	4.9	2.9	3.7	5.2
East Asia and Pacific	7.4	4.6	5.2	6.9	6.5	4.6	4.9	6.8
Europe and Central Asia	6.4	2.2	3.2	4.3	4.0	2.1	3.0	4.2
Latin America and the Caribbean	3.8	0.6	0.5	3.8	3.8	0.9	2.5	4.5
Middle East and North Africa	4.2	3.1	2.7	3.3	3.3	3.4	2.9	3.6
South Asia	4.0	4.3	4.9	5.3	5.2	4.5	5.3	5.5
Sub-Saharan Africa	3.1	2.6	2.6	3.6	3.6	2.7	2.7	3.9
Memorandum items								
East Asian crisis–affected countries[e]	7.1	2.3	3.5	5.9	5.5	2.3	3.4	5.4
Transition countries of ECA	6.2	4.4	3.4	4.0	4.0	4.0	3.1	3.8
Developing countries,								
Excluding the transition countries	5.3	2.6	3.2	5.2	5.0	3.1	3.8	5.5
Excluding China and India	5.1	1.8	2.2	4.4	4.2	1.9	2.9	4.5

a. The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. Unit value index of manufactures exports for G-5 countries (G-7 minus Canada and Italy) to developing countries, expressed in dollars.
c. London interbank offered for dollars.
d. Interbank offered rate for euros.
e. Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.
Source: World Bank Economic Policy and Prospects Group, February 2002 forecast; *Global Economic Prospects (GEP) 2002* projections of October 2001.

many developing countries. Together with limited availability of international private capital, this could generate new financial strains, which could impede further recovery.

Recession and recovery in the industrial world

The United States, Japan, Germany, and several smaller industrial countries in Europe entered into—or came close to—recession in the course of 2001. Aggregate annual growth in the industrial world decelerated from 3.4 percent in 2000 to 0.9 percent in 2001. With almost all recessions having started in the second half of 2001, it is unlikely that aggregate annual growth in 2002 will exceed 2001 growth, even with a solid rebound in the second half of the year. Indeed, measured growth is likely to decline further, to only 0.8 percent. The advance in output in 2003, in contrast, is expected to return to 3.1 percent, assuming that no major crisis evolves

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from the fragilities in the Japanese banking system or other sources of tension in the forecast. Growth in 2004 is assumed to fall back to near its long-term trend of 2.5 percent.

In the fall of 2000 the downturn still had characteristics of a soft landing, with cyclical corrections that did not suggest one of the most severe decelerations in economic activity in decades. However, in two steps—the first initiated by the burst of the high-tech bubble at the end of 2000, and the second by terrorist attacks in September 2001—the global economy decelerated further.

A three-phase slowdown—

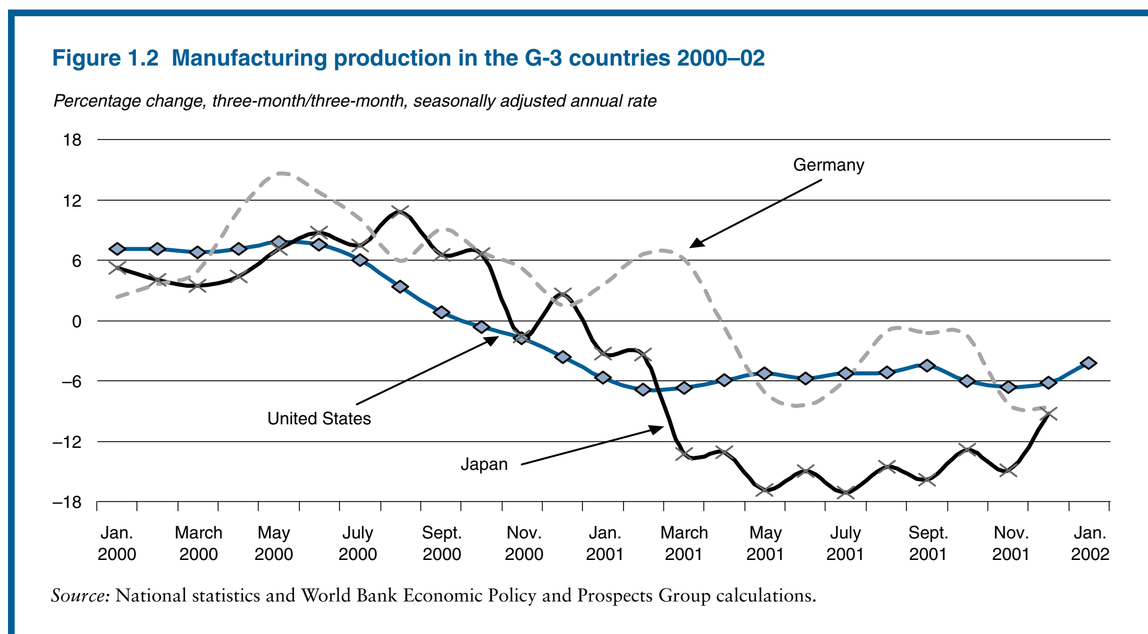
At the root of the simultaneous economic downturn in all major industrial countries was a severe slowdown in manufacturing sectors (figure 1.2). That slowdown went through three phases. The *first phase* began in the middle of 2000 with the slowdown in the United States, which was partly a reaction to the tightening of monetary policy by the Federal Reserve Board, a move designed to slow an economy that had been growing well above capacity. Production of traditional durables declined, and production in high-tech sectors started to slow. The latter was partly a reaction to the high-tech investment bubble that had been swelling since 1998, especially in the United States, and then burst. Japan and the European economies clearly lagged in the downturn.

The *second phase* began at the end of 2000 when the recession in durable goods had begun to bottom out, but the high-tech bubble burst yet further, forcing stock markets into sharp decline while high-tech production started to fall at dramatic rates (figure 1.3). Japanese output, highly dependent on high-tech exports, declined precipitously. The fall in exports and the accompanying drop in equity prices exacerbated the bad-loan problems in the Japanese banking sector, which could not escape the spiral of defaults and thin margins in a deflationary environment. In Europe, signals were mixed in the beginning of this phase. Since European growth in 2000 hardly exceeded its long-term capacity trend, the internal cyclical forces were much weaker than in the United States. However, the slowdown in world trade affected the manufacturing sectors, while the European telecommunications industry shared the fate of the global high-tech sectors as future profitability was suddenly reassessed. The European Central Bank hesitated to ease monetary policy in the face of inflationary pressures originating from temporary increases in food prices due to livestock diseases, high oil prices, and a weak euro. The slowdown, first apparent in Germany, gradually spread to several other European countries.

The terrorist attacks in September 2001 marked the start of the *third phase*. At that time the recessions in manufacturing production had more

Figure 1.2 Manufacturing production in the G-3 countries 2000–02

Percentage change, three-month/three-month, seasonally adjusted annual rate



Source: National statistics and World Bank Economic Policy and Prospects Group calculations.

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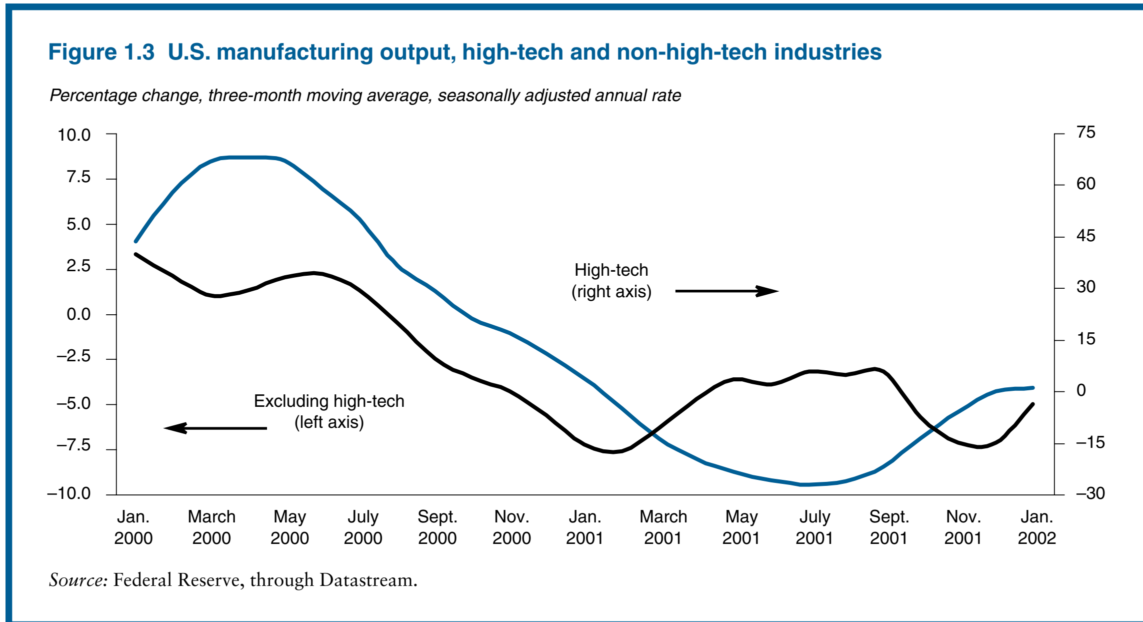
Figure 1.3 U.S. manufacturing output, high-tech and non-high-tech industries

Percentage change, three-month moving average, seasonally adjusted annual rate

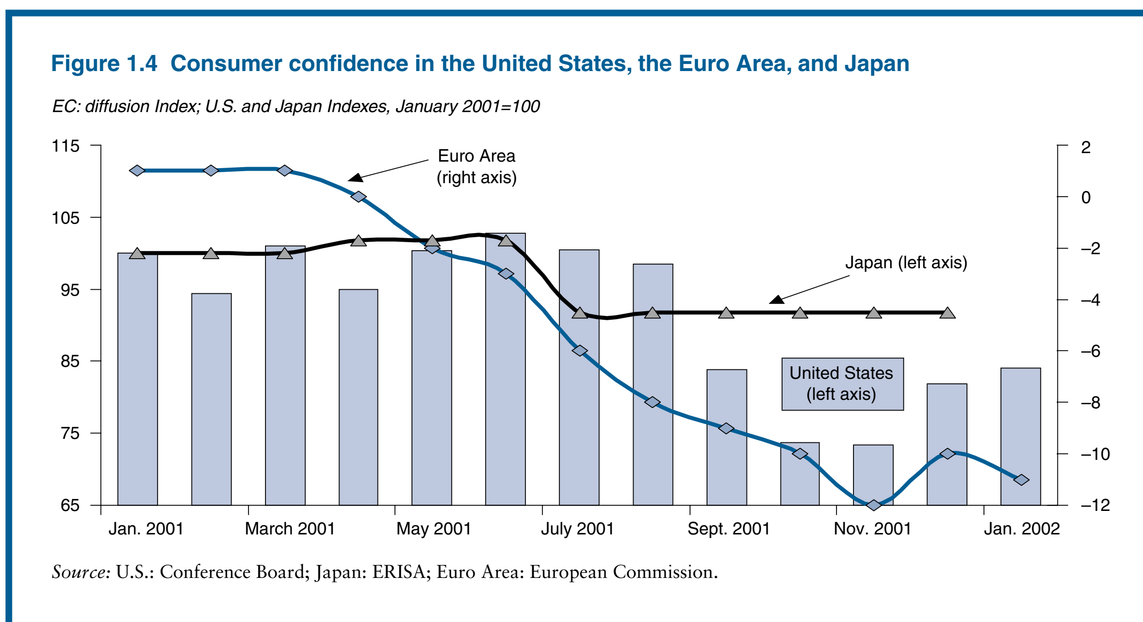


Source: Federal Reserve, through Datastream.

or less bottomed out, albeit for Japan and the United States at still large declining rates. The period immediately after the terrorist attacks was characterized by an extraordinary, but temporary, loss of consumer confidence and deterioration of business sentiment (figure 1.4). Equity prices plummeted 15 percent immediately after the attacks, spreads on junk bonds jumped 200 basis points within weeks, and commodities prices fell 7 percent within one month. Industrial production dipped once again, although it seemed that the high-tech cycle was less affected (figure 1.3). While these first market reactions were reversed within one quarter, economic recovery will probably be delayed by about two quarters as a result of supply disruptions and shaken confidence.

