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The Global Slowdown: Prospects for Developing Countries

THE CYCLICAL SLOWDOWN OF THE GLOBAL economy that started in the second half of 2000, brought on by rising interest rates and oil prices in preceding quarters, suddenly intensified toward the end of the year. Although an earlier recovery remains likely, the probability of a prolonged period of slow growth has increased over recent months. Even in the most likely case of a soft landing, certain cyclically sensitive sectors and vulnerable countries will be hit hard. On the other hand, a harder landing in the industrial world, painful to all in the short run, could bring some partially offsetting positive developments, such as lower interest rates.

The intensified deceleration was triggered by a loss of confidence in equity markets and the accompanying swift loss of momentum in the U.S. economy. Data at the beginning of the fourth quarter of 2000 continued to strongly support prospects for a soft landing, but financial market sentiment shifted abruptly in November. This was yet another example of the intensified interaction between financial markets and the short-run dynamics of production and trade. The spillover from the United States was quick. East Asian countries in particular were immediately hit by a sharp fall in U.S. imports of semiconductors and other high-technology products.

Moderate inflation, softening energy prices, and vastly improved fiscal balances in the United States and Europe provide policymakers latitude to deploy stabilization tools—notably a reduction in policy interest rates—to bring about an early recovery. In addition, new technologies have increased the growth rate of productivity and tended also to shorten economic cycles. These factors underpin this report's baseline forecast of a fairly quick turnaround in the industrial world. This chapter elucidates further the nature of the slowdown and the likely impact on developing countries. The main conclusions are the following:

- Even a moderate global slowdown may create serious challenges for some developing countries. Countries specializing in information and communications technology (ICT) products—notably Malaysia and the Philippines, and to a lesser extent the Republic of Korea, Taiwan (China), and Thailand—have already experienced a sharp decline in their export earnings, albeit from remarkably high levels.
- In a harsher environment, developing countries with severe domestic imbalances, glossed over until now by an exceptionally favorable external environment, may face closer scrutiny from financial markets.
- The most recent financial crises, in Argentina and Turkey, were by and large domestic in origin. In both cases, however, tensions culminated when the external environment deteriorated. The forecast anticipates a severe output contraction in Turkey this year and a significant rebound in 2002, driven by increased competitiveness and restored investor confidence, with new policies in place.
- A harder landing in the United States would most likely coincide with declining interest rates, a weakening of the dollar, and a reduction of the U.S. current account deficit. Lower interest rates would reduce developing countries' debt service obligations. Depreciation of the dollar would benefit countries with currencies pegged to the dollar, such as Argentina. It might also benefit non-oil commodity ex-

porters, especially in Africa, by eventual firming of commodity prices in dollar terms.

- Because developing countries' stock markets and "high-risk" bond markets are, at least in certain periods, highly correlated with those of the industrial countries, a deterioration in U.S. stock markets could temporarily trigger worsening conditions in emerging markets, though the long-term impact—a reduction of the historically high U.S. external imbalance—would tend to increase the availability of capital to these markets. 1a 1b

Table 1.1 summarizes the global outlook for the next three years and compares it with World Bank forecasts made in the fall of 2000. The current outlook is closer to the low-case scenario described in *Global Economic Prospects 2001* (World Bank 2001), which starts with a sharp slowdown in the United States that then spills over to the rest of the world. Unlike in that low-case scenario, the new baseline continues to foresee a relatively rapid stabilization in the course of this year, as cuts in interest rates propagate through the economy, and tax cuts, or the announcement

Table 1.1 Global conditions affecting growth in developing countries, and growth forecasts by world region, 2000–03

(percentage change from previous year except where stated otherwise)

	Current estimate for 2000	Current forecast			*GEP* 2000 for 2000	November 2000 forecast		
		2001	2002	2003		2001	2002	2003
Global conditions								
Volume of world trade	13.0	5.5	7.3	7.3	12.5	8.0	6.8	6.8
Inflation (percent per year)[a]								
G-7 countries[b]	1.9	1.8	1.7	1.8	2.0	1.9	1.9	2.0
United States	3.4	3.0	2.6	2.7	3.4	3.0	2.8	2.6
Commodity prices[c]								
Non-oil commodities	–1.2	–0.3	5.4	5.6	–0.8	3.4	4.9	3.7
Oil	56.2	–11.4	–16.0	–4.8	55.0	–10.7	–16.0	–4.8
Price (dollars per barrel)	28.2	25.0	21.0	20.0	28.0	25.0	21.0	20.0
G-5 MUV[d]	–2.6	5.9	3.1	2.4	–2.3	3.6	3.7	2.6
Interest rates (percent per year)								
6-month LIBOR[e]	6.7	4.8	4.7	5.0	6.7	6.8	6.2	5.6
6-month EURIBOR[f]	4.5	4.3	4.2	4.5	4.5	5.0	4.6	4.0
Growth in GDP								
World	4.0	2.2	3.3	3.4	4.1	3.4	3.2	3.2
High-income countries	3.7	1.7	2.9	2.9	3.8	3.0	2.8	2.8
OECD	3.6	1.6	2.8	2.9	3.7	2.9	2.7	2.7
United States	5.0	1.2	3.3	3.2	5.1	3.2	2.9	3.2
Japan	1.7	0.6	1.8	2.3	2.0	2.1	2.2	2.2
Euro Area	3.4	2.5	3.1	2.9	3.4	3.2	2.8	2.6
Non-OECD	7.0	4.1	4.9	5.2	6.3	5.1	5.1	5.2
Developing countries	5.4	4.2	4.9	4.9	5.3	5.0	4.8	4.9
East Asia and Pacific	7.5	5.5	6.0	6.1	7.2	6.4	6.0	6.0
East Asia Crisis Five[g]	7.0	3.7	5.1	5.2	6.9	5.5	5.1	5.1
Europe and Central Asia	5.6	2.3	4.2	4.1	5.2	4.3	3.9	3.9
Transition countries	5.5	4.1	3.8	3.8	5.0	4.2	3.7	3.6
Latin America and the Caribbean	3.8	3.7	4.4	4.4	4.0	4.1	4.3	4.4
Middle East and North Africa	3.2	3.9	3.5	3.6	3.1	3.8	3.6	3.6
South Asia	5.8	5.5	5.5	5.6	6.0	5.5	5.5	5.5
Sub-Saharan Africa	2.7	3.0	3.4	3.6	2.7	3.4	3.7	3.7
All except transition countries	5.3	4.2	5.1	5.1	5.3	5.1	5.0	5.1
All except China and India	4.8	3.4	4.4	4.4	4.7	4.4	4.3	4.3

a. Change in consumer price index.
b. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States; measured in local currency and aggregated using 1995 GDP weights.
c. Change in price measured in nominal dollars.
d. Manufactures unit value index of exports from the G-5 (G-7 except Canada and Italy), expressed in dollars.
e. London interbank offered rate for dollars.
f. Interbank offered rate for euros.
g. Indonesia, Republic of Korea, Malaysia, the Philippines, and Thailand.
Source: World Bank staff calculations and World Bank, *Global Economic Prospects 2001*.

thereof, have a positive impact on consumer sentiment and spending in the United States and Europe. However, with equity markets continuing to slide through the early months of 2001, further movement to the low-case scenario, and hence a more prolonged period of subdued consumer and producer sentiment, becomes increasingly likely. 2

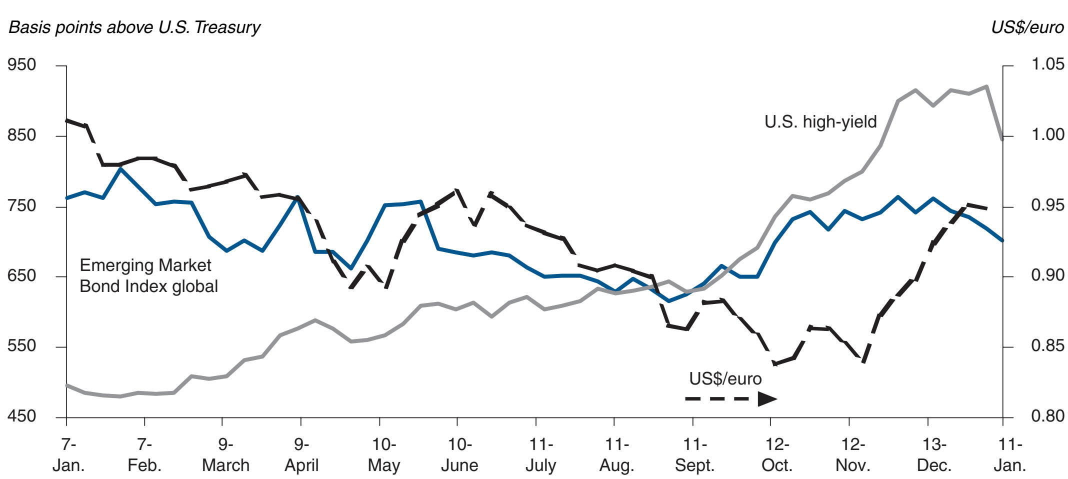
Global gross domestic product (GDP) is now expected to grow in 2001 by 2.2 percent, well below its estimated potential of 3.3 percent and a sharp drop from last year's 4 percent growth rate. The pace of industrial-country output growth falls by more than half, to 1.6 percent, from its robust gain of 3.6 percent during 2000. And aggregate developing-country growth declines by 1.2 percentage points, to 4.2 percent for this year, although this estimate obscures sharp differences in developments across regions. The forecast anticipates volume of trade in a sharp decline, from a record 13 percent growth last year to 5.5 percent this year. Oil prices are expected to ease to $25 per barrel in 2001 and further to $20 by 2003; at the same time non-energy prices are likely to firm but remain low by historical standards.

The remainder of this chapter is organized as follows. The discussion of the industrial countries elaborates on the possible reasons behind the sudden sharpening of the slowdown and the expected early recovery. This is followed by a discussion of the consequences of the sharp downturn for world trade, commodity markets, and international financial markets. The next part of the chapter focuses on the current account imbalances that have become key risk factors in the global economic environment. It is argued that a reduction of these imbalances over the medium run is likely to take the form of a beneficial redirection of capital flows toward developing countries, but that in the short run, periods of increased uncertainty and instability in international capital markets remain a serious risk. A summary of the diverse consequences of the global outlook for the different developing regions concludes the chapter.

