1

Prospects for Developing Countries: Coping with a Global Slowdown

Global economy stalls

The global economy, already balanced precariously between recession and recovery in the summer of 2001, received a sharp negative shock with the terrorist attacks in the United States on September 11. The probability of a more severe global slowdown has since increased, but because of the difficulties of anticipating the responses of businesses and consumers to these unprecedented events, together with the unpredictable ramifications of the attacks, forecasts are subject to an unusually high degree of uncertainty. Nonetheless, U.S. consumer demand, instead of fueling a recovery in global demand in the fourth quarter, now seems likely to decline. The September 11 events snuffed out the first signs, clearly discernible in late summer, of an incipient rebound in U.S. manufacturing production. As perceived risks rose, stock markets fell around the world, and new private lending to most developing countries has effectively ceased. Trade flows, already depressed by slowing demand, are under new pressures from rising security-related costs, disruptions in normal air traffic, and further post-attack slackening in demand.

The origins of the global downturn can be traced to the sudden decline in U.S. financial markets in mid-2000. This signaled the end to the worldwide bubble in equity values and created over-capacity in global high-tech sectors. In the ensuing slowdown of the U.S. economy, investment demand plummeted, and consumer confidence waned. Weakening investor confidence quickly spread to Europe, first evident in equity markets but soon transmitted to business and consumer demand. The phased contraction of U.S. and then European import demand, in combination with the reversal of incipient recovery in Japan, heralded an unprecedented deceleration of world trade in 2001 that has adversely affected developing countries.

Growth of global trade fell from record 13.3 percent growth in 2000 to 1 percent in 2001. Because nearly half of U.S. investment was in computers, electronics, telecommunications, and other high technology products, the sharp contraction of investment hit East Asia's technology-heavy exports swiftly and hard. The U.S. downturn also rippled through Mexico into the rest of Latin America. The downturn spread to the Euro area where economies were reaching the top of the business cycle in early 2001. Conditions then worsened as the technology slump cut into demand, rising oil prices cut into the purchasing power of consumers, and the profits of European companies in the large U.S. market sagged. The European Central Bank, still fearful of future inflation associated with oil prices and the Euro's value, did not immediately cut interest rates. In Japan, slumping exports cut the tenuous string preventing the economy from slipping back into recession as the government bumped up against ceilings on fiscal headroom. These forces, together with weak commodity prices, reduced growth in virtually all major regions of the developing world.

Those countries that still depend heavily on commodity exports were particularly hard-hit. Many have experienced falling commodity prices since 1997, prices that never recovered from the East Asia crisis. These countries were unable to rebuild reserves and other buffers to cushion this year's further terms-of-trade losses, and suffered declines in income. Sub-Saharan Africa as a whole, for example, seems likely to witness a decline in real per capita income of 0.7 percent during 2001.

For the first time since 1974–1975, the world's major economies are decelerating in tandem. With Japan in recession, Europe decelerating, the United States dealing with the aftermath of the attacks, and many developing countries seeing their own growth slow, the downturn has now become global in scope. Global gross domestic product (GDP) is projected to increase by a tenuous 1.3 percent in 2001, down from 3.8 percent in 2000 (table 1.1).

The most probable scenario is a recovery in mid-2002—

The global economy, in the most probable scenario, will begin to recover in mid-2002, probably starting in the United States and then spreading to Europe and elsewhere. With inflation in abeyance, U.S. monetary authorities have progressively brought interest rates down 400 basis points over the course of the year through October and new tax cuts and spending increases provide additional stimulus for this year and next. The European Central Bank cautiously started to bring interest rates down in the third quarter of 2001, and, after September 11, did so in tandem with other central banks around the world. Both the low inflation and the improved structural policies in most industrial countries have created an environment in which technology-driven productivity growth can gain traction rather promptly, once the cyclical downturn has reversed. Moreover, rapid technological developments, high depreciation rates of investment goods, and just-in-time production systems tend to generate relatively rapid rebounds after downturns. Only Japan, facing severe financial problems, is unlikely to become a source of global growth in the short run. Oil prices, averaging $25 a barrel in 2001, are likely to drift downward to an expected long-run equilibrium of $20 a barrel, underpinning growth in oil-importing countries.