Figure 1.4 Consumer confidence in the United States, the Euro Area, and Japan

EC: diffusion Index; U.S. and Japan Indexes, January 2001=100



Source: U.S.: Conference Board; Japan: ERISA; Euro Area: European Commission.

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The prolongation and deepening of the downturn in the aftermath of the terrorist attacks made this recession comparable in intensity to the recessions of the early 1980s and 1990s, at least for industrial countries. Although the downturn in individual countries has not necessarily been as deep as during those two severe recessions, its simultaneous character made the current slowdown especially sharp for the industrial world as a whole. Experience during the last decades suggests that the turning point to positive growth will probably be triggered by the investment cycle, and that recessions of this magnitude tend to result in a deterioration of fiscal balances that typically lasts for three or more years. The sharp fall in private spending implies an improvement of the current account in the short run, despite increased fiscal deficits. The mirror image of the industrial countries' reduced current account deficit is the tendency of current account surpluses to narrow and deficits to widen in the developing world. The remainder of this section will discuss triggers of turning points in economic activity and the behavior of government balances in the industrial world. Increased trade linkages have made developing countries more dependent on these turning points in the industrial countries' business cycles, and as the current account surpluses of developing countries start to decline, a deterioration of government balances could increase tensions in global capital markets.

—largely driven by investment cycles

The deep recessions and subsequent recoveries in the United States during the last three decades were primarily the reflection of inventory and investment cycles.[2] Table 1.2 summarizes the main sources of change in GDP growth at the beginning and end of recessions. In the majority of U.S. recessions since the 1970s, changes in investment or inventories were the main source of changes in GDP growth, both at the start and close of each recession. With the structural decline in inventories through the use of new technologies and just-in-time supply systems, the inventory cycle, still dominant in the 1970s and 1980s, has become less important. The investment cycle was the main contributing factor in the current recession, and investment will likely be the force that brings GDP growth out of negative territory. As capital stocks adjust downward, the decline in investment rates will soften, reversing the downward spiral.

Table 1.2 highlights the fact that net exports have been a relatively more important factor determining the dynamics of recessions in Europe

Table 1.2 Initiating factors: turning points to downturn and recovery in OECD recessions
(changes in contribution to growth, at seasonally adjusted annualized rates)

	Downturn		Contributions		Recovery		Contributions	
	Starting quarter	Change in GDP growth	Principal sources		Ending quarter	Change in GDP growth	Principal sources	
United States								
Mid-1970s	Q1, 1974	–6.4	S: –4.6	C: –1.6	Q2, 1975	6.0	S: 3.6	I: 1.9
Early 1980s	Q4, 1981	–9.5	S: –4.8	C: –3.2	Q4, 1982	3.8	I: 1.4	C: 1.3
Early 1990s	Q4, 1990	–2.8	C: –1.5	I: –1.0	Q1, 1991	2.8	C: 2.1	S: 0.9
Current	Q3, 2001	–1.3	I: –1.1	C: –0.7	—	—	—	—
Japan								
Mid-1970s	Q3, 1973	–6.1	S: –3.3	I: –3.3	Q1, 1975	5.5	C: 2.4	I: 2.3
Early 1990s	Q2, 1993	–3.5	G: –1.7	S: –0.8	Q3, 1992	1.0	S: 0.9	G: 0.6
Asia crisis–present	Q2, 1997	–7.3	C: –7.1	I: –1.5	—	—	—	—
Europe								
Mid-1970s	Q4, 1974	–3.6	S: –3.8	C: –1.6	Q3, 1975	3.4	I: 1.4	S: 1.4
Early 1980s	Q2, 1980	–3.5	C: –2.1	I: –1.4	Q3, 1980	1.2	X: 0.8	I: 0.5
Mid-1990s	Q2, 1992	–2.4	I: –1.0	C: –0.9	Q2, 1993	2.0	C: 2.1	I: 0.7
Current	Q2, 2001	–1.7	X: –1.9	C: –0.6	—	—	—	—

— Not available.
Notes: GDP growth and contributions by expenditure component are expressed as the *change* in GDP growth and contributions to growth, measured (1) for "downturn": average of one or two quarters prior to the turning point, and (2) for "recovery": turning point to the average of two quarters following. Principal sources: C=private consumption, G=government expenditures, I=gross fixed investment, S=change in stocks, X=net exports of goods and services.
Source: World Bank Economic Policy and Prospects Group calculations.

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than in the United States. The inventory cycle has never been as important in Europe as in the United States. This could reflect the less pronounced domestic business cycles in Europe, which has more automatic stabilizers in place, as well as greater regional diversity in monetary and fiscal policies. Note that the recent downturn in Europe was triggered mainly by swings in international trade, rather than by changes in domestic consumption, investment, or inventories. It is thus likely that the international trade cycle will also be an important ingredient of the recovery, in which case Europe will lag behind the United States in the rebound.

Japan is the odd one out in this picture. Recessions were avoided during the 1980s due to strong, continuous growth in investment and productivity. However, investment growth has been declining since the early 1990s, when structural growth rates fell, financial bubbles burst, and problems in the banking sector began to mount. This trend was so strong that it overwhelmed the tendency for investment to experience sharp cyclical changes. As a result, investment failed to play the standard role of initiating a turning point in economic activity. This is one reason why Japan staggered from one recession into another during the 1990s, and why it is not easy to identify a source that could reverse the current downturn.

Policy is supportive, but will operate with some delay—

Policies will play an important role in the recovery of the industrial countries. Monetary policy has now turned highly expansionary in the United States, and with some delay, has eased in the Euro Area. In Japan the economy remains in a state of deflation (consumer prices have declined for the past two years), and interest rates can hardly fall any further. Given the lack of headroom for alternative action, the Bank of Japan initiated a program of liquidity injections—potentially weakening the yen as a way to combat deflation and stimulate exports.

The effects of monetary easing are likely to be felt with some lag, and should provide a needed fillip to demand for consumer durables and housing across the Organisation for Economic Co-operation and Development (OECD) countries. But there is concern that the eventual impact of lower interest rates on business investment may be limited. In particular, investor risk aversion has risen significantly, depressing investment in high-risk assets, especially in the United States. In Japan, financial markets are burdened by the accumulated debt of failed businesses, which has reached ¥50 trillion ($420 billion) since 1999, of which ¥16 trillion accrued during 2001. This has exacerbated the "bad loan" problems of the commercial banking system, adding new nonperforming assets almost as quickly as "old" nonperforming loans are written off. Under these circumstances, additional Bank of Japan liquidity is unlikely to greatly increase the willingness of Japanese commercial banks to lend, and signs of a credit crunch for the small-business sector may be emerging.

Fiscal policy also offers promise for boosting growth, especially in the United States. The U.S. Congress approved more than $40 billion in emergency and industry-support funds in the immediate aftermath of September 11. Moreover, tax reductions enacted earlier in 2001 will continue to be implemented over the next few years. In the Euro Area, automatic stabilizers will tend to increase public deficits, but the constraints inherent in the Stability and Growth Pact of the European Union could limit government support for slowing economies.[3] In Japan debate continues regarding the degree and nature of supplemental budget programs, against the background of Prime Minister Junichiro Koizumi's stated limits to bond-market funding of such efforts. On balance, fiscal stimulus is likely to be a significant additional driving force for recovery in the major industrial economies, particularly for the United States.

However useful and needed the fiscal stimulus may be in the short term, increased deficits could become a burden in the medium run. Historically, deficits that originated in severe downturns tend to last well beyond the recovery in economic activity (figure 1.5). After the brief and steep recession following the first oil crisis in the mid-1970s, the average fiscal deficit (as a share of GDP) in the OECD turned from positive to negative, never again to return to positive territory. After the second oil crisis, it took a decade for the deficits to come back close to precrisis levels, and after the Gulf War this took five years. The stubbornness of deficits is partly due to the vicious circle of higher debt and increasing debt service, and partly due to the temptation to see recessions as unique, temporary phenomena and a subsequent recovery as a permanent improvement. While the deterioration of government

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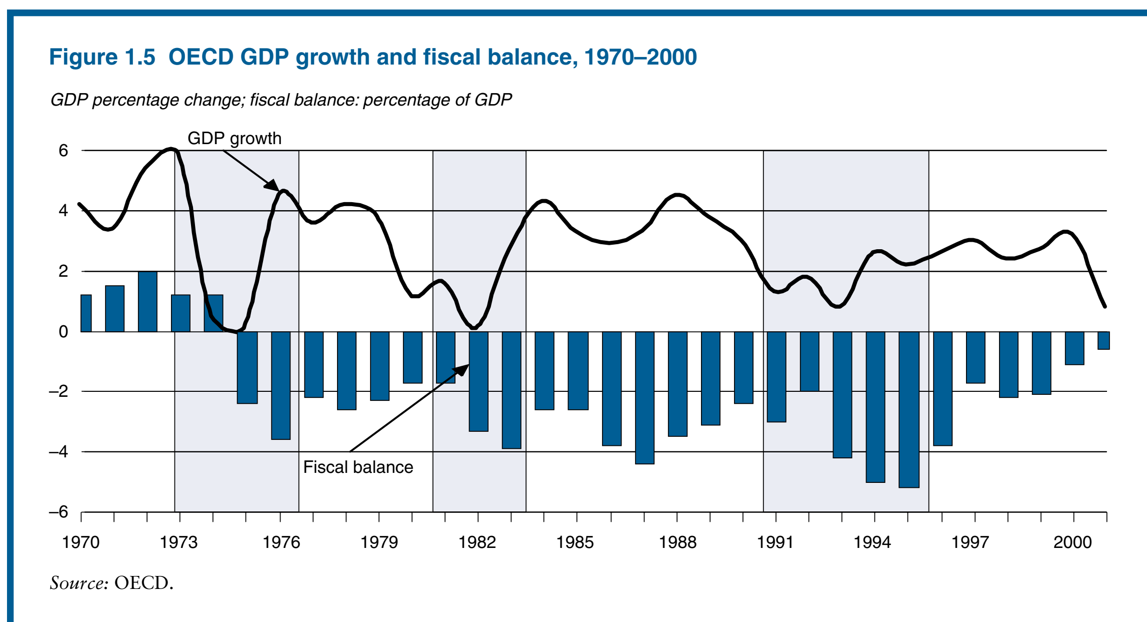

Figure 1.5 OECD GDP growth and fiscal balance, 1970–2000

Source: OECD.

deficits is often abrupt, the restoration tends to be smoothed out over time. Of course, many regional differences and different policy decisions determined the trend in the average deficit. Nevertheless, the historical pattern of persistent deficits is clear, and the main challenge in the current recession is to keep the necessary stimulus confined to the short run. In the medium run, improvement in the industrial countries' fiscal deficits will facilitate a resumption of capital flows toward developing countries.