Industrial countries: sharp downturn with opportunities for a quick rebound

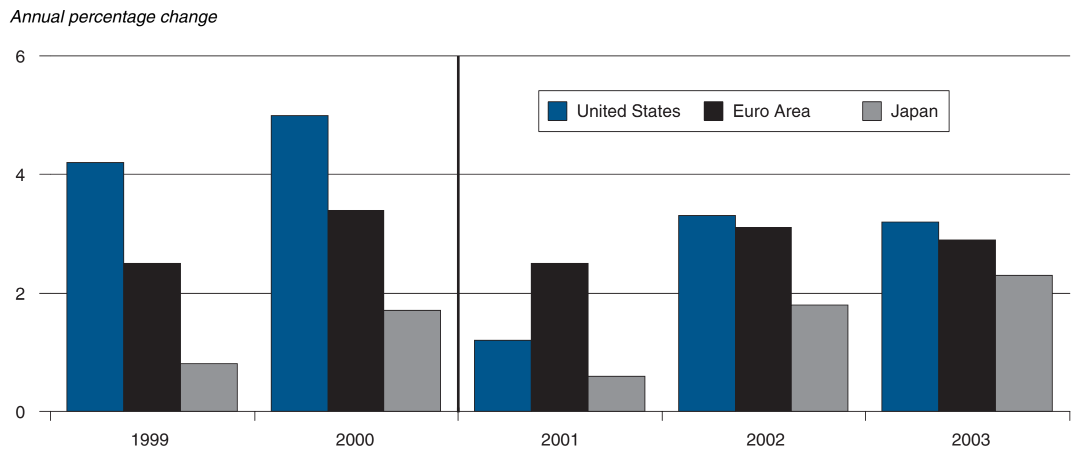
During the last two months of 2000 a sudden worsening of sentiment in financial markets—to a large extent driven by a reassessment of profitability in the high-technology sectors—threatened to derail the U.S. economy from a path toward a softer landing. The change in sentiment was reflected in increased spreads on high-yield bonds in the United States and a reversal of the trend in the dollar-euro exchange rate (figure 1.1). Conditions affecting growth in Japan also took a turn for the worse, as Japanese exports fell from double-digit

Figure 1.1 Spreads on high-yield asset class and the dollar/euro rate in 2000



Source: Bloomberg and World Bank staff estimates.

Figure 1.2 GDP growth for major industrial countries



Source: Datastream and World Bank projections for 2001–03.

gains at midyear to double-digit declines by the end of 2000. The Euro Area, too, saw demand and output soften over the second half of 2000 but appeared on course to continue growth at a moderate rate.

Healthy fiscal positions in the United States and Europe, and low inflation throughout the industrial world, despite high oil prices, provide policymakers latitude to deploy stabilization tools—reducing policy interest rates, tax rates, or both—to counteract the sudden deterioration. The U.S. Federal Reserve lowered the federal funds rate by 50 basis points (half a percentage point) in a surprise move in early January 2001, and this was followed by a second reduction of 50 basis points later in the month and a similar cut in March. The Fed's moves underscore the U.S. central bank's willingness to use the tools available to it to forestall a sharper decline. Combined with technological changes that tend to make business cycles shorter and less pronounced, this creates an environment in which a hard landing can still be avoided.

Growth in the industrial countries (defined here as the high-income members of the Organisation for Economic Co-operation and Development) is projected to fall from its robust 3.6 percent pace in 2000 to 1.6 percent in 2001. This represents a downward revision of 1.3 percentage points from previous projections for 2001 (figure 1.2). GDP growth in the United States may turn negative during the first quarter of 2001 but is likely to reach the trough in that period. A recovery in the course of the year seems possible given the availability of policy instruments for stabilization. Similar profiles of near-term weakness and fairly rapid recovery by the end of 2001 or early 2002 are also anticipated for the Euro Area, but this is much less the case for Japan. Both the specific policy responses and the implications of developments in the external environment will differ markedly across the world's industrial centers.

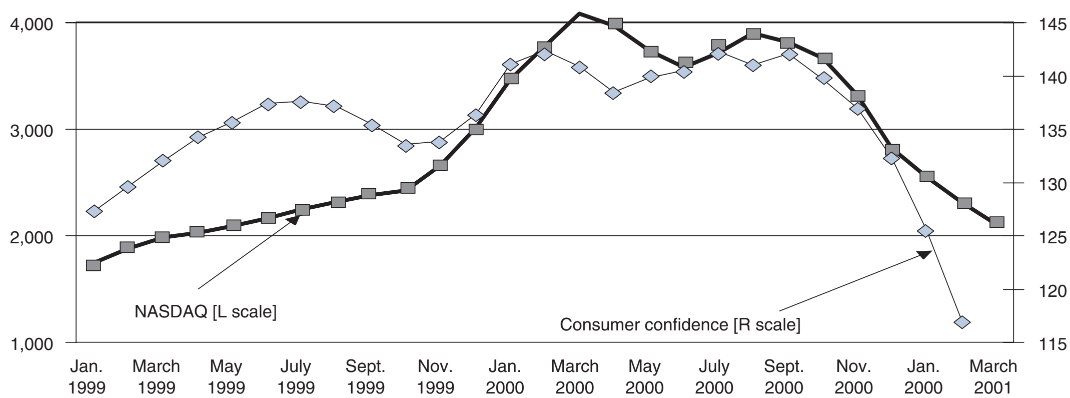
In the *United States* the slowdown in economic activity intensified over the last months of 2000 as exports and investment decelerated and eventually dropped into negative territory. Consumer confidence fell abruptly in December and since then. Several factors contributed to the decline in confidence: earlier wealth effects from rising stock prices were sapped by a continued decline in equity markets, higher oil prices eroded real earnings, and softening labor markets raised uncertainty about job security (Figure 1.3a).

Growth in manufacturing production fell from 8.5 percent (seasonally adjusted at an annual rate) in the spring to –2 percent by December, and slipped further toward a 5 percent rate of decline in January. Outside the high-technology sector, industrial output has registered a sharper decline of some 9 percent (figure 1.3b).

Manufacturers' inventories built up as production outstripped demand. And new orders (es-

Figure 1.3a NASDAQ market and Conference Board consumer confidence indexes

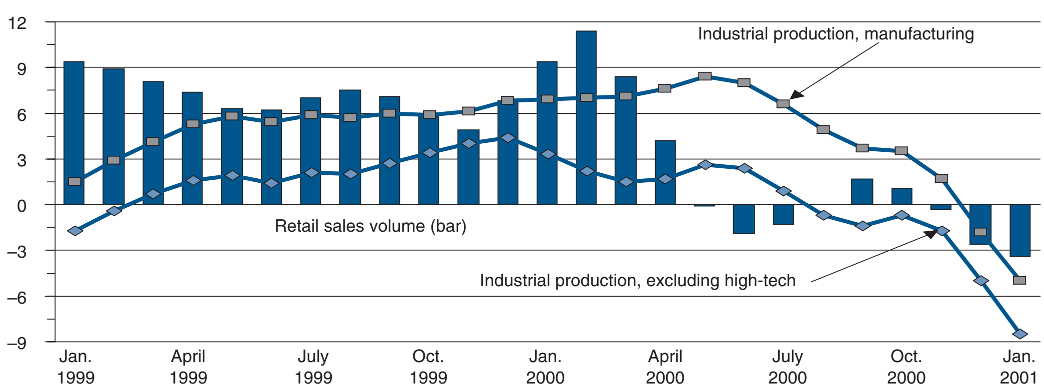
Three-month moving averages of respective indexes



Source: Conference Board and Datastream.

Figure 1.3b U.S. real retail sales and manufacturing output

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



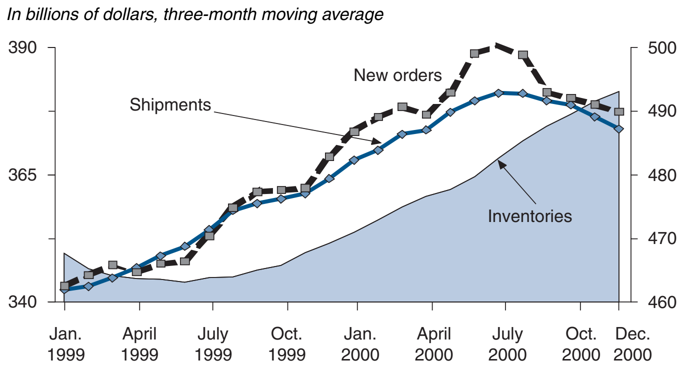
Source: U.S. Census Bureau and Federal Reserve, through Datastream.

pecially for high-technology goods) declined sharply over the last months of 2000, suggesting the potential for a further falloff in output as the need to work off excess inventories intensifies (figure 1.4).[1] Indeed, the business inventory-sales ratio has risen from low levels in mid-2000 to breach the secular downtrend established over the last 20 years (figure 1.5). 3

Signs of adjustment to this situation through both the labor market (reduced working hours, employment growth, and rising claims for unemployment insurance) and scalebacks of planned capital spending are now apparent. Moreover, weakening overseas demand is now reflected in U.S. export performance: export volume growth dropped precipitously from an annual rate of more than 20 percent in October to a decline of 15 percent in January. Following an advance of 5 percent in 2000, U.S. GDP growth is now anticipated to register 1.2 percent in 2001, 2 percentage points below the projections published in *Global Economic Prospects 2001* (World Bank 2001).