—creating a global environment better for developing countries in 2002–03

These developments in the high-income countries, if they evolve as anticipated, will create a moderately propitious external environment for a rebound in developing countries in late 2002, and stronger growth in 2003. Aggregate growth rates for the developing countries are expected to fall from 5.5 percent in 2000 to 2.9 percent in 2001; if global recovery takes hold as anticipated by mid-2002, growth in developing countries would probably pick up to 3.7 percent in 2002, and then rebound to over 5 percent in 2003. Trade and financial links, which had transmitted weakening impulses to growth from the large high-income economies to developing countries in 2001, appear now likely to reverse in 2002, and to do so sharply in 2003.

Trade growth is likely to accelerate modestly next year to 4 percent, and then gain substantial momentum in 2003 to exceed 10 percent. The last decade of trade growth has created structural changes that now favor expansion for many developing countries. Many countries not only gained global market share during the 1990s, but also diversified heavily into manufactures. This enabled them to escape the volatility inherent in commodity trade and price movements. It also cushioned the 2001 shock, and should allow them to benefit from high growth when the projected rebound in global demand begins to occur over 2002–03. However, those countries remaining dependent on commodity exports are experiencing severe stress today, and can expect little relief from forecast developments over the next years.

Developments in global financial markets are also likely to favor renewed growth beginning in 2002, if on a more selective basis than

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

	Current estimate	Current forecasts			April 2001 Forecasts		
	2000	2001	2002	2003	2001	2002	2003
Global conditions							
World trade (volume)	13.3	1.0	4.0	10.2	5.5	7.3	7.3
Inflation (consumer prices)							
G-7 OECD countries[ab]	1.9	1.8	1.4	1.5	1.8	1.7	1.8
United States	3.4	2.8	2.2	2.3	3.0	2.6	2.7
Commodity prices (nominal dollars)							
Commodity prices, except oil (dollars)	–1.3	–8.9	1.6	8.1	–0.3	5.4	5.6
Oil price (dollars, weighted average), dollars/barrels	28.2	25.0	21.0	20.0	25.0	21.0	20.0
Oil price, percent change	56.2	–11.3	–16.0	–4.8	–11.4	–16.0	–4.8
Manufactures export unit value (dollars)[c]	–2.0	–4.6	4.0	4.4	5.9	3.1	2.4
Interest rates							
LIBOR, 6 months (dollars, percent)	6.7	3.6	2.8	3.0	4.8	4.7	5.0
EURIBOR, 6 months (euro, percent)	4.5	4.1	3.3	3.3	4.3	4.2	4.5
World GDP (growth)	3.8	1.3	1.6	3.9	2.2	3.3	3.4
High-income countries	3.4	0.9	1.1	3.5	1.7	2.9	2.9
OECD countries	3.3	0.9	1.0	3.4	1.6	2.8	2.9
United States	4.1	1.1	1.0	3.9	1.2	3.3	3.2
Japan	1.5	–0.8	0.1	2.4	0.6	1.8	2.3
Euro Area	3.5	1.5	1.3	3.6	2.5	3.1	2.9
Non-OECD countries	6.3	0.6	3.2	5.7	4.1	4.9	5.2
Developing countries	5.5	2.9	3.7	5.2	4.2	4.9	4.9
East Asia and Pacific	7.5	4.6	4.9	6.8	5.5	6.0	6.1
Europe and Central Asia	6.3	2.1	3.0	4.2	2.3	4.2	4.1
Latin America and the Caribbean	3.8	0.9	2.5	4.5	3.7	4.4	4.4
Middle East and North Africa	3.9	3.4	2.9	3.6	3.9	3.5	3.6
South Asia	4.9	4.5	5.3	5.5	5.5	5.5	5.6
Sub-Saharan Africa	3.0	2.7	2.7	3.9	3.0	3.4	3.6
Memorandum items							
East Asia crisis–affected countries[d]	7.1	2.3	3.4	5.4	3.7	5.1	5.2
Transition countries of ECA	6.1	4.0	3.1	3.8	4.1	3.8	3.8
Developing countries							
excluding ECA	5.3	3.1	3.8	5.4	4.2	5.1	5.1
excluding China and India	5.0	1.9	2.9	4.6	3.4	4.4	4.4