—auguring a strong recovery in 2003

Taking into account the likely impact of the inventory and investment cycles, and the policy responses, we anticipate that the United States will come out of the recession in the beginning of 2002 and European countries will follow one or two quarters later, but Japan will hardly reach positive growth during the year—resulting in annual 2002 growth rates of 1.3, 1.2, and –1.5 percent respectively for these countries (figure 1.6). As industrial production, investment, and global trade pick up rapidly over the course of the year, 2003 is expected to provide a much rosier picture, with GDP growth climbing to 3.7, 3.3, and 1.7 percent in the three industrial centers. If banking problems in Japan remain unsolved, a relapse into low or negative growth after a temporary export-led recovery in that country cannot be excluded.

The U.S. current account deficit, which already diminished to $420 billion in 2001 from $445 billion in 2000, as a result of recession and falling oil prices, is expected to deteriorate only modestly over the next two years. The adjustment in 2002 and coming years is expected to be accompanied by a gradual weakening of the dollar and a widening of current account deficits in some Euro-

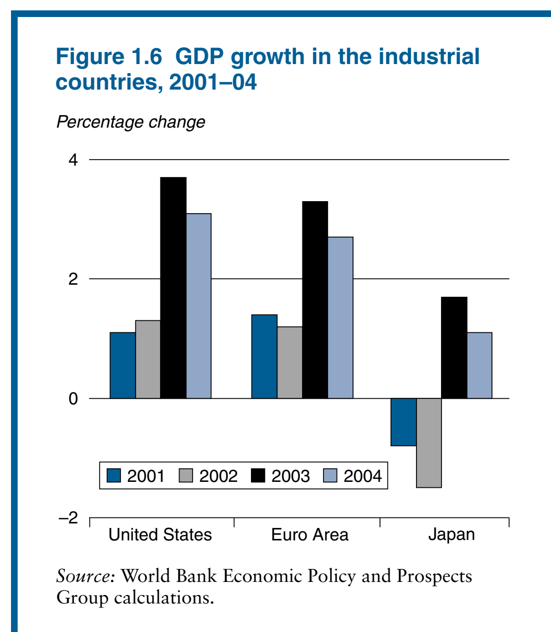

Figure 1.6 GDP growth in the industrial countries, 2001–04

Source: World Bank Economic Policy and Prospects Group calculations.

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pean countries. The Japanese current account surplus declined substantially in 2001 because the latest recession in Japan was driven mainly by a decline in exports instead of a deceleration in investment. Because Japanese investment is also not likely to recover strongly in the near future, the current account surplus is expected to widen again when world trade, and Japanese exports, rebound. The current account deficit for the industrial countries as a whole is expected to decline from $280 billion in 2000 to $240 billion by 2004, most of the improvement being realized in the near term. The mirror image of this development is a reduced current account surplus in the developing countries, partly reflecting declining oil prices and partly reflecting reduced export opportunities.

Bust and boom in world trade

World trade, already undergoing the sharpest deceleration on record, suffered additional setbacks following the terrorist attacks of September 11. These events delayed the expected recovery in output, which will in turn delay the rebound in merchandise trade for one or two quarters. Moreover, security concerns disrupted trade flows, as did increased shipping and insurance costs, although medium-term effects arising from these developments are more uncertain. The attacks also reduced developing countries' revenues from international tourism. However, longer-run prospects for global trade have improved after a first important step toward a new round of trade negotiations was made at the World Trade Organization (WTO) ministerial conference in Doha, Qatar, in November 2001.

The record deceleration of merchandise trade growth in 2001 was due to a collapse in high-tech markets and recessions in the manufacturing sectors of the industrial countries. Import demand declined sharply in the United States and Japan during the first half of 2001, while European import demand fell in the second half. High-tech-intensive merchandise exports from the East Asian newly industrialized economies (NIEs—Hong Kong (China); Singapore; and Taiwan (China) declined much more rapidly than merchandise exports from the rest of the world (figure 1.7).[4] Trade flows also slowed in the developing world, although not as sharply as in the NIEs. By the third quarter of 2001, developing-country export volumes were near levels of a year ago, and this deterioration intensified into the fourth quarter.

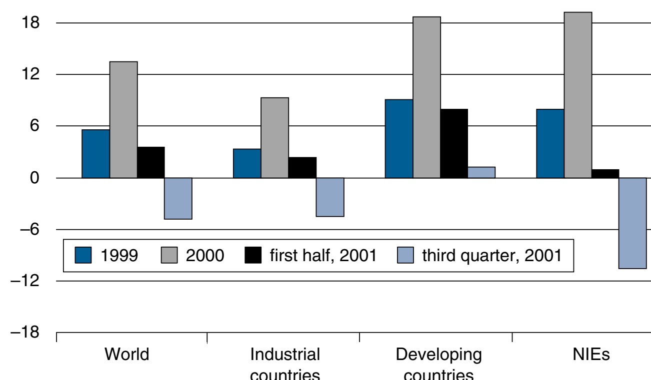
The regions most affected by the fall-off in trade were East Asia—from depressed world demand for high-tech goods and associated slippage in intraregional trade—and Latin America, due to the extensive trade relations between Mexico and the United States. Central European economies continued to witness robust (although slowing) trade growth, while Sub-Saharan African countries were more affected by falling commodity prices than by declines in volume. Merchandise imports are now expected to rebound strongly in the second half of 2002, together with a recovery of world industrial production (figure 1.8). By 2003 growth rates could approach double-digit levels again, of which 3 percentage points will be positive carryover from 2002.[5] North American exports are expected to return to 9 percent growth in 2003, European exports to 7.5 percent, while Japanese trade flows are expected to achieve growth of 6.5 percent. The high-tech exporters are likely to experience the most rapid recovery, with particularly fast export growth expected for East Asia (near 10 percent), boosted by China's accession to the WTO.

Trade logistics disrupted . . . air transport continues to suffer—

The disruption of the global transportation system resulting from the terrorist attacks appears

Figure 1.7 World export growth, 1999–2001

Percentage change, year-over-year



Note: Exports are for a sample of countries representing 79 percent of world exports.
Source: Datastream and World Bank Economic Policy and Prospects Group calculations.

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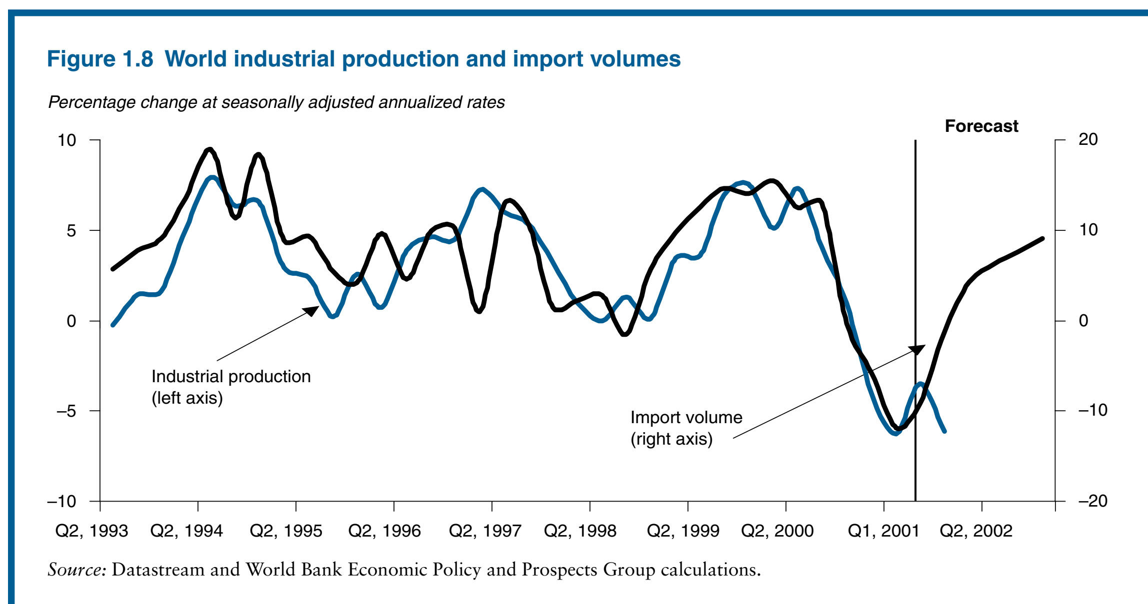
Figure 1.8 World industrial production and import volumes



Source: Datastream and World Bank Economic Policy and Prospects Group calculations.

to have had only temporary adverse impacts on trade growth, but uncertainties continue to loom. Air cargo has suffered more than other transport modes. After September 11, U.S. airspace was completely shut down for several days to domestic and international passenger and cargo traffic, and capacity utilization and revenues in air transport remained significantly below preattack levels for several months. Other parts of the world, especially South Asia and the Middle East, also suffered interruptions in transportation, albeit less severe than those in the United States. There is evidence to suggest, however, that the physical constraints on trade from the security response to the attacks are abating.

The attacks had the immediate effect of increasing insurance and security costs. Maritime shipping costs rose for 10 to 15 days in the aftermath of September 11, rising on average 7 percent according to the most widely available shipping cost indexes. One of these indexes, the Baltic Dry Index, shows a price spike shortly after September 11 (figure 1.9). However, costs declined quickly thereafter. The Baltic Dry Index resumed its sharp downward trend in a matter of days, continuing to track the decline in world trade volumes over the last year. Furthermore, the available data on seaborne shipping costs generally cover the major trade routes—for example, those between Asia and North America, and between North America and Europe. There is anecdotal evidence suggesting that costs have risen substantially more on less-traveled routes, particularly those close to the conflict zone around the Middle East and South Asia. For example, insurance rates on traffic through the Suez Canal increased dramatically after September 11.

Security concerns following the terrorist attacks had a more pronounced impact on the cost of air transport. In September, the air cargo index for transportation across major routes increased by an average of 17 percent, with cargo costs from the United States increasing by 22 percent. By October, the global index had declined by only 2 percent, with costs still nearly 15 percent higher than before September 11. It is likely that a significant portion of the rise in air cargo rates may be longer lasting.