Several factors are likely to abet the resumption of growth to rates near 3.3 percent by 2002. Additional interest rate reductions are expected, favorably influencing durable goods purchases, housing,

Figure 1.4 New orders, shipments, and inventories in U.S. manufacturing sector, January 1999 to December 2000



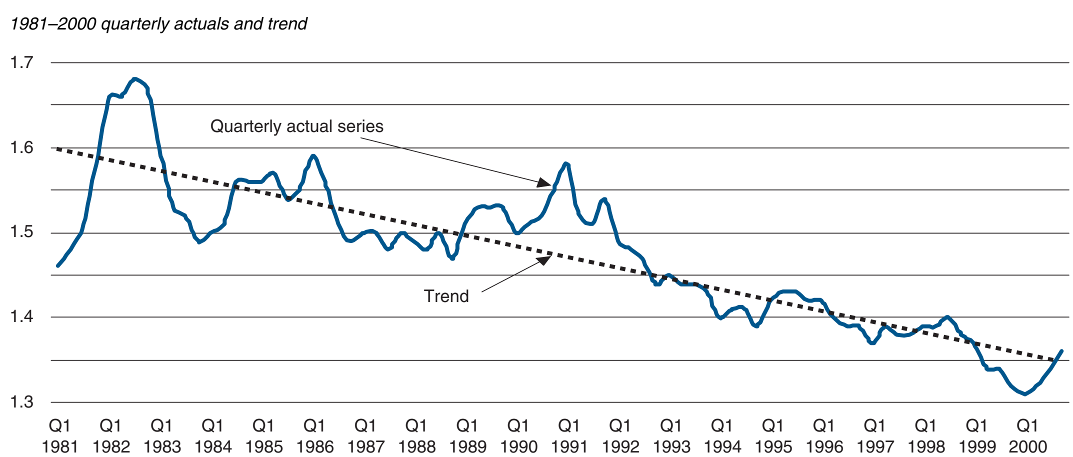
Source: U.S. Department of Commerce through Datastream.

and investment. Lower inflation, reflecting an anticipated decline in oil prices, should raise consumers' real purchasing power. The potential for depreciation of the dollar against the euro—as European growth comes to exceed that in the United States, and some funds are repatriated to EU financial markets—should help boost the competitiveness of U.S. exports while dampening import demand. On top of that, cuts in income taxes now under consideration may add to consumer demand, and effects from the announcement of such cuts may boost consumers' confidence. Finally, new technologies have not only increased productivity trends but also reduced the cyclical impacts of inventory dynamics and reduced the volatility of the investment cycle.[2] A fairly rapid conclusion to the inventory cycle, against a background of stabilizing demand conditions, could add to GDP growth later in 2001.

The risks to the forecast are substantial, and arise mainly in the financial sphere. As revenues have softened in both goods- and services-producing industries, the increasing cost of capital—tied to lower equity prices, rising spreads on high-yield bonds, and tightened bank-lending criteria—has placed a squeeze on profits. Commercial banks' charge-off rates and rates of loan delinquencies have risen to levels not seen since the early 1990s. A further tightening of credit conditions, following a possible scenario in which international capital flows reverse course quickly away from the United States, could further increase the number of defaults in the high-yield sectors, which in recent years were the main engines of growth. Under such circumstances the downturn could be deeper and the recovery would take longer.

Japanese growth has reverted to an anemic pace. The effects of the round of government stimulus applied in fiscal 2000 have faded, private consumption continues to stagnate or fall on the heels of subdued household income and consumer confidence, and exports turned abruptly from double-

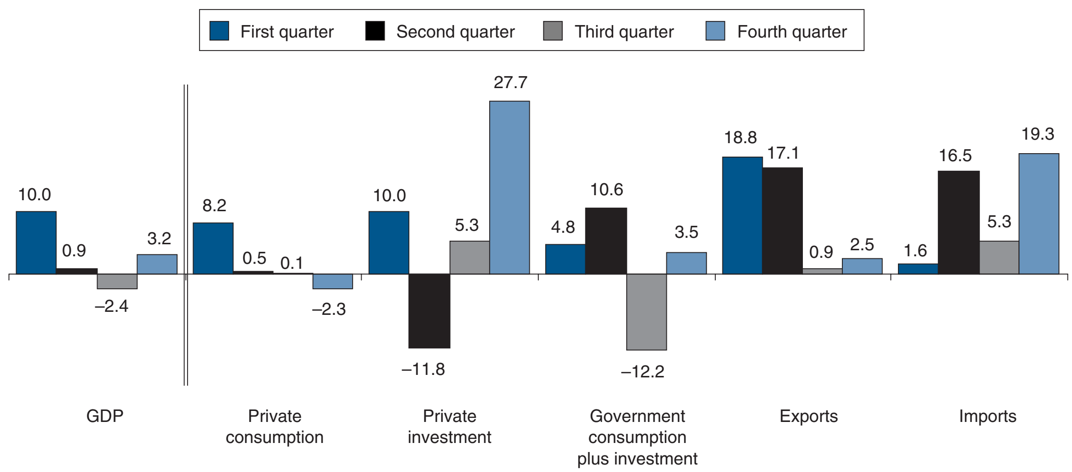
Figure 1.5 U.S. inventory/sales ratio



Source: U.S. Census Bureau through Datastream.

Figure 1.6 Japan: growth of selected GDP components 2000q1–2000q4

Percentage change, quarter/quarter seasonally adjusted annual rate



Source: Japanese Economic Planning Agency, through Datastream.

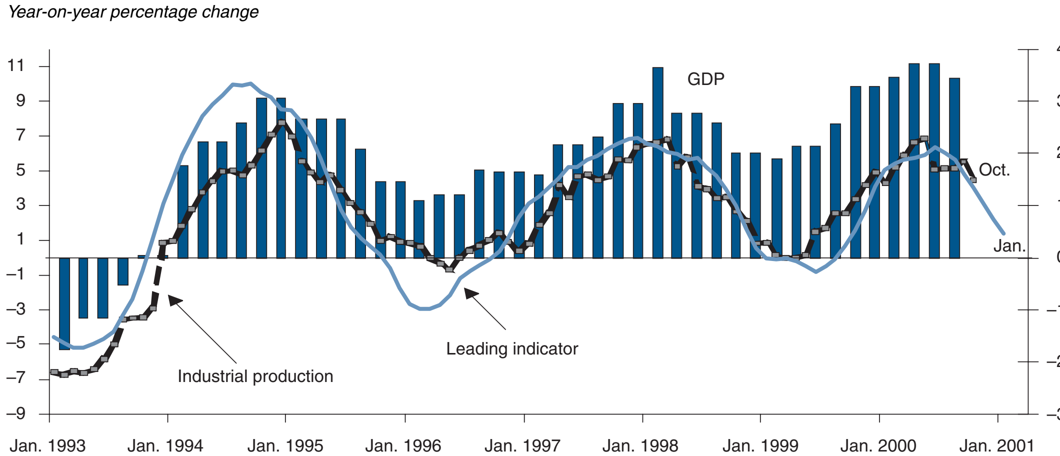
digit growth in the first half of 2000 to a sharp decline by the end of the year. At the same time, however, private capital spending continues to grow. Revised third-quarter GDP figures revealed a drop in output of 2.4 percent in the period, which was followed by a 28 percent burst of private investment during the fourth quarter, powering GDP to a 3.2 advance (figure 1.6).

Clearly, the overall pace of growth will hinge on export performance, as the key stimulus behind the stronger tenor of private investment has been buoyant foreign sales as well as demand by domestic industry for upgrading of its information technology. Survey returns from sectors other than manufacturing and from small businesses remain negative, reflecting the lack of momentum in the domestic economy. With the recent decline in exports, the near-term prospects for Japan have diminished, and expectations for 2001 have been revised to 0.6 percent growth in GDP, from 2.1 percent in earlier projections. Growth is likely to be restrained near 2 percent annually over 2002–03. Public works spending during fiscal 2001, other government incentives, and a residual of momentum in private investment should play a role in underpinning growth against severe erosion.

But an increasingly fragile banking system and the potential for a steeper decline in exports stand as important risks to this view. Within the banking system key weaknesses remain, and policymakers have mobilized new efforts to shore up financial conditions. Not all of the banks' nonperforming loans are fully recognized or provisioned. Capital adequacy remains unclear, given the use of tax-deferred assets, the valuation of equity holdings at book rather than market value, and possibly inadequate provisioning. Moreover, core profitability in the banking sector remains weak because of the large scale of wholesale corporate lending at thin margins, coupled with stagnant demand for credit.

Activity in the *European Union* began a gradual deceleration from the second quarter of 2000, driven by interest rate hikes and the adverse terms-of-trade shock stemming from the combination of higher oil prices and the weaker euro. Leading indicators and industrial production reflect the downshift in activity (figure 1.7) and suggest that the slowdown will be steeper and more protracted than envisaged in *Global Economic Prospects 2001* (World Bank 2001). These considerations prompt a 0.7-percentage-point downward revision in the growth projection for 2001, to 2.5 percent. The Euro Area has been undergoing a tightening of financial conditions, as European Central Bank (ECB) policy rates have been raised by 2.25 percentage points since November 1999, principally to dampen inflationary pressures

Figure 1.7 Euro Area GDP, industrial production, and leading indicator



Notes: The leading indicator is industrial production excluding construction. Data for the leading indicator have been moved four months back; data are monthly except for GDP figures, which are quarterly. R^2 = .78 for the period May 1992 to December 2000 between industrial production and leading indicator.
Source: Eurostat and OECD.

from the rise in oil prices. Risk perceptions among businesses have increased, in large part because of the unwinding of the technology bubble, the undershooting of the euro (to a low of $0.82 in late October), and reduced export orders. Against this background, domestic demand is likely to slow moderately, while exports decline more rapidly during the first part of 2001. Conditions in export-powerhouse Germany, with large exposures to world markets, have weakened considerably.

Nonetheless, the fundamental conditions for growth in Europe remain in place, and a firming of growth is expected during the second half of the year. Tax cuts introduced over 2000–01, mainly in France, Germany, Italy, and the Netherlands, on the order of 1 percent of Euro Area GDP, will help bolster disposable incomes and consumption. An easing of oil prices will also contribute to higher real incomes. Moreover, recent wage moderation, together with tax reduction, diminish the potential for "second round" effects of the oil price hike, in the form of inflationary wage bargains. This should provide the ECB some leeway to reduce interest rates during 2001. On balance, Euro Area GDP growth is projected to revive to 3.1 percent in 2002, then moderate to 2.9 percent by 2003.