[a] Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
[b] In local currency, aggregated using 1995 GDP weights.
[c] Unit value index of manufactures exports from G-5 to developing countries, expressed in dollars.
[d] Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand.

Source: Economic Policy and Prospects Group, October 2001; and *GDF 2001* projections of April 2001.

in the past. Lower international interest rates eased the pressure on developing countries' debt servicing, particularly in the most creditworthy countries. However, this positive news is likely to be offset in the short run with a flight to quality, and rising risk premiums globally. These have increased financial strains in some highly indebted countries. Investors, with memories of financial crises in East Asia and elsewhere firmly in mind, are more dis-

criminating, and that at least partially explains why financial stress in Turkey and Argentina have not produced more widespread contagion. Capital flows are thus likely to constrain growth in some countries, but will probably reward good policies in other countries. As in the case of trade flows, only by 2003 should growth of capital flows be expected to show a significant acceleration.

Short-term risks are high—
Even though the most probable scenario is for recovery by mid-2002, risks to this global outlook are unusually high and depend largely on the still unfolding ramifications of the terrorist violence in the United States. Moreover structural and policy risks persist. The U.S. current account deficit remains large, and global financial markets could impose a disruptive adjustment. Japanese domestic financial strains, should improvements in policy not be forthcoming, may have a destabilizing effect on the global economy. Furthermore if both monetary and fiscal policies in Europe are insufficient to offset the worsening of market sentiment, the slump could be deeper and longer than in present projections; a longer and more pronounced downturn in Europe would be especially harmful for developing countries due to the region's strong trade and financial linkages with all developing regions. Finally, financial tensions in some developing countries may significantly delay the recovery in more tightly linked groups of countries.

These risks argue strongly for continued policies in the high-income countries that will support growth, and for policies in developing countries that quicken the pace of structural reforms to improve their investment climate.

—but long-term prospects are favorable
Even though today's environment is weak and unusually uncertain, the long-term growth potential of developing countries is promising. This is because improved macroeconomic management, rising savings, increased openness, and greater diversification create better incentives for investment, technological progress, and growth. Yet, with these favorable growth trends in most regions, some will be left behind, and may find it difficult to meet development goals, such as a reduction in child mortality, without additional policy measures and external support.

To understand ways the global slowdown is affecting the prospects for developing countries, the first three sections below discuss elements of the global environment that shape the outlook for developing countries: the synchronous slowdown in the high-income countries, then deceleration of trade, and diverse trends in financial markets. We then show how these forces shape the short-term outlook for developing countries, as well as the risks that could undermine this outlook. A final section concludes with a discussion of long-term prospects and potential consequences for reductions in poverty.