Developing countries' exports will be more affected by rising transportation costs than will exports from industrial countries, because developing countries tend to specialize in exports of primary goods and labor-intensive manufactures, which have higher trade margins (international transport costs) than the high-tech exports from industrial countries.[6] One estimate of the effects of a sustained increase in the cost of trade on world trade flows suggests that, if the terrorist attacks caused a 10 percent increase in the port-to-port costs of merchandise trade, world trade could decline by

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Figure 1.9 Shipping cost index (Baltic Dry)

Note: The index is computed for the third day of each month.
Source: The Baltic Exchange through Datastream.

about 1 percent, approximately $60 billion (relative to a projection where the terrorist attacks have no lasting impact on costs).[7] Developing countries' trade would fall by 1.6 percent, and industrial countries' exports would fall by 0.8 percent.

—and world tourism arrivals and revenues approach record lows

The terrorist attacks also reduced developing countries' foreign exchange revenues from international tourism, which amount to 7 percent of total exports of goods and services, about equivalent to revenues from high-tech exports or exports of agricultural and food products. The World Tourism Organization reports that travel reservations worldwide in November 2001 stood 12 to 15 percent below the levels of a year earlier.[8] Anecdotal evidence suggests that the fall in tourism revenues may well have reached double-digit rates, as both tourist arrivals and expenditures collapsed. Directly after September 11, 40 percent of booked vacation trips with Caribbean countries as the destination were canceled. Airlines have substantially trimmed their schedules to other destinations as well. Several mid-size carriers in Europe have failed in the last few months, and some carriers in the United States are threatened with bankruptcy despite the $15 billion support package quickly enacted in the aftermath of September 11. Aside from declines in volume, price effects may also be important as resorts and hotels drop their prices in order to entice visitors.

In the first eight months of 2001 world tourism was on track for an increase of 2.5 to 3 percent for the year as a whole, but after September 11 expectations were adjusted to only 1 percent growth, implying a decline of more than 20 percent (annualized) in fourth quarter momentum.[9] Assuming a 20 percent drop in tourism revenues during a period of six months, the loss in export revenues for developing countries could amount to $14 billion. The impact on employment could be particularly severe, because tourism services tend to be highly labor intensive. Short-term impacts probably far exceed the longer-term consequences, since past trends indicate that demand for travel and tourism services recovers relatively rapidly from setbacks. Even so, countries near the conflict zone in South Asia and the Middle East may suffer a more sustained reduction of revenues. The impact of any decline in tourism revenues will vary enormously among developing countries. For example, tourism can constitute as much as 70 percent of goods and services exports in some small island economies, and also

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has become a key export sector in many Sub-Saharan African countries. Revenues from tourism for the 14 Sub-Saharan African countries with the highest dependency on tourism revenues average 22 percent of total export revenues.[10] In absolute terms, Turkey is the largest recipient of tourism revenues, and the sharp fall in these receipts since September 11 has complicated efforts to overcome the financial crisis.

Improved prospects for a development round of multilateral trade negotiations

The Doha Development Agenda—which emerged from the WTO Ministerial Conference held in Doha, Qatar, in November 2001—demonstrates the increased prominence of development concerns in WTO deliberations, in turn reflecting increased participation by developing countries in the international trading system. Doha launched negotiations on market access for manufactures, dispute settlement, WTO rules, environmental policies, and intellectual property protection. These negotiations will complement ongoing talks on market access in agriculture and services, which are mandated by the Uruguay Round agreements. Negotiations will be launched on four so-called Singapore issues—competition, investment, trade facilitation, and transparency in government procurement—at the next WTO ministerial meeting in 2003, if consensus can be reached on the modalities of such negotiations at that time. Completing negotiations by January 1, 2005, as envisaged in the Doha Ministerial Declaration, represents a major challenge (box 1.1), but success in doing so would imply large welfare gains for both developing and industrial countries.

Secular declines and cyclical swings in commodities prices

Non-oil commodities. The global economic slowdown, a strong dollar, and large supplies of most commodities reduced the average dollar price of developing countries' non-oil primary commodity exports by 9 percent in 2001. Demand for metals was most affected by the economic slowdown, while agricultural commodities continued to face large supply increases despite falling prices. Non-oil commodity prices are now one-third below their cyclical high of 1997. Currency depreciation in major commodity exporters in East Asia and Latin America resulted in sharp price declines for coffee, oilseeds, sugar, and raw materials such as rubber. Continued rapid technological progress contributed to supply increases in a number of commodities,[12] and improved policies in some developing countries contributed to large increases in exports.[13] Coffee prices were especially hard hit (down 30 percent in 2001 compared with 2000) due to a 20 percent increase in global production over the past three years with little increase in consumption. Cotton prices declined 20 percent in 2001 due to large production increases in China and the United States, and rice prices fell 15 percent due to the large exports from Thailand and Vietnam. Copper prices fell by 12 percent in 2001, and prices would have declined even further if major producers had not cut production by about 5 percent in an effort to prevent additional price declines.

The price declines have been especially hard for exporters in Africa, where non-oil commodities often account for 70 percent or more of export revenues. Ethiopia, for example, derives nearly two-thirds of total export revenues from coffee, and Mali derives about 40 percent of total exports from cotton. Moreover, the prices of commodities that account for a large share of Sub-Saharan exports (such as cocoa, coffee, and copper) have fallen by more than the prices of commodities exported by other developing countries (figure 1.10). Since 1980, the index of real non-oil commodity export prices of Sub-Saharan African countries has declined by 10 percent relative to the index of all developing countries. On top of that, the African index tends to be more volatile over the price cycle, implying a sharper fall during a downturn. African producers have been unable to make up for the decline in prices through higher volumes, since African agricultural production has been flat over the past two decades, while agricultural production increased rapidly in developing countries as a whole (figure 1.11). Sub-Saharan Africa's non-oil commodity export revenues dropped at least $3 billion between 1997 and 2001—equal to 3.6 percent of non-oil export revenues in 1997 and 25 percent of total official development aid to these countries in 1999.

We expect a recovery of only 15 percent in non-oil commodity prices from current cyclical lows over the interval through 2004. This will leave non-oil commodity prices 22 percent below their 1997 level. The short-term recovery will be driven

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Box 1.1 The Doha Development Agenda

The Doha agenda has great potential to be beneficial from a development perspective. A great deal of research has documented that there is still a large market-access agenda and that dealing with this agenda will significantly increase real incomes and reduce poverty in developing countries (World Bank 2001). Research also suggests that care is required to determine the development relevance and payoffs of extending the WTO into regulatory areas (Hertel, Hoekman, and Martin 2002). The key areas of concern for developing countries in the new trade round will be market access, regulatory issues, and the magnitude and effectiveness of the technical assistance that was promised in Doha.

Improving *market access* remains a key goal of multilateral trade negotiations. Industrial countries will need to mobilize the political will to reduce remaining pockets of protection in key sectors such as agriculture, labor-based services, and labor-intensive manufactures. Developing countries also need to be willing to liberalize access to their markets for goods and services. The relatively high barriers to trade in goods *and* services that continue to prevail in many developing countries implies that they have a lot to bring to the table in a mercantilist sense. Identifying a set of "concessions" that are of interest to politically powerful groups in OECD countries and that are beneficial to developing countries is the major challenge confronting policymakers in the coming years. The research and development communities need to help identify what such issues might be and assist in mobilizing the affected constituencies.[11]

As far as multilateral rule-making on *regulatory issues* is concerned, better understanding of the issues in developing countries is required, not just by government officials but also by the private sector and civil society. Despite five years of studying trade and investment-competition linkages in WTO working groups set up for that purpose, many low-income countries were fearful in Doha of launching negotiations in these areas. There is clearly a need to provide greater assistance to build capacity and undertake analysis in developing countries to determine the merits and implications of multilateral disciplines. Whether it makes sense to rely on negotiation and binding dispute settlement to address behind-the-border policies in the WTO is a question that developing countries need to answer for themselves. The Doha ministerial meeting revealed that many countries had an answer to that question, but that many others did not.

The Doha declaration contains numerous commitments by high-income WTO members to provide *technical assistance*. However, there is no mention of the magnitude of assistance that will be offered, nor is there discussion of any mechanism to determine what the needs are and how they should be addressed (that is, what the delivery mechanism might be). Embedding technical assistance in a broader development framework is critical in ensuring that the assistance focuses on the priority needs of each country and is consistent with its development strategy. The separate section in the Doha declaration on technical cooperation and capacity building provides scope to move in this direction: Ministers "instruct the Secretariat, in coordination with other relevant agencies, to support domestic efforts for mainstreaming trade into national plans for economic development and strategies for poverty reduction" (paragraph 38). A concerted effort will be needed to ensure aid is targeted at national priorities, and to ensure that assistance is provided in an effective manner by agencies with a comparative advantage in an area.

Ensuring that the new round of trade negotiations achieves a pro-development negotiating outcome is a major challenge. Resistance to liberalization of agriculture and textiles is very strong. Conversely, many low-income countries are unwilling to extend the reach of the WTO to cover issues such as competition and investment policies. A major question confronting WTO members is whether a deal should be constructed that involves linking old market access issues to disciplines on new issues such as investment and competition. The feasibility of any such linkage will depend greatly on what is done in the coming years to address developing-country concerns regarding implementation of Uruguay Round agreements and the magnitude and effectiveness of the technical assistance that was promised in Doha.

by a rebound in global economic activity, reduced supplies and stocks in response to current low prices, and some weakening of the dollar. There is uncertainty associated with the factors that underlie the recovery of commodities prices, but the impacts of the uncertainties on prices differ markedly. While the timing of the rebound of demand is uncertain, a recovery that is further delayed will have only a limited negative impact on prices. The potential for unexpected supply increases may be a greater risk. During the 1990s rapid technological progress, combined with improved policies, led to the emergence of major producers in a relatively short period of time, resulting in sharp declines in prices (as

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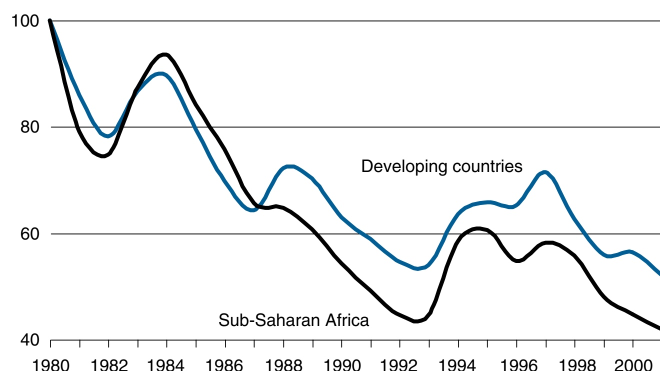
Figure 1.10 Real non-oil commodity prices since 1980

Index, 1980 = 100; deflated by MUV



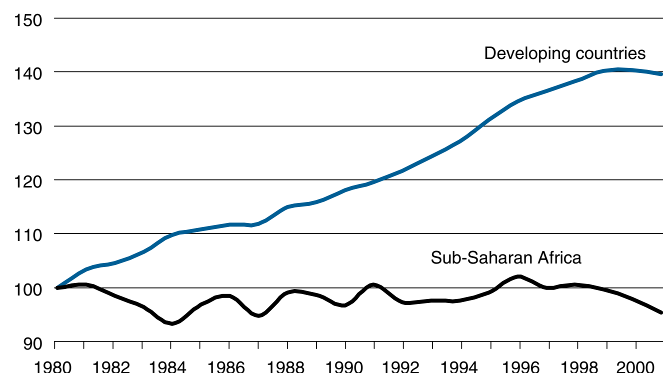
Note: MUV is the unit value of manufactures exports from the G-5 countries to developing countries, expressed in U.S. dollars.
Source: World Bank Economic Policy and Prospects Group calculations.

in the case of coffee). While such supply increases are difficult to predict, they remain an important risk to the forecast. Conversely, abnormal weather conditions are more likely to lead to higher prices, since bad harvests tend to result in much larger falls in production than would be the case when good weather conditions boost production.