World trade growth expected to fall by more than half from its 2000 record

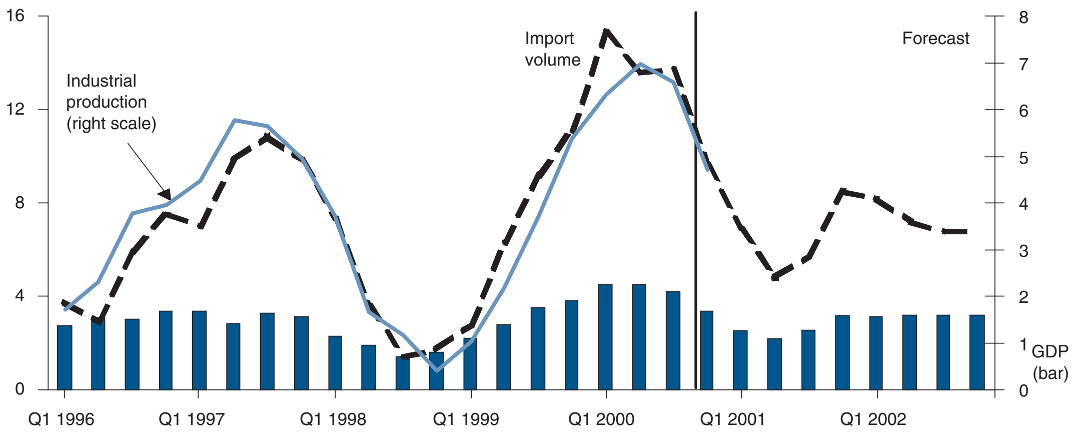
Trade tends to follow a more pronounced cycle of industrial production (figure 1.8). Even in the case of a soft landing in the industrial world, *Global Economic Prospects 2001* (World Bank 2001) expected a deceleration of world trade from the record 13 percent[3] last year to 8 percent this year. The sharpening of the global downturn has brought the forecast of world trade growth in 2001 down to 5.5 percent. The expected rebound of the global economy in the course of late 2001 to 2002 could bring growth in world trade next year back to just above 7 percent, close to the expected long-run growth rate of world trade during the coming decade.

Even the revised projections are high in historical perspective. This reflects in part the increased openness of most economies, especially developing countries, after the impressive trade liberalization of the 1990s. It also reflects the further global integration of production processes, relevant especially to the ICT sector, which has made increasing contributions to world trade growth (table 1.2).

With the growing importance of the ICT sector in economic performance and in international trade,

Figure 1.8 World industrial production, import volumes, and GDP, 1996–2002

Percentage change year-on-year



Source: Datastream and World Bank staff estimates.

the characteristics of the business cycle change. For example, in the semiconductor sector, recoveries during the 1990s occurred within six to nine months (figure 1.9). 4

The initial deceleration of world trade in the current cycle is similar to those observed after the first oil price shock in 1973 and the East Asian crisis of 1997–98, and steeper than the downturns in the recessions of the early 1980s and early 1990s (figure 1.10). However, the prospects for developing countries in the current slowdown appear better than in most of the earlier ones for two reasons. First, the growth rate during the trough is expected to be significantly higher than during most of the earlier downturns. The sharp deceleration reflects in part the exceptionally high growth rate of trade—relative to GDP—last year. Second, during the current slowdown, import growth is expected to be fairly well sustained among developing countries, whereas in the 1998 slowdown the trough in world trade growth was mainly due to the collapse of trade in developing Asia (table 1.3).

Divergence between oil and non-oil prices to narrow

Forecasts for oil and non-oil commodity prices are, on balance, not affected dramatically by the sharper slowdown in world output. In the oil market the Organization of Petroleum Exporting Countries' (OPEC's) production cuts will likely compensate for the slowdown of demand. In other commodity markets a possible weakening of the dollar may counteract some of the downward pressure on prices resulting from lower demand. The minor adjustments in the price forecast imply that, as in *Global Economic Prospects 2001* (World Bank 2001), the price divergence between oil and other commodities is expected to reduce somewhat.

In 2000 the ratio of oil prices to an index of non-oil commodity prices was at its highest since

Table 1.2 Contribution of ICT exports to total exports and export growth, selected countries and regions, 1990–99

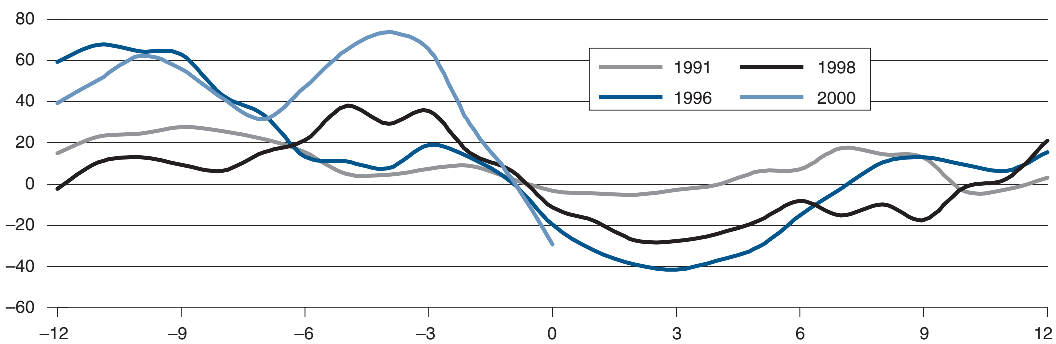
(percent)

Country or region	Share of ICT exports in total merchandise exports		Contribution to export value growth[a]	
	1990	1999	1990–99	1998–99
Europe	4.7	8.1	14.2	n.m.[b]
United States	11.0	16.0	22.7	97.7
Japan	14.0	17.0	23.5	15.6
East Asia[c]	14.0	31.7	49.3	84.6

a. Ratio of the change in the value of ICT exports to the change in the value of total merchandise exports.
b. Not meaningful: total European merchandise export growth in 1999 was negative, but ICT exports grew by 5.6 percent in value terms.
c. Excludes China.
Source: COMTRADE and World Bank staff calculations.

Figure 1.9 Comparison of semiconductor cycles

Three month/three month, seasonally adjusted annual rate

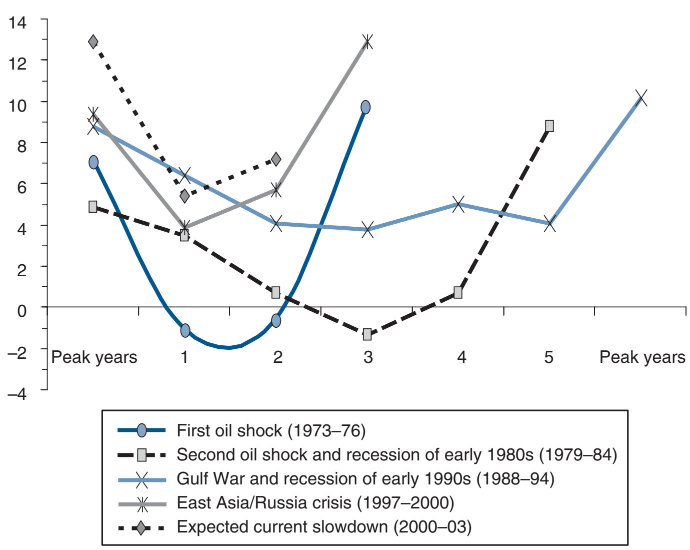


Note: The four cycles are centered at 0, which is the first month of negative growth, and shows the cycle evolution 12 months before and after.
Source: Semiconductor Industry Association through Datastream and World Bank staff estimates.

the early 1980s (figure 1.11). This placed a severe strain on the current account balances of countries dependent on non-oil commodity exports—many of which are among the world's poorest. The situation was worst for countries that depend on exports of coffee or cocoa: these commodities have seen price declines of nearly 50 percent in the past two years.[4]

Figure 1.10 World trade growth during episodes of global slowdown (peak to peak)

Percentage points of volume growth



Note: "Peak" connotes previous peak year of trade growth before and following the period of slowdown.
Source: World Bank.

The divergence between oil and non-oil commodity prices has begun to close as crude oil prices have fallen since November (figure 1.12), and they are expected to fall further. The recent weakness in global economic growth, especially in the United States and in East Asia has reduced the prospects for a recovery in non-oil commodity prices. Thus exporters of these commodities may benefit from lower oil import prices, but they are not expected to obtain significantly higher prices for their exports. However, a potential weakening of the dollar could provide a relative boost to non-oil commodity prices (box 1.1).

OPEC has established a price band of $22 to $28 a barrel for its crude oil and appears determined to adjust output to keep prices within these limits for the foreseeable future. The organization raised production quotas four times last year to pull prices back into this range, but as the market began tilting into surplus, it cut output by 1.5 million barrels a day in February 2001 and 1 million barrels a day as of April 1. Since stocks remain low, the organization should be able to keep prices within its targets this year, although a sharp slowdown in demand could require further reductions in supply. In the absence of a severe economic slowdown, it is likely that OPEC will have to raise production later this year ahead of the peak winter demand season.

Table 1.3 Contribution to world import growth by region, 1998–2003
(percent)

Country or region	1998	1999	Estimate 2000	Forecasts 2001	Forecasts 2002–03
G-7 countries	4.0	4.2	5.5	2.1	3.2
North America	2.2	2.4	2.5	0.7	1.6
Japan	–0.4	0.5	0.5	0.1	0.1
G-4 Europe[a]	2.1	1.4	2.5	1.2	1.4
Other industrial countries	1.6	1.5	1.8	0.6	1.0
Asian newly industrializing economies[b]	–0.5	0.3	1.2	0.5	0.6
Developing countries	0.0	1.2	4.5	2.3	2.5
East Asia	–1.2	1.6	2.2	1.0	1.1
Latin America	0.8	0.1	0.9	0.4	0.5
Central and Eastern Europe	0.7	0.1	0.5	0.3	0.4
CIS countries	–0.4	–0.5	0.2	0.2	0.1
Other developing	0.0	–0.1	0.6	0.4	0.4
World import growth	5.2	7.2	13.0	5.5	7.3

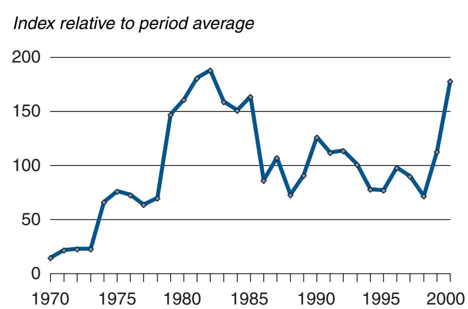
Note: Contribution is share of world trade times import growth.
a. France, Germany, Italy, and the United Kingdom.
b. Hong Kong (China), Singapore, and Taiwan (China).
Source: World Bank staff estimates.

Oil prices are expected to average $25 a barrel in 2001 and then fall to $20 a barrel by 2003, but near-term prices are expected to remain relatively high and volatile. Rising non-OPEC supplies are expected to exert downward pressure on prices in the coming years. Meanwhile higher prices are leading to large investments in exploration and development, and steady increases in supply are expected in a number of areas, including offshore West Africa and the deepwater Gulf of Mexico.

The expected recovery in non-oil commodity prices did not occur in 2000. Instead the index fell 1.2 percent from 1999 levels, largely because slumping beverage prices (down 18 percent) offset gains in some other commodities (table 1.4). The sharp fall in cocoa and coffee prices in 2000 was due to continued large production increases in the face of weak demand growth. Coffee prices were hurt by large exports from Vietnam, which has become the second-largest exporter, after Brazil, while cocoa exports from Côte d'Ivoire flooded the market. Efforts to curtail exports in both coffee and cocoa markets failed, and the current surplus is expected to keep prices depressed in 2000 and perhaps 2001.

Overall, agricultural prices fell 5.4 percent in 2000, as production and stocks remained higher than expected. Although sugar and cotton prices recovered remarkably from severe losses in 1999, the price of vegetable oils fell an additional 8.5 percent in 2000 after a 21 percent decline in 1999. With strong supplies and weakening demand, a substantial price increase is not foreseen for any agricultural commodity. Metals and minerals prices rose 12.6 percent with the global economic recovery of 2000 and production cuts by major producers. As a result, inventories remained low, and prices are expected to rise somewhat further in 2001.

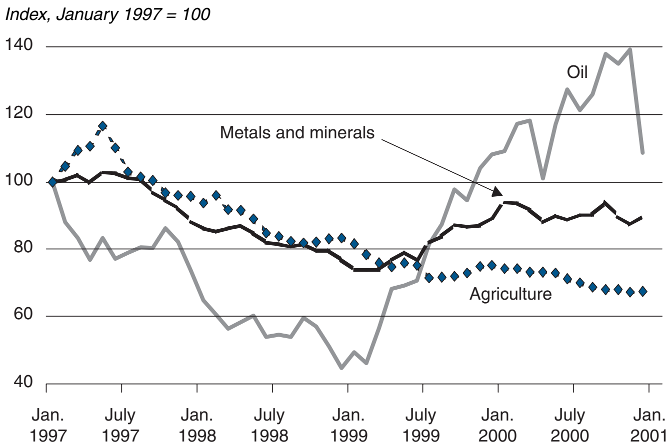
Figure 1.11 Ratio of oil to non-oil commodity prices



Note: Period average = 100.
Source: World Bank.

On balance, developments over recent months have led to downward revisions in the forecast and a postponement of a generalized recovery in non-oil primary commodity prices until 2002. Coffee and

Figure 1.12 Oil and non-oil commodity indexes



Source: World Bank.

cocoa prices are expected to continue their decline into 2001, offsetting expected large rises in grains prices. The recovery in metals and minerals prices is mostly over, given the overall weakening in world industrial production, with only modest gains expected in 2001 and 2002. For oil-importing developing countries this implies an improvement in the terms of trade this year, but coffee and cocoa exporters are likely to experience further income losses and may require additional financial support.

Capital flows to developing countries on an upward trend

Cyclical conditions in industrial countries are likely to have a marked impact on capital flows to emerging markets (discussed more fully in chapter 2). Late last year the deterioration of sentiment in capital markets increased uncertainty and made investors more risk averse. This substantially limited the borrowing opportunities of developing countries in the last two months of 2000. The cut in interest rates in January created a window of opportunity for bond issuers, but February saw another slowdown in flows. The reduction of U.S. interest rates again in March and expected further cuts could provide a boost to flows. Improving economic fundamentals will be important to achieving greater capital flows to developing countries.

Box 1.1 Benefits of a weaker dollar for non-oil commodity producers

A weakening of the dollar would be expected to increase non-oil commodity prices relative to oil prices. The dollar strengthened during the Asian financial crisis and has remained strong. It has been well documented that a strong dollar is associated with weak dollar commodity prices. (See, for example, studies by Adams 1988; Radetzki 1985; and Ridler and Yandle 1972.) This is confirmed by Gilbert (1989), Baffes (1997), and World Bank staff estimates showing that, on average, a 1 percent appreciation of the dollar is associated with a 0.5 to 1.0 percent fall in the dollar price of commodities.

After depreciation of exchange rates, prices tend to be relatively constant in the currencies of the major exporters and hence lower in dollar terms. Weakness in individual commodity prices in dollar terms following the Asian financial crisis was clearly linked to depreciation of the currencies of major commodity exporters. For example, the devaluation of the Thai baht in July 1997 was followed by a 22 percent fall in the dollar price of natural rubber and a 16 percent fall in rice prices over the next three months. (Thailand accounts for 40 percent of the world's exports of natural rubber and 23 percent of world rice exports.) When Brazil devalued its currency in mid-January of 1999, the prices of its major exports fell over the next three months: coffee by 10 percent, soybean meal by 15 percent, and sugar by 26 percent. When Malaysia devalued its currency beginning in August 1997, the dollar price of Malaysian sawn wood fell 45 percent over the next seven months. And when the Russian Federation, the world's largest aluminum exporter, devalued the ruble in mid-1998, the price of aluminum fell by 12 percent over the next six months.

In contrast to non-oil commodities, oil markets are characterized more by dollar price targeting. Oil prices tend therefore to be relatively stable in dollars terms after exchange rate movements. The present ratio of oil to non-oil commodity prices is the widest since the early 1980s because oil prices have increased sharply while non-oil commodity prices have continued to fall. For example, compared with 1995, oil prices have increased 64 percent and non-oil commodity prices have declined 29 percent. Rough estimates show that dollar appreciation was responsible for about half of that decline.

Table 1.4 Changes in oil and non-oil commodity prices, 1981–2002
(percent per year)

Commodity group	1981–90	1991–98	1999	Estimate 2000	Forecasts 2001	Forecasts 2002
Non-oil commodities	–2.2	–0.1	–11.2	–1.2	–0.3	5.4
Agriculture	–3.2	0.9	–13.9	–5.4	–1.1	6.6
Food	–3.3	0.6	–16.5	–3.5	4.9	5.2
Grains	–2.9	0.2	–14.7	–8.0	10.3	5.8
Beverages	–5.8	4.3	–23.4	–18.0	–13.9	14.6
Raw materials	–0.4	–1.7	1.4	3.4	1.0	3.5
Fertilizers	–2.5	2.5	–6.6	–7.3	–1.9	4.1
Metals and minerals	0.6	–3.5	–2.3	12.6	1.9	2.5
Petroleum	–4.7	–6.8	38.3	56.2	–11.4	–16.0
G-5 MUV[a]	3.3	0.8	–2.7	–2.6	5.9	3.1
Memo item:						
Average petroleum price (dollars per barrel)	24.1	17.6	18.1	28.2	25.0	21.0

Note: Data are annual average changes in World Bank commodity price indexes calculated from prices in nominal dollars.
a. Manufactures Unit Value index.
Source: World Bank staff calculations.

During 2000, gross capital market financing exhibited volatility in tandem with credit conditions in the United States, which were tight during April and May and then eased in June to September before tightening again in November and December. The pattern of capital flows was similar: $6 billion to $7 billion monthly in April and May, and $13 billion and $11 billion in November and December, but $19 billion to $24 billion monthly in the remaining months. Despite this volatility, gross flows from capital markets rose 28 percent for the year as a whole, to about $237 billion (table 1.5). On a net basis, however (that is, taking into account principal repayments on outstanding debt), market flows were well below their levels before the Asian crises, rising from a very small $35 billion in 1999 to $79 billion in 2000. Although capital market financing is on an upward trend, foreign direct investment (FDI) to developing countries slowed somewhat in the year to $178 billion, from $185 billion in 1999, but was still high enough to bolster total net capital flows to an overall increase in 2000 (see chapter 2 and table 2.2 for further detail).

The outlook for capital flows to developing countries is for a moderate increase in 2001 followed by a more rapid rise in 2002. Divergent developments in different developing regions will limit the rise in net capital flows during 2001. Latin America is expected to benefit most from the decline in global interest rates, stabilization in the U.S. current account deficit, and a continuation in the reduction of emerging market spreads witnessed since mid-December. Gross flows to East Asian economies, on the other hand, are likely to be limited, given their current account surpluses, high levels of reserves relative to short-term debt,

Table 1.5 Gross capital market flows to developing countries
(billions of dollars)

Type of flow	Annual total 1997	Annual total 1998	Annual total 1999	Annual total 2000	Monthly average 2000	Monthly average October	Monthly average November	Monthly average December
Bonds	114	73	70	77	6.4	3.3	4.4	1.0
Loans	179	108	94	125	10.4	12.7	8.7	9.7
Equity	22	9	21	35	2.9	10.8	0.3	0.3
Total	316	190	185	237	19.7	23.8	13.4	11.0
Total, net	124	107	35	79	6.6	n.a.	n.a.	n.a.

n.a. Not available.
Source: Euromoney and World Bank staff estimates.

and an expected increase in domestic credit. Although bond issues are expected to rise, FDI flows may again decline marginally, reflecting the drop in commitments over the past few years and fewer large-scale privatization programs and mergers and acquisitions.

Capital flows are anticipated to recover in 2002 in tandem with the growth recovery in industrial countries—which will improve developing countries' export performance, a key determinant of the level of gross capital market financing—and a further reduction of emerging market spreads. The East Asian economies are likely to gain the largest share of the expected increase in private capital market flows as their current account surpluses are reduced further and improving global economic conditions support a resumption of moderately fast growth. Highly indebted countries, particularly in Latin America, may face more supply constraints during this period and see little increase in net flows. Complementing the rise in capital market financing is a potential turnaround in FDI to more substantial increases, as economic conditions improve in developing countries. Overall, this trajectory for capital flows is consistent with a shift in developing countries' overall current account balance, from a surplus of $60 billion in 2000 to a modest deficit in 2001, toward average deficits of near $60 billion in 2002–03.

Current accounts: opportunities and risks from an unwinding of imbalances

In recent years, large current account imbalances have been built up, particularly in the United States, but also among the East Asian economies and the oil exporters (box 1.2). These imbalances are expected to unwind slowly over the next few years, enabling some redirection of capital flows toward developing countries. However, an uncontrolled reversal could increase investor nervousness and lead to a "flight to quality," temporarily restraining flows to emerging markets.