Oil prices. The global economic slowdown contributed to a reduction of oil prices from \$28.2 a barrel in 2000 to \$24.4 in 2001.[14] Oil prices spiked briefly to \$31 a barrel immediately following September 11, but when it became apparent that there were no immediate threats to oil supplies, prices quickly fell, ending the year at \$18.5. World oil demand grew little in 2001, and actually fell by 1 percent year-on-year in the second half of the year as a result of the after-effects of the attacks (such as reduced jet travel, for example), the deepening economic slowdown, and mild weather. With non-OPEC (Organization of Petroleum Exporting Countries) production growing moderately overall (increases occurred mainly in the Commonwealth of Independent States, or CIS), oil inventories have risen back to a more comfortable range compared with the low levels of 2000 (figure 1.12).

Figure 1.11 Per capita agricultural production

Index, 1980 = 100



Source: United Nations Food and Agricultural Organization Statistical Office (FAOSTAT).

OPEC reduced production three times prior to September 11 to keep the price of its crude basket within its target range of \$22 to \$28 a barrel. But, with the changed political environment after September 11 and as the economic slowdown worsened, OPEC chose not to activate its "automatic mechanism" that reduces output when the price of oil falls below \$22 for 10 consecutive days. Instead, OPEC countries relied on reducing their production above quota (estimated at 0.54 million barrels a day in November) to help support prices.

With oil prices well below \$20 a barrel in November, OPEC agreed to reduce quotas by 6.5 percent or 1.5 million barrels per day (mb/d) beginning January 1, 2002—but only if non-OPEC producers firmly committed to reducing production by 0.5 mb/d. OPEC threatened a price war if a deal could not be reached. Non-OPEC producers responded in part, with major producers Norway and the Russian Federation each agreeing to cut production by 0.15 mb/d. While non-OPEC cuts fell short of the 0.5 mb/d demanded, they were large enough for OPEC to follow through on its proposed cuts, which will last "as long as necessary" according to OPEC's secretary general.

We expect oil prices to average \$20 a barrel in 2002, somewhat above current levels but well below the 2001 average. It will be difficult to lift prices to 2000 levels, mainly because of the underlying weakness in demand and because non-OPEC capacity has been increased during the recent period of high prices. But with an economic recovery in the second half of 2002, oil demand is expected to increase marginally, following sharp declines in the prior year. Non-OPEC supplies are expected to rise by 1 mb/d, excluding any temporary, volun-

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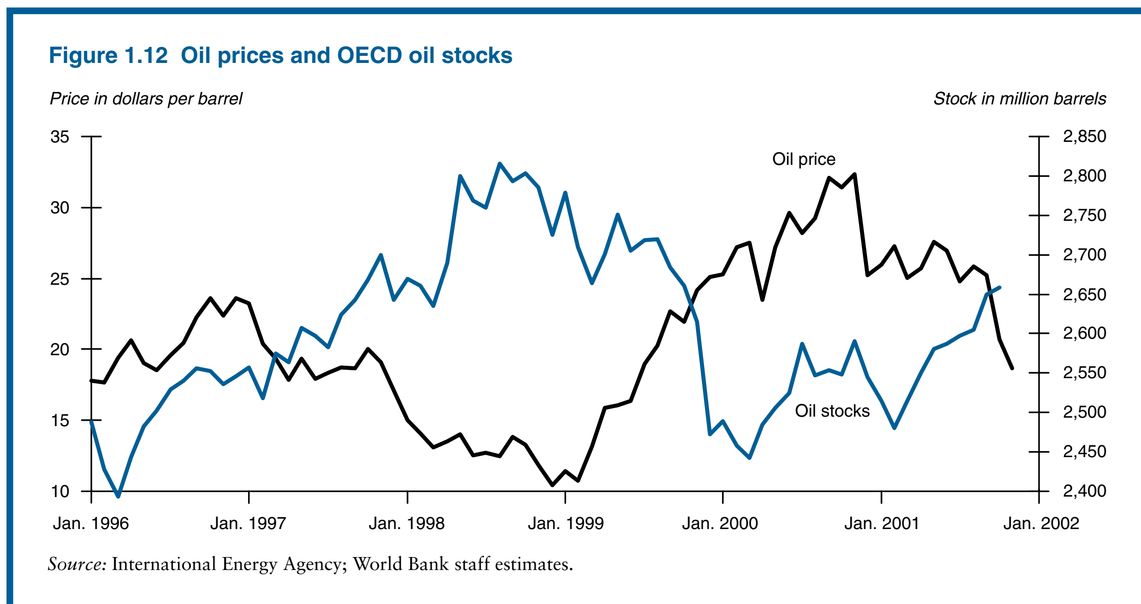
Figure 1.12 Oil prices and OECD oil stocks



Source: International Energy Agency; World Bank staff estimates.

tary reductions. Consequently, OPEC will be required to produce less oil in 2002. If oil producers maintain low levels of output throughout the year, oil inventories could begin to tighten; that would help firm prices later in 2002 and into 2003, to average $21 for the latter year. In 2004 non-OPEC supplies are expected to capture much of the expected growth in demand, and oil prices are expected to weaken, to $19 a barrel, as OPEC members continue to lose market share. The increase in non-OPEC supply is expected to exceed the rise in demand when global economic growth solidifies.

The risks to the price forecast are mainly on the downside, since the agreement between OPEC and non-OPEC producers is likely to be fragile under expected weak demand conditions. However, while the potential for supply disruptions is thought to be small, disruptions could have a large impact if they do occur. The major uncertainties include the prospects for exports from Iraq, which will depend on that country's reactions to changes in the sanctions regime, and any military conflict in the Middle East due to the war on terrorism. The impact of the latter could be extremely significant. For example, the loss of 5 mb/d of Iranian production in 1980 caused a 150 percent rise in prices within several months, and the similar-size loss of Iraq and Kuwait production in 1990 caused a temporary doubling of prices within three months.

Regional developments

Severe recession in the rich countries, unprecedented deceleration in world trade, weak commodity prices, and heightened risk perceptions and increased selectiveness in financial markets affected all developing regions during 2001.[15] GDP growth for the aggregate of developing and transition countries fell from a record 5.4 percent in 2000 to 2.8 percent in the year, and per capita growth declined to 1.4 percent, both rates well below the averages of the 1990s (table 1.3). The intensity of the international effects differed across countries and regions, tied to—among other factors—market orientation and product specialization in patterns of trade; initial conditions in domestic financial markets, and different policy measures adopted in response to the slowdown. Country-specific conditions are likely to shape the recovery onto differing paths of growth by region following the expected rebound in industrial-country activity and trade.

The movement from boom to bust in the external environment is reflected distinctly in the fall of export market growth from 13 percent to 1.1 percent, and the concomitant decline in developing-country export performance from 15 percent to 4 percent—although this movement still implies a pick-up in market share for the group. Terms of trade, expressed as a proportion to GDP, dropped

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Table 1.3 Developing-country forecast summary, 1991–2004
(percent per year)

Growth rates/ratios	1991–2000	1999	2000	Estimate 2001	Forecast 2002	2003	2004
Real GDP growth	3.2	3.3	5.4	2.8	3.2	5.0	4.9
Consumption per capita	0.9	1.0	3.2	1.5	1.8	3.0	3.1
GDP per capita	1.6	1.8	3.9	1.4	1.8	3.7	3.5
Population	1.6	1.5	1.5	1.4	1.4	1.3	1.3
Gross domestic investment/GDP[a]	23.5	23.2	24.0	24.2	24.6	24.8	25.0
Inflation[b]	11.7	5.4	6.4	5.3	4.4	4.2	4.1
Central government budget balance/GDP	–3.6	–4.0	–3.2	–3.2	–3.5	–3.5	–3.1
Export market growth[c]	7.6	5.3	12.9	1.1	2.5	7.7	7.4
Export volume[d]	7.1	4.9	14.6	3.7	6.1	9.6	9.4
Terms of trade/GDP[e]	–0.2	0.6	0.4	–0.1	–1.1	–0.2	–0.3
Current account/GDP	–1.2	0.4	1.2	0.4	–0.2	–0.4	–0.7
Memorandum items							
GDP growth: developing excluding the transition countries	4.8	3.3	5.3	2.6	3.2	5.2	5.0
Excluding China and India	2.1	2.3	5.1	1.8	2.2	4.4	4.2
Excluding transition, China, India	3.7	2.1	4.8	1.3	2.0	4.4	4.3

a. Fixed investment, measured in real terms.
b. Local currency GDP deflator, median.
c. Weighted average growth of import demand in export markets.
d. Goods and nonfactor services.
e. Change in terms of trade, measured as a proportion to GDP (percent).
Source: World Bank baseline forecast, February 2002.

by 0.1 percent. These developments pushed export revenues into negative territory (a decline of 1.3 percent), and contributed to a narrowing of the aggregate current account surplus to 0.4 percent of GDP in the year. At the same time, however, underlying inflation trends have continued on a path of deceleration, central government budget balances have narrowed from the averages of the 1990s, and a general improvement in the investment climate in many countries, including new emphases on governance and institutional reforms, have helped maintain the flow of FDI into selected developing and transition economies at high levels. These factors have opened the door—for those countries with a favorable climate—to pursue countercyclical policy options to help mitigate the full brunt of the external shocks of 2001. For example, large levels of reserves, low inflation, and manageable government debt enabled many countries in East Asia to reduce interest rates and to implement fiscal stimuli. Other countries, with weaker initial conditions (including, for example, Indonesia), several countries in Latin America, and Turkey, were forced to persist in fiscal consolidation, or even to tighten further, and many did not see lower international interest rates reflected in reductions in domestic rates.

An important challenge for most developing countries during the current downturn has been coping with much-reduced export revenues, at the same time that access to international capital has grown more limited. Decline in export receipts ($26 billion or 1.3 percent of regional GDP), was largest for East Asia, the origin of some 80 percent of developing countries' high-tech exports. And oil exporters throughout the developing world have seen their export revenues fall more than $100 billion as the price of oil fell sharply. For these countries, though, financing difficulties are not as pressing, since most East Asian and oil-exporting countries accumulated substantial current account surpluses and reserves over the last several years. More vulnerable are countries that depend largely on non-oil commodities exports, or on tourism, other services receipts, and transfers; these countries usually have less-than-creditworthy borrowing status. Most pressing are the financing problems for countries such as Turkey and Argentina that had amassed very large financial imbalances.