Deceleration of demand is likely to reverse the rapidly increasing external deficit in the United States and to bring the European balance into positive territory again. However, to achieve substantial reduction of the U.S. current account deficit, which is needed eventually to restore sustainability, domestic demand in the United States would have to fall more sharply than foreseen in the forecast.

In East Asia investment rates are likely to recover, but to a level somewhat lower than before the crisis, as investors—abetted by new investment and disclosure regulations—become more selective in their choice of projects. The rising investment rates should offset declining public sector deficits and lead to a narrowing of the region's current account surpluses, which, however, are expected to remain through 2003. And the anticipated decline in oil prices and modest recovery in non-oil commodity prices could bring current account balances of both oil-exporting and oil-importing developing countries back within sustainable limits.

The financial risks of a rapid unwinding of current account imbalances are sizable. Adjustments in financial markets are frequently abrupt and tend to overshoot (box 1.3). Abrupt reversals of capital flows may entail inefficient liquidations and unnecessary destruction of physical and social capital. One of the driving forces behind the U.S. productivity surge was the ample availability of venture capital, attracted by large capital gains. Although potential rates of return for individual high-technology ventures have likely been overestimated, the social rate of return of these new initiatives has undoubtedly been high. For Japan as well, a sudden increase in capital outflow or reduced liquidity in the domestic economy could be especially harmful. With banks still suffering from large amounts of bad debt, a corresponding decline in stock values could raise systemic risks in the financial system to potentially critical levels.

In developing countries, which notionally would be at the receiving end of a redirection of capital, uncertain prospects could dampen the inflows. With the global economy—and therefore export opportunities—slowing and the recent financial crises still fresh in memory, investors may choose to park their resources in the safety of government bonds rather than take risks on investment opportunities in developing countries. Probably such a flight to quality would only be temporary, but it would interrupt a smooth redeployment of capital flows. In the short run, financial conditions in developing countries could even worsen, reflecting an increase in perceived overall uncertainty.

For oil and commodity exporters the risks are also considerable. Both groups may experience for some time the adverse—and persistent—conse-

Box 1.2 Recent developments in current accounts

From a collective surplus of $83 billion as recently as 1997, the high-income Organisation for Economic Co-operation and Development (OECD) countries have witnessed an unprecedented deterioration to a deficit of $295 billion in 2000, representing some 1.3 percent of the group's combined gross domestic product (GDP). Widening of the current account deficit in the United States is the major factor behind this phenomenon. The beginning of the sharp rise in the U.S. deficit coincided with the start of the Asian crisis, which led to a massive redirection of financial flows. As Feldstein (2000) argues, such redirections tend to be temporary phenomena and not sustainable; he concludes that the United States will not be able to maintain its present large current account deficit. The question is not whether, but how and when that deficit will be reduced.

A sharp rise in the private sector deficit—the result of high investment rates and sharply falling saving rates—is the main contributing factor in the rising U.S. current account deficit (see table). Public finances, in contrast, are now solidly in surplus, having shifted toward surplus by some 5.3 percent of GDP over the last decade. A similar but less pronounced pattern in the European Union has also contributed to the rising current account deficit of the high-income OECD countries. There the private sector balance has fallen narrowly into deficit, outweighing the improvement in public balance following the 1991 adoption of the Maastricht criteria for participation in European monetary union. Both U.S. and EU public finances have also been abetted by robust economic recovery.

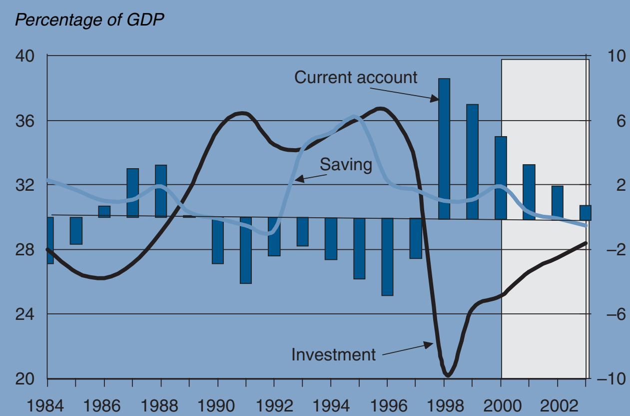
Current accounts and private and public sector financial balances in the three major industrial regions, 1990–2000

(percentage of GDP)

Region and balance	1990	1995	1998	2000[a]
United States				
Current account balance	–1.3	–1.5	–2.5	–4.5
Private sector balance	3.1	1.8	–2.5	–5.4
Public sector balance	–4.4	–3.3	0.0	0.9
Japan				
Current account balance	1.5	2.2	3.2	2.7
Private sector balance	–1.4	5.4	9.2	9.1
Public sector balance	2.9	–3.2	–6.0	–6.4
European Union				
Current account balance	–0.5	0.6	0.9	–0.2
Private sector balance	2.9	5.2	2.3	–0.3
Public sector balance	–3.4	–4.5	–1.5	0.1

a. Estimated.
Source: OECD, IMF, national agencies, and World Bank staff estimates.

Saving and investment in the East Asia Five



Note: The current account is on the right axis.
Source: World Bank, *World Development Indicators,* various years; the World Bank's Statistical Information Management and Analysis database, and World Bank staff estimates.

Trends in Japan have been the polar opposite of those in the United States and Europe. The current account was in surplus throughout the 1990s—riding on the back of a very large private sector surplus—despite the rapid and sharp drop in the public sector balance, which has seen a movement toward deficit of 9.3 percent of GDP.

Collapse of investment in East Asia generated huge current account reversals in 1998.
The crisis in East Asia had a massive impact on investment rates in that region. In the East Asia Crisis Five economies (Indonesia, Korea, Malaysia, the Philippines, and Thailand), the investment rate dropped by 16 percent of GDP. This translated into a turnaround in their combined current account balance of some $124 billion (nearly 11 percent of 1996 GDP). Saving and investment rates in East Asia have been among the highest in the world over the last few decades, ranging from 25 to 35 percent (see figure). Nonetheless, current account deficits built up in the 1990s as investment rates exceeded even these high saving rates. The investment buildup is believed to have been partly responsible for the eventual financial crisis, as some of these investments proved to have low (if not negative) rates of return. By and large, saving rates held up well during the crisis, and even fiscal deficits turned out much lower than expected (or targeted). (See appendix 5 for further elaboration on fiscal deficits in the aftermath of the crisis.) The stable saving rate, combined with the plunging investment rate, generated the huge current account rever-

(Continued)

Box 1.2 *(continued)*

Combined current account balances in Sub-Saharan Africa, 1990–2003

(percentage of GDP)

Year	Total	Oil exporters	Non-oil exporters
Average, 1990–98	–2.5	–2.7	–2.4
1999	–2.0	–1.9	–2.0
2000[a]	–1.2	2.7	–2.5
2001[b]	–2.0	–0.7	–2.5
2002[b]	–2.1	–2.5	–1.4
2003[b]	–1.8	–2.2	–1.7

a. Estimated.
b. Projection.
Source: World Bank data.

sal, which in turn financed in part the U.S. investment boom of the last few years. 5

Commodity exporters' current accounts are extremely volatile.
The $10-per-barrel rise in oil prices in 2000 yielded an estimated increase in oil export revenue of $135 billion compared with 1999. Thus the world's oil exporters have witnessed huge swings in their current accounts over the period 1998–2000, ranging from 7 to 35 percent of GDP. This reflects not only the recent volatility of oil prices, but also the fact that the recent windfalls have not yet been spent on increased imports.[5] The counterpart of these shifts in oil exporters' current accounts is largely seen in the industrial countries, although those hit the hardest are low-income, commodity-exporting countries.

Commodity exporters—oil and non-oil—are subject to severe price volatility and thus to sharp swings in income. Their current accounts can act as buffers to smooth consumption over time, although not all countries have the same opportunities for smoothing. However, for developing countries that import oil and export other commodities, the increased oil bill poses bigger challenges as, at the same time, they face low non-oil commodity prices and have limited access to international capital markets. For example, Zambia, which depends on copper and cobalt exports, has suffered a deterioration in its trade balance of $1.2 billion as a result of recent trends in commodity prices, equivalent cumulatively over the last three years to some 35 percent of its GDP.[6] Clearly, shocks of this nature have required huge adjustments, as these countries are largely unable to finance current account deficits of such magnitude. The contrast between oil and non-oil exporters is most evident in Sub-Saharan Africa. The non-oil exporters in the region tried to smooth consumption and production by running temporary current account deficits. But the deterioration of their current accounts has been much smaller than one would have expected given the changes in their terms of trade. This suggests that such countries have responded to the higher oil price by compressing imports to some degree and holding current account deficits to within a range they have historically been able to finance.

quences of the temporary imbalances, even after balance is restored. Oil-importing developing countries have increased their debts and debt service, and their creditworthiness may have deteriorated, making access to international capital markets more difficult. Oil exporters may have lost competitiveness in non-oil goods as a result of real exchange rate appreciation. In a slowing world economy with increased competition for market share, such a loss in competitiveness makes it harder to overcome the expected decline in oil prices.

Most of these risks are not easily prevented. However, some policy priorities may help reduce the risks. Improvement of the investment climate in developing economies that stimulates FDI may facilitate a successful redirection of capital flows. Countercyclical policies may mitigate contagion. Finally, for economies facing a temporary exclusion from international capital markets as a result of increased overall uncertainty, temporary financial assistance may prevent a severe and prolonged recession.

Overview of developing regions

Following a decade-high advance of 5.4 percent during 2000, GDP growth in developing countries is expected to fall to 4.2 percent in 2001 (figure 1.13). Slower growth in world demand and trade will affect most countries for the worse, although lower inflation and interest rates among the industrial countries will be a common favorable factor.[7]

The evolution of the global environment described earlier will have differing impacts on different developing economies. The countries hardest hit will be those with a strong export orientation to the United States, in particular the substantial number of East Asian economies specializing in

Box 1.3 Overreactions and reassessments in financial markets

Despite early warning signals from survey data, participants in financial markets waited until the end of 2000 to make abrupt and deep revisions to their forecasts. Suddenly, expectations about the U.S. economy were adjusted downward, and the euro appreciated 15 percent against the dollar in December after having weakened almost continuously since its introduction (see figure). At the same time, uncertainty in many markets increased, as reflected in increased spreads and a flight to quality, resulting in a rally in long-term government bonds. This brought yields on these bonds down some 30 basis points, to 5.1 percent, from the end of October to December 13 (European Central Bank 2000).

Although news about the rapidity of the slowdown accumulated during the latter part of the year, it appears insufficient to explain the strengthening of the dollar through November and its subsequent rapid reversal. If financial markets are efficient, the earlier signs concerning the slowing of activity should have prevented the appreciation, making the subsequent depreciation more moderate.

New behavioral finance theories (for an overview see Shleifer 2000) offer two explanations for this often-observed behavior in financial markets, in which, for an extended period, traders driven by extrapolative expectations "chase the trend," only to reverse themselves suddenly. The first mechanism focuses on the short-term gains available during speculative bubbles. Even if a trend is unsustainable in the long run, investors who ride the tide may generate—and at the same time keep alive—short-run gains. These investors hope to be out of the market before the disequilibria become too large and the trend reverses. The second mechanism, described in De Grauwe (1996) and Frankel (1997), focuses on uncertainty and information costs. Within a (sometimes large) range of equilibria, fundamental analysis of investment opportunities is not worthwhile, given that the returns from arbitrage might not offset the costs. Most market participants will then economize by relying on technical analysis. This involves observing movements in market prices (information that is public and almost free) and extrapolating certain systematic tendencies as a way to extract information about what other agents will do—a kind of free ride on others' supposed fundamental analysis. This type of behavior can perpetuate deviations from equilibrium because, within a certain range, no one is doing fundamental analysis, and those doing technical analysis move the market. This will continue up to the point where the disequilibrium is so large that the potential gains from arbitrage reemerge, making fundamental analysis worthwhile again.

Although such behavior is understandable from an investor's point of view, the overreactions and abrupt reassessments that result may have adverse consequences in the real economy. As the Asian crisis and the dot-com boom and bust have shown, overoptimistic investment behavior driven by short-term gains may lead to inefficient investments, and the sharp reversals may lead to inefficient liquidations.

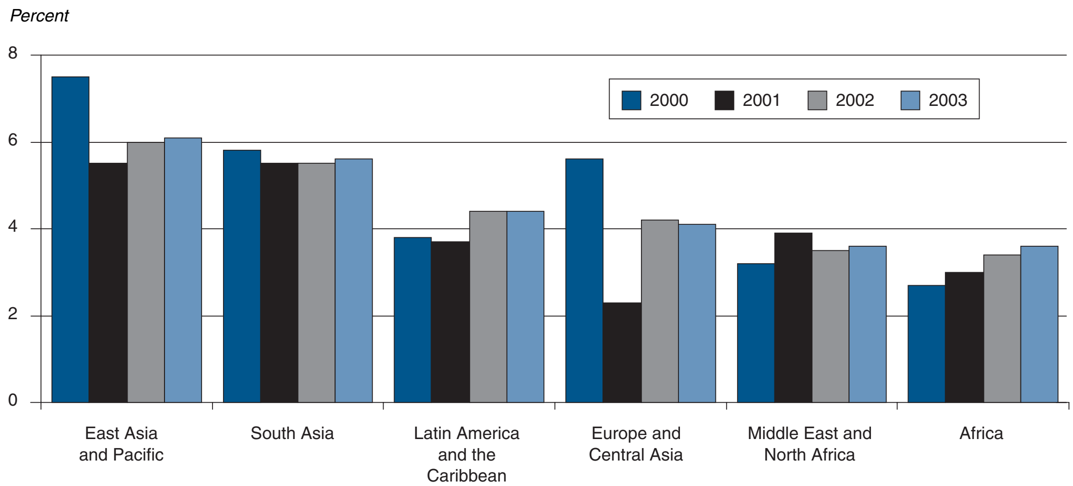
U.S. dollars per euro, December 1999 to December 2000

Source: Datastream.

semiconductor and other high-technology trade, which have recently experienced a robust recovery from the late-1990s crises. Sluggish conditions in Japan are likely to accentuate the overall weakness of Asian trade. The Mexican outlook will clearly be dominated by much lower demand from its partners in the North American Free Trade Agreement (NAFTA). But the prospects for other Latin American economies are mixed, with lower interest rates potentially setting the stage for an easing of domestic financial conditions in some countries (such as Argentina and Brazil), but continued soft commodity prices affecting others adversely.

The expectation that growth in the Euro Area will be sustained at higher rates than in North America bodes better for developing regions more tightly aligned with that group of countries. Only a moderate slowing of growth is anticipated in the countries of Central Europe seeking accession to the European Union,[8] and Sub-Saharan Africa as well as the

Figure 1.13 Developing regions' real GDP growth, 2000–03



Source: World Bank staff estimates.

Maghreb countries of North Africa should be able to maintain growth momentum at a modest pace. Some commodity exporters may benefit from a weaker dollar, whereas oil prices are likely to be central to the outlook for the Russian Federation and the other hydrocarbon exporters of the Commonwealth of Independent States (CIS), as well as for Africa and the Middle East. Here prospects appear favorable for continuation of fairly firm price levels through the near to the medium term, helping to keep these economies out of a significant downturn.

Recovery for the developing countries should find its roots in a fairly rapid stabilization and revival in U.S. demand and a step-up in European growth. Renewal of growth in intraregional trade in East Asia and in the Mercosur countries of South America, for example, should abet these developments. In the interim, however, with favorable trends in international interest rates and historically low inflation profiles across developing regions, room for an easing of monetary policy in a number of countries, particularly in East Asia, Latin America, and Central Europe, can assist in supporting domestic demand. Although fiscal positions are generally more fragile, room for an easier fiscal policy stance may be available in a number of countries to buoy consumption and output. And exploiting possible shifts in the dollar-euro exchange rate to reorient the focus of exports toward markets where competitiveness has been enhanced may serve to offset a more severe downturn in trade. In the recovery phase, GDP growth in developing countries is anticipated to rise toward 4.9 percent per year in 2002–03.

East Asia and Pacific

The East Asian economies will experience much slower growth in the first half of 2001, as external conditions have deteriorated more rapidly than previously foreseen. Asia's reliance on high-technology-laden exports is being affected by a sharp decline in demand for high-technology goods, particularly in the United States.[9] In contrast with other developing regions, however, the prospects for developing East Asia in 2001 as a whole are still favorable, with anticipated GDP growth of 5.5 percent, although this is down from the 7.5 percent outcome for 2000. The expected slowdown is more pronounced for the East Asia Crisis Five economies, where growth in 2001 is projected at 3.7 percent, a drop of more than 3 percentage points from actual growth in 2000, and of almost 2 percentage points from the fall 2000 forecasts. Prospects are little changed for 2002–03, with growth for developing East Asia projected to continue at about 6 percent each year.

A return to stronger growth in the wake of plummeting exports and manufacturing output in the region during 2001 will require stimulating domestic demand. The initial conditions for such stimulus are generally favorable, but prospects for policy action are mixed across the countries of the region. International reserves are high, short-term debt has dropped substantially, current accounts are still positive (although diminishing), inflation has been subdued despite the sharp upswing in regional growth and increase in energy costs during 1999–2000, and exchange rates have remained competitive. An easing of monetary policy may be feasible in countries such as Korea.

However, stabilization policies in the region face some challenges and constraints. Fiscal positions in East Asia have deteriorated sharply since the onset of the crisis in 1997. Moreover, the serious downturn in sales of high-technology goods puts the far-from-complete recovery of many distressed firms and banks in East Asia under pressure. A loosening of monetary policy may have less impact than in the past because of persistent weaknesses in the banking sector. Bank credit toward businesses continues to be rationed, and although nonperforming loans have declined, they remain stubbornly high. Banking authorities are considering more proactive policies. For example, the Bank of Korea has initiated a program in which it provides banks loans—at much reduced rates—earmarked for small- and medium-size enterprises; this program was extended at the beginning of 2001 to second-tier conglomerates. Although such policies may ease an incipient credit crunch in the short run, they could lead to worsening bank balance sheets in the longer run, should these loans sour.

Unfortunately, many countries in the region have also been gripped by a wave of political weakness. This has had the greatest impact in Indonesia and the Philippines, which have seen a substantial weakening of their currencies,[10] but it has also affected Malaysia (which is suffering from steady capital flight), Taiwan (China), and Thailand. The political and economic changes induced by the financial crisis of 1997–98 are likely to have beneficial impacts in the long run, but may inhibit policymaking in the short term as governments confront their first postcrisis challenge. 6

Latin America and the Caribbean

Economic recovery in Latin America and the Caribbean was uneven in 2000, with GDP growth estimated at 3.8 percent. Continued weakness in non-oil commodity prices, high oil prices, and a sharp fall in bond financing in the fourth quarter affected growth performance across most of the region—oil importers as well as some oil exporters with significant dependence on agricultural exports. A $40 billion financial package extended to Argentina by international financial institutions and other donors was successful in staving off the worst of a financial crisis in that country. But necessary fiscal tightening, the depreciation of the euro, and confidence effects yielded stagnant growth in Argentina and dampened growth in income per capita in its smaller Mercosur partners.

Mexico's GDP, in contrast, grew faster than expected, at 6.9 percent, thanks to a combination of strong U.S. import demand, high oil prices, and increased public expenditure—financed by the high oil revenues—in the runup to presidential elections. In the middle of the growth spectrum, Brazilian output advanced by more than 4 percent, as it did for most oil exporters. Growth in Peru was affected by political developments and by sluggish performance of metals and minerals prices in the last quarter of the year (which also affected Chile).

Growth prospects in the region for 2001 will continue to differ markedly across countries. Exports are likely to be strongly affected by slowing U.S. demand,[11] and key industrial commodity prices are expected to soften. Mexico is seen as likely to be the country most affected by the slowdown in the United States: Mexican production is intricately interwoven with U.S. manufacturing through NAFTA, in the automotive sector among others. The slowdown in the United States may be accompanied by a fall in the dollar-euro exchange rate; this would be a potentially welcome development for countries that trade heavily with Europe, such as Argentina and Brazil, because their currencies would become more competitive.[12] And easing of international interest rates should reduce the cost of new borrowing and of interest on foreign debt, while offering some leeway for more substantive reductions in domestic rates, given positive developments on the inflation front. The GDP growth forecast for 2001 for the region as a whole has been reduced by 0.4 percentage point, to 3.7 percent, and the dispersion of projected country growth outturns should begin to narrow by the end of the year.