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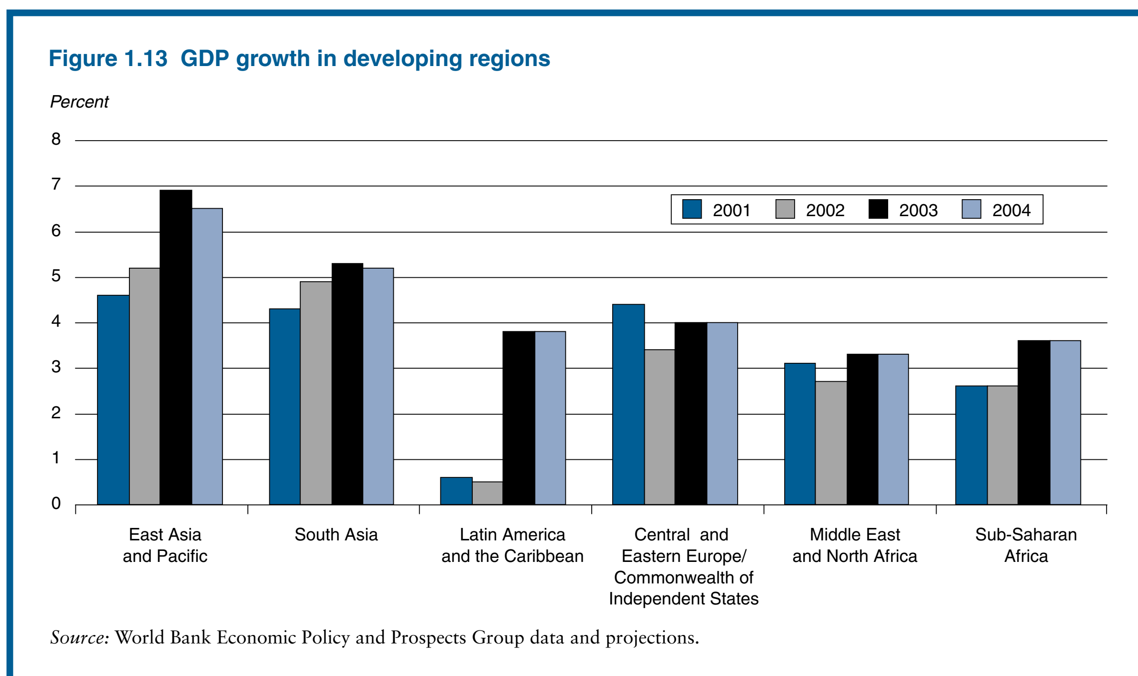
Figure 1.13 GDP growth in developing regions



Source: World Bank Economic Policy and Prospects Group data and projections.

For developing and transition countries as a group, recovery is anticipated to build momentum over the course of 2002. Growth is expected to reach 3.2 percent in 2002, and rise to 5 percent during 2003–04 (table 1.3). A rebound in export market growth to rates near 8 percent by 2003 would suggest a return of export performance toward double-digit gains. Terms of trade for the aggregate of developing countries is likely to worsen in the short to medium term, since it is tied in part to the large weight of oil exporters in the group, as well as to anticipated increases in the dollar cost of manufactures imports from the industrial countries.[16] Nonetheless, strong export volume growth should underpin domestic investment, with positive multiplier effects, and falling inflation should boost real incomes and consumption. A gradual return of private capital to emerging markets will accentuate these developments, so that by 2003 growth will be returning toward 5 percent. Moreover, recent developments, including the Doha Round, China's accession to the WTO (and the Russian Federation's expressed interest in the organization), offer promise of a broader scope for fuller participation in global trade, which will benefit the new members and their trading partners alike.

Recovery in the developing world is likely to begin, and to be strongest, in East Asia, where countries have benefited from domestic stimuli, and where strong dynamics in the high-tech sectors could once again work in their favor (figure 1.13). In contrast, little recovery for the aggregate of Latin American countries is anticipated, given their much less favorable starting points, since financial strains remain elevated and commodity prices are expected to rebound only modestly. Subdued commodity prices will also continue to restrain economic growth in Sub-Saharan Africa. The war on terrorism could hamper growth in South Asia and the Middle East and North Africa in the short run as trade and tourism flows remain disrupted, while at the same time financial flows to frontline states should ease current account tensions. In the medium run, necessary fiscal austerity in South Asia is expected to dampen growth rates in the region somewhat. Recovery in Central and Eastern Europe will hinge critically upon developments in the European Union (EU), suggesting somewhat delayed recovery relative to East Asia, while the Russian Federation and other countries of the CIS are likely to see recent stronger rates of growth—linked in large measure to the price of oil—fade gradually over the next years.

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East Asia and Pacific

Growth in East Asian developing countries slowed to 4.6 percent in 2001 from the 7.4 percent registered during the 2000 boom. The growth slowdown in the region, excluding China, was more dramatic—from 7 percent in 2000 to 2.3 percent. Chinese growth remained above 7 percent, boosted by large-scale fiscal stimulus.

The collapse of global demand for high-tech products, compounded by progressively weaker economic conditions in the United States and Japan, hit exports, industrial production, and investment in most countries quite hard and raised unemployment rates. Regional export volume growth slowed sharply to 3 percent—in contrast to the robust 22 percent advance of 2000—with the largest growth decline occurring in the five countries most affected by the 1997–98 Asian crisis. Manufacturing output in the larger countries, excluding China, dropped by some 7.5 percent, fixed investment slowed by 4 percentage points, and liquidation of unwanted inventories played a substantial role in the downturn, subtracting more than 1 percentage point from the regions' output in the year. The high-income, high-tech-dependent *entrepôt* centers of the NIEs were battered into recession despite strong monetary and fiscal stimuli; this led to a sharp compression of East Asia's intricate network of intraregion trade. The events of September 11 only exacerbated the difficult external environment facing the region, especially for tourism revenues, as tourist arrivals in the five leading Association of Southeast Asian nations countries are thought to have fallen by 10 to 15 percent in October (year-over-year).

Low and declining inflation rates allowed most countries to use fiscal and monetary stimuli to mitigate the downturn. For example, the Republic of Korea lowered interest rates by 140 basis points, stepped up fiscal outlays—with the central government balance deteriorating from a surplus of 1.3 percent of GDP in 2000 to a small deficit in 2001—and tapped international capital markets for gross flows of some $21 billion in the year. These measures provided cushion for domestic demand while increasing reserve levels. Similar policy measures by several other economies in the region (with the exception of Indonesia) yielded a widening of the average fiscal deficit to 3 percent of GDP from 2.5 percent in 2000, while the current account surplus position diminished by 1.5 percent of GDP. Financial difficulties in Indonesia—and to a lesser degree, in the Philippines—were being addressed through agreements with the International Monetary Fund and multilateral development banks.

East Asia may be the first developing region to emerge from the current global downturn, and growth there is expected to pick up to 5.2 percent in 2002—reflecting the positive impact of looser monetary and fiscal positions and improvement in external conditions. But the strength of recovery will hinge upon the revival of world trade and rise in global demand for technology-based products. There are some early signs of encouragement in the information and communications technology (ICT) sector, as world semiconductor sales appear to have reached a trough. Industrial production is now rising across key ICT-producing economies of the region—notably Korea, but also Malaysia, the Philippines, Thailand, and the NIEs. As demand is unlikely to gain substantial momentum until the second half of 2002, however, a more robust export-led recovery in East Asia is not likely until 2003, with GDP growth expected to reach about 7 percent, before moderating toward potential growth of 6.5 percent in 2004. Challenges will remain during recovery, especially the potential widening of fiscal balances and the need to re-address fragile banking systems in several countries. China's recent accession to the WTO offers the broader region both substantial opportunities, in an opening of the large Chinese market to the region, and potential competitive pressures in third markets, because these open wider to Chinese products.

Latin America and the Caribbean

Regional GDP grew 0.6 percent in 2001 in Latin America and the Caribbean, a substantial slowdown from the 3.8 percent advance registered in 2000. The weak growth performance reflects adverse external conditions alongside a progressive worsening of the political and economic situation in Argentina. Output in Latin America, excluding Argentina, increased by 1.3 percent in the year. Following September 11, economic conditions worsened for the region as Argentina's crisis deepened, commodity prices fell, secondary market spreads rose, and capital flows fell from already subdued levels in July and August. The Caribbean region witnessed a steep decline in tourist bookings, while weakening labor markets in North America led to a slackening of remittances to Central American and

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Caribbean countries. Few countries (among them, Chile and the República Bolivariana de Venezuela) were able to pursue countercyclical fiscal policy or monetary expansion to mitigate the growth slowdown, due to generally high public debt and relatively large external financing requirements. These developments translated into a rise in regional unemployment, with falling inflation rates in most countries, but little change in real interest rates or fiscal balances.

International developments were a major constraint on external revenues in 2001. The regional trade balance moved from a deficit of $35 billion in 1998 to a surplus of almost $10 billion in 2000 on the back of rising surpluses for major oil exporters. During 2001, however, aggregate dollar exports declined 1.5 percent and imports fell 1 percent, narrowing the trade surplus by about $3.6 billion. Oil exporters saw their surpluses diminish while Argentina and Brazil raised their surpluses significantly. In combination with these trends, a softening of receipts from tourism and remittances contributed to a widening of the region's current account deficit by $5 billion. With declines in financing from international capital markets, the current account deficit was balanced by a drawdown of reserves and increased support from the international financial institutions.

The outlook for 2002 has dimmed, with GDP now expected to rise by 0.5 percent—assuming that the repercussions of the Argentine default and devaluation have been discounted by financial markets, and that regional contagion remains limited. The forecast revision is also due to a much weaker fourth quarter 2001 outturn for most countries—implying delay to the recovery, the growth-eroding effects of crisis for Argentina itself, and a decidedly weaker outlook for private-capital market and business-related foreign direct investment (FDI) inflows. Fiscal deficits were deteriorating sharply at the end of 2001 for a number of countries due to slowing growth and continued declines in the prices of commodity exports, and government debt levels have risen. Hence fiscal consolidation may be required in 2002 to avoid excessive debt burdens, and this may constrain governments' ability to support growth through increased spending. Growth is expected to recover to 3.8 percent in 2003—yet with considerable downside risks, should Argentina's output decline become more protracted—maintaining growth at that rate during 2004, as the industrial world eases. By that time private capital flows will have increased again, and earlier recovery in industrial countries should boost the price of the region's primary commodities and the volume of manufactured exports.

Europe and Central Asia

Europe and Central Asia grew by 2.2 percent in 2001, contrasted with 6.4 percent growth in 2000. The sharp deceleration was due to a 7.5 percent contraction in Turkish output, the fall in Russian growth to 4.8 percent following robust 8.3 percent performance in 2000, and a 0.9 percentage point deceleration in Central and Eastern European output. Growth for the region, excluding Turkey, amounted to 4.4 percent, down from 6.2 percent in 2000. Most transition economies witnessed declining inflation and interest rates, reflecting lower import prices and falling international interest rates. However, adoption of accommodative fiscal and monetary policies in the face of slowing growth led to a slight deterioration of fiscal deficits in several Central European countries.

Developments during the year served to narrow current account surpluses for those countries recently attaining positive balances (for example, Kazakhstan, the Russian Federation, and Ukraine) and widened deficits for countries whose external balances have remained persistently negative (such as Bulgaria, Croatia, Romania, and the Slovak Republic). This reflects delayed spending of oil revenues (as in the Russian Federation and Kazakhstan), and a deterioration in the external environment, particularly weaker external demand from the EU area. There are exceptions. In Turkey, the current account deficit shifted into a $3 billion surplus in 2001, as net external finance plummeted and the February 2001 crisis resulted in drastic measures to reduce domestic demand, and to switch expenditure, including a 56 percent depreciation of the lire. In Poland compressed domestic demand (linked to previously tight monetary policy, easing as of late 2001) has contained imports, translating into a narrowing of the current deficit, from $10 billion to $7 billion in 2001.

Growth in the region is expected to pick up modestly in 2002, to 3.2 percent from 2.2, but largely based on the assumed strength of recovery in Turkey. In contrast, among the transition economies, growth in the CIS is anticipated to decline to 3.8 percent in 2002, driven principally by a sharp

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decline in Russian oil revenues. Growth may ease moderately in Central and Eastern Europe from 2.9 percent to 2.8, while recovery in the Euro Area develops only gradually and fiscal consolidation may be necessary for potential accession countries to the EU. The region as a whole should see an acceleration of growth to between 4 and 4.5 percent in 2003–04, as the eventual pickup in Europe increases demand for the region's exports, although continued sluggish oil markets will partially constrain growth in the CIS.

South Asia

Although South Asia is relatively less integrated into the global economy than most developing regions, trends in the external environment served to restrain the pace of growth during 2001. Growth rose from a 4 percent advance in 2000 to 4.3 percent in 2001, as a decline in manufacturing output offset general improvement in agricultural performance (agriculture accounts for 50 percent or more of output for all countries of the region). Export market growth declined abruptly and sharply, leading to a fall in regional export growth to 1.1 percent from the strong 12.3 percent outturn of 2000. Indian exports, for example, dropped by 2 percent over the period from April to September compared with the levels from a year earlier. Manufacturing output in that country showed no growth in the first half of the calendar year. Pakistan will clearly pay a toll in economic activity for the duration of the military activities in Afghanistan, but it will also receive adequate financial support from the international community to reduce debt-servicing requirements, possibly establishing a foundation for renewed growth.

Given the size and relative self-sufficiency of the Indian economy, tepid domestic demand is the main culprit behind the current sluggishness of growth, although external factors have played a greater role than was typical in the past. Investment is slowing, in part due to the slackening of export growth, and capital goods output dropped 8 percent during the first half of fiscal 2001. However, positive developments on the inflation front, with the consumer price index moving below 3 percent, provided some headroom for easing of monetary policy in response to increasingly weak conditions. The recent fall in oil prices, continued growth of software exports (albeit at reduced 30–percent rates), and slower import growth are expected to keep India's current account deficit well below 2 percent of GDP. FDI inflows ballooned to $4.5 billion in the year, twice the level of any previous fiscal year. Given a comfortable foreign reserve position, India is unlikely to face tight constraints in external finance. But increasing direct government spending and subsidies, in India as well as in Bangladesh and Pakistan, will tend to widen central government fiscal deficits—to 5.3 percent, 6.3 percent, and 5.3 percent respectively—and these deficits are likely to remain impediments to a more robust acceleration of growth in the medium term.

Output in the region is expected to gain momentum over 2002–03, partly on the strength of global trade recovery, although political and military tensions in the region create large uncertainties. Removal of sanctions by the United States on India and Pakistan and a potential pick-up in textile and clothing exports linked to eventual opening of rich-country markets are additional favorable factors that could support the medium-term outlook. And hoped-for progress in addressing structural reforms across countries of the region should support gains in productivity. Regional output is expected to register growth of 4.9 percent in 2002, before rising somewhat faster over 2003–04 at a pace above 5 percent.

Middle East and North Africa

Middle East and North Africa region GDP slowed to 3.1 percent in 2001, following above-average growth performance of 4.2 percent during 2000. Cutbacks in oil production by OPEC members of the region to support oil prices within a target band, coupled with volatility—and recent sharp declines—in the oil price, depressed growth among the major hydrocarbon producers. For example, following a rise of some 4.5 percent in 2000, GDP in Saudi Arabia advanced by slightly less than 2 percent in 2001. At the same time, progressive weakening of conditions in continental Europe (the dominant export market for countries of the Maghreb and several countries of the Mashreq) dampened export performance substantially—Moroccan export growth dropped into negative territory during the first half of the year. These trends were exacerbated by declines in revenues from tourism and remittances due to heightened security concerns after September 11. Against this back-

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ground output growth for the oil exporters of the region dropped from 3.6 percent in 2000 to 2.5 percent in 2001; and with the exception of Morocco, which was recovering from severe drought conditions, growth among the diversified exporters of the region slowed to 3.2 percent from 4.7 percent in 2000.

An important consequence of these developments has been a substantial waning of external surpluses across the region. This is most evident among the oil-exporting countries, where current account balances that ballooned to some $59 billion (13 percent of GDP) with the jump in oil prices in 2000, dropped quickly to less than $40 billion on the back of slumping prices and curtailment of exports. Although public spending levels were adjusted in many countries, fiscal deficits increased. In the case of Saudi Arabia, despite public sector wage restraint, the 2002 budget foresees a deficit of some $6 to 7 billion, contrasted with a surplus of similar magnitude in 2000. Similar adverse fiscal trends are affecting countries such as the Arab Republic of Egypt, Morocco, and Tunisia, and may broaden across the diversified exporters as external revenue shortfalls become more acute in the near term.

Some countercyclical policy actions have been possible. Improved inflation performance in Egypt has allowed a full percentage point reduction in the central bank discount rate; and exchange rates have been falling relative to the dollar as well as the euro over the second half of 2001 in Egypt, Morocco, Tunisia, and the Republic of Yemen. These measures may help to mitigate the effects of the global slowdown to a modest degree; but given the importance of the EU as an export market and a principal source of remittance and tourism income, recovery there will be necessary for a return of more buoyant external conditions in the Middle East and North Africa.

Given difficult conditions in the external environment, near-term prospects appear muted: growth recovery in the EU is likely to lag behind that of North America and East Asia; underlying demand for hydrocarbons will require some time to reach 1999–2000 levels, and uncertainty associated with the war on terrorism will likely remain a dampening factor for regional dynamism. GDP growth is anticipated to fall to 2.7 percent in 2002, while recovery over the following years may be protracted relative to other developing regions, rising by 3.3 percent over 2003 and 2004.

Sub-Saharan Africa

Growth in Sub-Saharan Africa eased to 2.6 percent in 2001 from 3.1 percent in 2000, as the global slowdown exacted a toll on commodity prices and growth in the region's export markets. The slowing of Sub-Saharan Africa's aggregate growth was moderate because oil exporters enjoyed relatively high oil prices for much of the year, and favorable weather conditions boosted agricultural production in several countries (for example, cocoa production in West Africa increased sharply). But terms-of-trade losses as a proportion to GDP were 1 percent, the worst performance outside of the Middle East and North Africa region, and export market growth fell from 11 percent in 2000 to 1 percent. These fundamental conditions were reflected in African high-frequency data covering production, trade, and financial markets, which indicate that, as elsewhere, economic conditions deteriorated sharply over the course of the year. Growth of regional export volumes dropped by 5.4 percentage points, to 2.1 percent, and revenues by 24 percentage points, to –4.3 percent from 2000 outturns. Moreover, weak tourism demand in the critical year-end period—and in the wake of September 11—further affected a number of countries dependent on tourism, especially Kenya and Tanzania. In South Africa GDP registered growth of 1.2 percent (seasonally adjusted annual rate) in the third quarter, down from a recent peak of 3.4 percent in the fourth quarter of 2000. A deterioration in the country's trade balance coupled with a decline in equity capital flows precipitated a sharp fall in the value of the rand, which lost nearly a third of its value over the fourth quarter.

Looking to 2002, the projected decline in oil prices will adversely affect fiscal and external balances of hydrocarbon exporters, but at the same time it will provide a degree of relief to the large number of oil-importing countries of Sub-Saharan Africa. Oil contributes 70–80 percent of export revenues for Angola, the Republic of Congo, Gabon, and Sudan, and more than 90 percent for Nigeria and Equatorial Guinea. It is also the source of a majority of government revenues, pointing to a difficult period of fiscal consolidation. At the same time lower oil prices, if sustained, reduce the attrac-

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tiveness of FDI flows into new production facilities in southern and western Africa. Elsewhere, revenues from tourism are also likely to remain depressed pending a resumption of faster growth in the industrial countries (even without concerns over security in the wake of the September 11 attacks), and the recovery in non-oil commodity prices is expected to be relatively muted. This balance of factors suggests that regional output should only maintain growth of 2.6 percent in the year.

Both export revenues and the terms of trade may decline slightly in 2002, requiring a further 3 percentage point reduction in import growth. However, for the 19 Sub-Saharan Africa countries that have fulfilled the conditions for debt relief under the Heavily Indebted Poor Countries Initiative, a reduction in debt service payments by $656 million compared to the average of recent years will provide some offset to reduced export revenues. Conditions in export markets (particularly in Europe) are expected to improve progressively through the year, setting the stage for 3.6 percent GDP growth over 2003–04, when oil prices may stabilize and non-oil commodity prices rise by a cumulative 15 percent.

Risks to the forecast

Uncertainties involved in macroeconomic forecasts are sizeable, and substantial forecast errors are virtually impossible to avoid. Errors in GDP growth forecasts made one year ahead tend to average around 1.5 percentage points.[17] Once leading indicators or partial data are available, the accuracy of forecasts improves dramatically. Current-year forecasts of GDP growth typically have errors substantially below 1 percentage point. It is extremely difficult to predict cyclical developments well in advance, partly because the timing of turning points is highly uncertain.

The prediction of recessions or severe downturns is particularly difficult, since they are often triggered by the burst of a speculative bubble or other unforeseeable events. Even if some tensions were observable in advance, the timing of their unwinding is close to random. The U.S. recession in the early 1990s provided an example of how forecasters can fail to anticipate recessions. The contraction of the U.S. economy (that started in the third quarter of 1990 and ended in the first quarter of 1991) resulted in a 0.5 percent annual decline of GDP in 1991 over 1990. From Spring until late Fall of 1990 international organizations forecast an increase of around 2 percent,[18] implying an average forecast error of 2.5 percentage points. In 1991 the forecast errors were reduced to on average 0.3 percentage points. The recent U.S. recession—reflected in the 1.1 percent GDP growth in 2001, compared to the more than 4 percent growth in 2000—provided an almost identical picture. The average forecast error in 2000 (for growth in 2001) was 2 percentage points, and it dropped to 0.3 percentage points in 2001 (figure 1.14).

This experience implies that uncertainty may be relatively small for the 2002 growth rate forecasts, but substantially larger concerning the strength of the recovery in 2003. Figure 1.15 shows that the current cycle, including the baseline forecast, is expected to have a recovery pattern similar to the 1990–91 cycle. Although the recent recession seems more shallow, the deceleration in growth was actually quite similar, as could be the acceleration. With the larger share of high-tech production in the current cycle, and possible further stimulus packages, the recovery could even turn out to be sharper. However, there are also significant downside risks to this prediction. The prospects for high-tech industries depend, to a large extent, on the sentiment in financial markets, which is notoriously difficult to predict. Continued nervousness about future profitability could make the recovery more fragile than is currently forecast.