With an upturn in industrial-country activity anticipated during the second half of 2001 and

2002, recovery in Latin America is likely to follow in a phased process. Export performance should improve, although some time will be required to rebalance inventories and production in line with more moderate prospective growth in the U.S. market. The stimulus derived from rising exports, together with the earlier easing of interest rates, should support a moderate revival of domestic demand. And a rekindling of trade within Mercosur is also likely as average growth rates of participating countries converge around 4 percent by 2002. Finally, as global growth regains more substantive momentum, a turnaround in the terms of trade for the region's smaller commodity exporters, particularly in Central America and the Caribbean, can be expected. As these developments unfold, GDP for the region is likely to rise toward a 4.4 percent annual pace over 2002–03.

South Asia

GDP advanced by 5.8 percent in South Asia during 2000, up marginally from 5.7 percent in 1999. In India recent statistics show continued growth in manufacturing, services, construction, finance, insurance, and real estate at rates of more than 6 percent through 2000. But South Asia remains the most energy-import-intensive of developing regions and has been hit hard by the escalation of world oil prices. This increase, coupled with deterioration in key regional commodity prices,[13] has placed heavy pressure on the region's current account deficit, which reached $14 billion, or 2.2 percent of GDP, in 2000—the worst performance since 1989. The current account imbalance is expected to rise toward 2.4 percent over the next two years. In India a slowdown in high-technology services exports appears imminent due to the global downturn in information technology, including the software industry. However, the country's foreign exchange reserves stand at comfortable levels, equivalent to six months of import coverage.

Average annual growth for the region in 2002–03 is anticipated to be 5.5 percent. Among the positive factors is the government of India's announced aim to liberalize the country's trade regime and to reduce other barriers in its export-import policies. But a factor restraining more robust growth in India is the persistence of large budget deficits, which currently stand at some 10 percent of GDP when capital expenditures are included. The slowdown in the industrial countries and continued softening of commodity prices will adversely affect the region, with stronger impacts on the smaller, more open economies of Bangladesh, Nepal, and Sri Lanka. 7

Middle East and North Africa

Increased oil output and terms-of-trade gains from high oil prices led GDP in the Middle East and North Africa to advance by 3.2 percent in 2000, up from 2.2 percent during 1999. Growth in the oil-dominant economies accounted for most of the gain. Results among the diversified exporters of the region were mixed. Higher prices for energy imports and lower prices for selected nonfuel commodities exports (such as phosphates and semiprocessed materials) yielded a decline in the group's terms of trade, compounded in several countries by continued relatively high real exchange rates, which dampened export performance. Moreover, severe droughts in Morocco and the Syrian Arab Republic decreased income and consumption, particularly in rural areas. Among positive developments, record tourism revenues, stronger flows of worker remittances, and privatization revenues provided a boost for this group of countries. But continued contributions from these factors depend on maintenance of a favorable external environment. That in turn depends especially on economic conditions in the European Union, which now show signs of a moderate slowdown.

GDP growth is expected to rise to 3.9 percent in 2001, as weather conditions improve and oil exporters use their recent windfall gains to implement new investment programs, targeted both to production and to upstream activities. Despite the moderate fall in oil prices anticipated for 2001, the region's oil exporters are well positioned to make the adjustment, given the long-held perception that the recent oil price rise would be temporary. Trade and current account surpluses will decline, but the commitment to encourage investment and further fiscal reform, particularly in the Gulf Cooperation Council countries, should continue. The slowing of growth in the industrial countries will dim the prospects for the diversified exporters. Although Morocco will see some improvement as it recovers from its second consecutive year of drought, sluggish growth in its export markets will serve to dampen trade, and tourist arrivals will be affected by slower growth in Western Europe. The region's GDP growth should ease to a range of 3.5 to 3.6 percent per year by 2003, as a further leveling off of oil prices induces a downscaling of growth in the oil-dominant economies toward 3 percent, while output gains stabilize in the major economies of the Maghreb and the Mashreq at annual rates between 4 and 5 percent.

Europe and Central Asia

Growth in the transition and developing countries of Europe and Central Asia is expected to fall to 2.3 percent in 2001 from a robust 5.6 percent advance during 2000. This outlook incorporates a moderate slowdown in external demand, effects of policy tightening to avoid overheating in some countries (such as Poland), and a sharp contraction of GDP in Turkey following the recent crisis. Hydrocarbon exporters—mainly Russia and some of the Caucasus and Central Asian countries—have benefited markedly from high oil prices, which have boosted budget revenue and allowed for increased investment and fiscal outlays. This should largely sustain domestic demand through 2001, despite the anticipated softening of oil prices.

The two crises that hit Turkey in November 2000 and February 2001 were primarily domestic banking crises. Currency and portfolio maturity mismatches made the domestic banks increasingly vulnerable in the course of last year. The rising real exchange rate and declining domestic interest rates were the main incentives that led to these mismatches. Toward the end of 2000 the exchange rate and the banking sector came under attack as doubts about the sustainability of policies increased. One alarming indicator was the rapid increase in Turkey's current account from less than 1 percent of GDP in 1999 to more than 5 percent of GDP in 2000. Roughly half of this deterioration is attributed to the impact of higher oil prices and increased import demand for reconstruction after the 1999 earthquake, with the balance attributed to the overvaluation of the lira and a cyclical rebound in domestic demand. Box 2.6 in chapter 2 elaborates on additional factors that contributed to the crises.

The lack of confidence led to a sharp rise in interest rates, both in November 2000 and in February of this year. A 30 percent depreciation of the lira in February completely eroded the liquidity of the banking sector and created pressing fiscal strains. The resulting credit squeeze makes it difficult to avoid a severe contraction this year. But the forecast anticipates a rebound in 2002, driven by increased competitiveness and restored confidence with new policies in place.

Over the 2002–03 period, aggregate growth in the region is projected to stabilize near 4 percent. For those countries seeking accession to the European Union, deepening reforms and continued significant levels of FDI should provide a strong impetus to growth. However, pressures on fiscal and external balances are expected to remain high over the medium term (but diminish over the long term) to finance the adjustment costs associated with the accession process. In the CIS the outlook is clouded, with substantial risks to the forecast on both the up- and the downside, mainly due to uncertain prospects for world oil prices and the greater prominence of political factors in the region. Progress in implementing reforms is anticipated in some CIS countries, but the breadth and depth of these reforms are uncertain, raising some doubt as to the sustainability of higher growth in the absence of high hydrocarbon prices.

Sub-Saharan Africa

Commodity price movements have had momentous, but mixed, impacts on Sub-Saharan African countries over the past two years. Tropical beverage prices are down 50 percent or more from their peaks in 1997–98, to their lowest levels in a generation. Meanwhile oil prices have surged, leading to the biggest divergence between oil and non-oil commodities prices in two decades. The least diversified exporters, which are heavily dependent on one or two non-oil commodities, have been the worst affected by the changes in terms of trade. At the same time, countries that export significant amounts of oil—Angola, Cameroon, the Republic of Congo, Gabon, and Nigeria—offset this impact for the region as a whole.

Economic activity in the region appears to have been stronger than expected during 2000, mainly because of developments in South Africa, where upward data revisions together with strong performance in the second half of the year boosted growth to 3.1 percent. The region as a whole is now estimated to have grown by 2.7 percent in 2000, and output should accelerate over the next few years, to 3 percent in 2001 and 3.4 to 3.6 percent in 2002–03. Despite the expected easing of oil prices, growth in the oil exporters will continue to outpace that in the region as a whole because of strong investment demand. Strong foreign investment flows should be sustained in the medium term, especially in the offshore sectors and in Nigeria, where meaningful reforms are expected to continue improving incentives in the energy sector. Non-oil exporters should also see a pickup in growth as the terms of trade improve or at least stabilize, with modest gains in non-oil export commodity prices and a softening of oil prices.

Notes

1. An inventory cycle of anticipatory accumulation was a positive factor underlying gross domestic product (GDP) in late 1999 and early 2000, contributing 0.4 to 0.9 percentage point to growth. As the cycle turns to a reduction in stock levels, GDP growth will be negatively affected—likely in the same order of magnitude as on the upside.

2. In a comprehensive econometric analysis, McConnell and Perez-Quiros (2000) trace the decline in the volatility of aggregate U.S. output to a decline in volatility of durables output and a smaller share of inventory investment in durables output. They identify the start of the structural decline in volatility in the early 1980s.

3. This was constituted by industrial country import volume growth of about 11 percent and developing country export volume growth of over 17 percent. In nominal U.S. dollars, world trade advanced by 16 percent, the fastest since 1995 when it grew by close to 20 percent.

4. Ethiopia, for example, received 65 percent of its export revenue from arabica coffee in 1997—about $384 million. However, with coffee prices having fallen by over half since then, Ethiopia's coffee export revenue in 2000 is estimated to be only $245 million.

5. Although the windfalls may eventually be spent, this does not necessarily imply inappropriate policies. First, countries may decide that part of the windfall represents a permanent income gain, warranting higher consumption. Second, if the windfall is spent on investment goods, this simply shifts the destination of the deferred spending from overseas financial assets to real capital goods.

6. For many commodity-dependent exporters the fall in prices for their products (in addition to the rise in oil prices) generated trade revenue losses (cumulated over three years) ranging from 11 to 35 percent of base-year GDP.

7. Appendix 5 provides further detail on economic and financial developments as well as the macroeconomic outlook by region.

8. Adjustment to the recent financial crises in Turkey will depress GDP growth in the Europe and Central Asia region as a whole to below that of the region's transition countries in 2001. The region's expected output growth of 2.3 percent contrasts with growth of 3.8 percent for the transition economies of Central and Eastern Europe, and 4.3 percent for the Commonwealth of Independent States.

9. Although the U.S. market accounts for only 20 percent of the exports of many East Asian economies, a sharp decline in U.S. demand would have multiplier effects on intraregional trade, which is concentrated in intermediate goods and components.

10. The weakness in the Philippines was partly reversed with the transfer of power to President Gloria Macapagal-Arroyo.

11. The United States absorbs some 20 percent of exports from the region, and 75 percent of Mexican shipments.

12. A weakening of Latin American currencies against the euro would tend to increase inflationary pressures to a degree—a risk for the larger countries of the region that have recently undergone financial difficulties.

13. Tea prices fell 5 percent, jute 11 percent, and rice 21 percent over the year to December 2000.

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