The prospects after the coming recovery are even more uncertain, particularly given that earlier recessions were often followed by a second dip. For example, in the beginning of 1993 U.S. GDP growth again fell below zero following the European recession. Since the current regional cycles are much more synchronized than a decade ago, such a strong double dip is not foreseen in the baseline. However, the cumulated financial imbalances in the U.S. economy could set off another reversal in market sentiment, leading to a sharper slowdown after the current recovery than is anticipated in the baseline forecast. In other words, a major risk is that the cyclical pattern could be more pronounced than is assumed in the baseline, with a stronger recovery, but a substantial reversal in the medium run.

Although the recovery may be stronger than currently anticipated, possible downside risks de-

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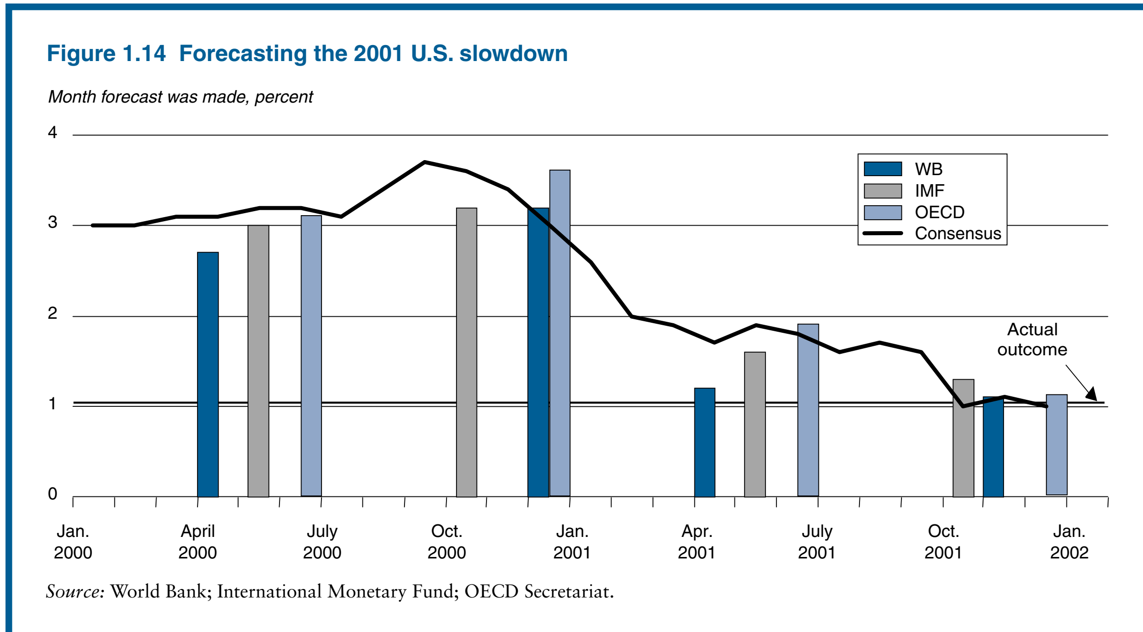
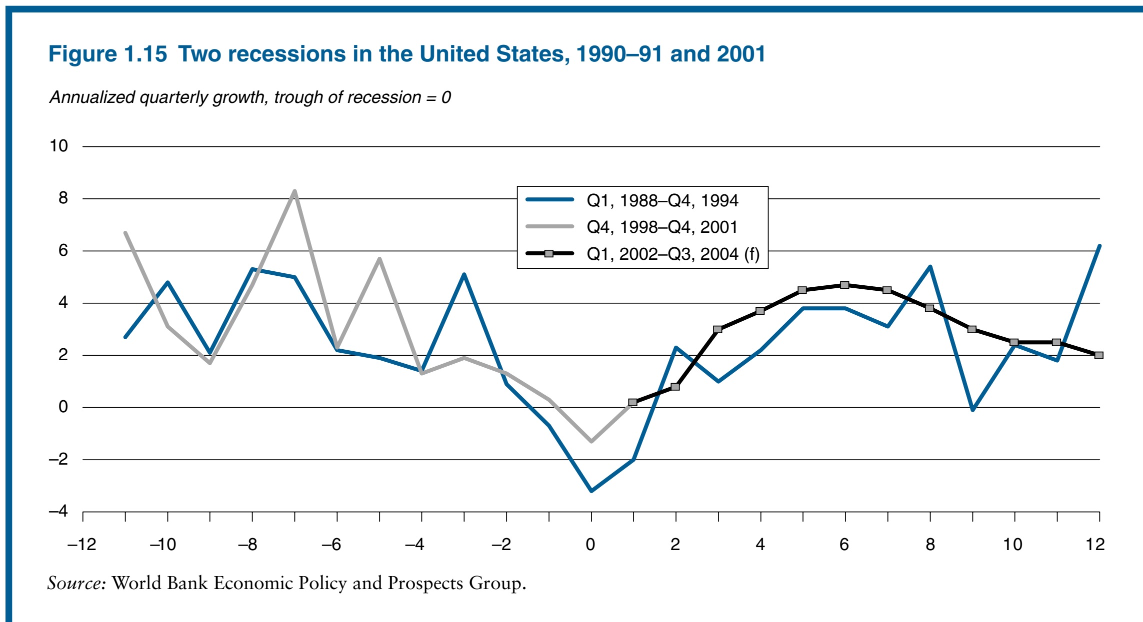


Source: World Bank; International Monetary Fund; OECD Secretariat.



Source: World Bank Economic Policy and Prospects Group.

serve more attention, since they often pose more serious challenges than do upside risks. Because the baseline forecast does not anticipate new major adverse shocks to the global economy, assumes only limited contagion from the breakdown of the Argentine economy, foresees an uninterrupted recovery of Turkey's economy, and excludes an outright Japanese banking crisis in the short run, the downside risks are significant.

Japan is mired in deep recession and deflation, with corporate profits declining sharply and bankruptcies mounting, and is beset by heightening concerns about credit availability and the soundness of the banking system. Commercial banks

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have become hesitant to lend, while the banks' capital base is being eroded by falling equity prices—commercial bank stocks dropped 45 percent during 2001. Credit availability for smaller companies is tight, a flight to quality into Japanese government bonds has ensued, and Japanese sovereign debt has been downgraded by Moody's and other credit rating agencies.

However serious these problems are, the probability of a full-blown crisis seems to be relatively low in the near term because the economy will benefit from the recovery of export demand, possibly fueled by a weakening of the yen. Such a depreciation could help to fight deflation through an increase in exports and a rise in import prices. This could have a negative impact on emerging countries in Asia who compete with Japanese exporters, depend on Japanese imports, or are recipients of Japanese FDI. However the adverse impacts are likely to be limited in the case of a modest depreciation, since the yen has appreciated in recent years, most countries in the region have adopted flexible exchange rate systems, and a gradual real depreciation of the yen seems warranted from a structural perspective.

Whatever happens in the current rebound of the global economy, the challenges are formidable in the medium term. The escalation of Japan's fiscal deficit has limited the scope for large injections of public funds for re-capitalization or closure of institutions. The major risk of a severe credit crunch is growing rather than shrinking. A sharp fall in Japanese domestic demand would be a major setback for developing economies in East Asia, with, for example, 15 percent of Chinese exports and 11 percent of Korean exports going to Japan.

Notes

1. See *Global Economic Prospects 2002* (World Bank 2001).

2. The so-called accelerator mechanism makes inventory and investment cycles much more pronounced than cyclical developments in other components of aggregate demand. Firms generally attempt to keep the *stock* of inventories and capital goods at a desired ratio to GDP. This implies that the *flows* of inventory accumulation and investment are linked to *changes* in GDP. Thus as stocks reach desired levels, the change in inventory accumulation and investment from the previous period can be quite large, generating sharp changes and turning points in GDP growth.

3. The Stability and Growth Pact, setting out the rules for budgetary behavior in stage three of the European Union's (EU's) Economic and Monetary Union, provides for a degree of budgetary flexibility during severe recessions. While the projected downturn in European economic activity could not be described as a severe recession, the September 11 attacks would certainly qualify as unusual events outside the control of member states. And some flexibility in fiscal positions may be witnessed in the short run.

4. On a momentum basis (quarter-over-quarter), these economies experienced the deceleration earlier, with a decline of 9 percent (seasonally adjusted annualized rate) in the last quarter of 2000 and the first quarter of 2001, before reaching 25 percent decline at the trough in the second quarter.

5. Almost 40 percent of each year's annual growth rate is determined by the quarterly growth pattern in the previous year. The contribution of the previous year's quarterly growth to the current year's annual growth is called "carry-over."

6. The average trade margin for total exports from industrial countries toward developing countries is 3.8 percent, but is 5.5 percent for developing-country exports toward industrial countries.

7. The impacts of higher international trade margins were evaluated using the World Bank's global computable general equilibrium model of world trade (van der Mensbrugghe 2001).

8. World Tourism Organization, Tourism Industry Takes Action to End Crisis, November 12, 2001. www.world-tourism.org.

9. World Tourism Organization third quarter 2001 news release. Other information confirms the sharp drop in tourism: two months after September 11 worldwide travel reservations were 12 to 15 percent below levels of the previous year.

10. Not all of the countries highly dependent on travel services are tourist destinations. A few countries affected by conflict (for example Sierra Leone and Rwanda) are dependent on revenues from travel services, probably due to the presence of staff from international organizations and non-governmental organizations, as well as the presence of peacekeepers. The data from IMF's Balance of Payments database lack sufficient detail to separate out the different purchasers of travel services for these countries.

11. To some extent this has already begun. A noteworthy difference between Doha and previous ministerials was the active involvement of representatives of development ministries on national delegations. National development communities and stakeholders represent a potentially powerful constituency in many European countries.

12. An interesting example of the impact of technology on commodity production is the new technique for cutting two-by-fours from logs. In the past a curved log could not be used to produce a straight board without huge wastage. However, lasers and computers are now used to scan a log and cut with the curve of the log. The two-by-fours are then pressed and dried to produce a straight board from a crooked log.

13. Vietnam reformed coffee marketing, which resulted in a large increase in the producer's share of international prices and led to a significant increase in exports.

14. The price used to represent oil market conditions is the average of West Texas Intermediate and Brent and Dubai crudes, and is roughly equivalent to the Brent price.

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15. See appendix 4 for a fuller treatment of recent macroeconomic and financial developments and prospects for the developing regions.

16. The manufacturing unit value (MUV) of exports in *dollar terms* from the G-5 countries to developing countries is anticipated to rise by 3.6 and 3.7 percent respectively in 2003–04, reflecting market expectations for a likely weakening of the dollar against the euro over the next years, counterbalanced by a trend of strength relative to the yen. For non-oil developing-country exporters, such development is likely to offset part of the firming of non-oil commodity prices, while mitigating gains from lower fuel import prices. For hydrocarbons exporters, the up-trend in MUV will serve to pressure terms of trade yet further.

17. See, for example, Batchelor 2001 and Loungani 2000.

18. IMF 1990a and 1990b. The World Bank did not produce annual forecasts at that time.

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