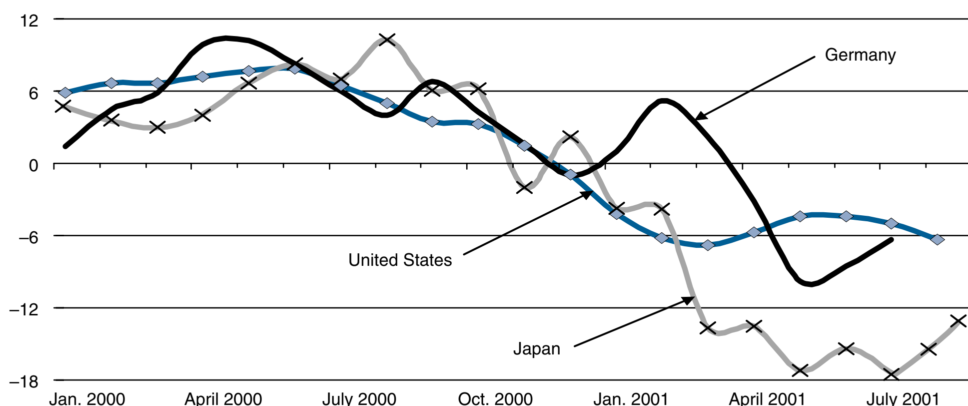
A simultaneous downturn in the industrial countries

Downturn broadened—
For the third time in two decades GDP growth in the industrial world slowed below 1 percent in 2001. By September, the downturn had not become as deep as during the early 1990s and the beginning of the 1980s. However, a worrisome characteristic of the current downturn is that all three industrial regions are simultaneously in a downward phase of the business cycle (figure 1.1). More pronounced weakness in the Euro Area and recession in Japan mirrored meager GDP growth in the United States.

While the end of the high-tech boom, the collapse of stock markets, high oil prices, and currency movements were factors that contributed to the downturn in all three regions, the relative importance of those factors differed across regions. Plunging sales of semiconductors and related products primarily affected the United States and Japan, as growth in Europe depended less on high-tech manufacturing. Also, the collapse of stock markets has probably affected the United States and

Figure 1.1 Industrial production in the G-3 countries falls in 2000–01

(percent change, 3-month/3-month, saar)



Note: The G-3 countries are United States, Japan and Germany.
Source: National statistics; Economic Policy and Prospects Group calculations.

Japan more severely: wealth effects are traditionally more important in the United States, and the fragile Japanese banking sector is vulnerable to low equity prices. Inflationary pressure coming from high oil prices and the strong dollar were a main impediment in Europe, where the European Central Bank tried to establish a tradition of keeping inflation strictly under control and hesitated to ease monetary policy.

—as growth stalls in the United States—

The downturn started in mid-2000 in the United States, with sharp corrections in the stock market ending a long period of large capital gains, especially in the high-tech sectors. Just when an expected soft landing seemed at hand, market sentiment worsened toward the end of the year. Uncertainty about future profits sharply reduced investment demand and borrowing, particularly by high-tech firms. The resulting negative wealth effects also sharpened the downturn in other sectors.

U.S. business investment continued to weaken sharply during 2001, exports and imports plummeted at double-digit rates, and jobless claims rose at a recession-like pace. Quarterly GDP growth rates flirted with recession during the first three quarters of the year. Manufacturing production had sagged—a result of declining domestic investment and the adverse effects on exports stemming from the strong dollar and weak global growth—which in turn yielded burgeoning excess inventory levels that required sharp curtailments in output.

The terrorist attacks on September 11 exacerbated the deterioration of economic conditions. The direct loss of U.S. output in the immediate aftermath of the September 11th tragedy is estimated to be $25 to $35 billion. This is about one day's GDP (1.5 percent of quarterly output)—as business, financial markets, and air transport effectively came to a halt as the events of the day unfolded. Financial markets remained closed for four trading sessions, a full ban on commercial air travel lasted for a week, and disruptions to the countries' "normal" order of business became widespread.

The collapse of air transport aggravated the direct output effects, because the sector is highly labor intensive, and air travel is an essential input to other economic activities. According to the World Bank's sectoral Linkage

Model, a 20 percent cut in air travel supply during one month would reduce annual GDP by more than 0.25 percentage points. Accommodations and restaurants are among the sectors that were affected severely, with "recreational services" representing over 3 percent of national value added—some three times that of air transport.

The indirect effects of the attacks are prospectively larger, operating through a fall in consumer confidence and lower equity market prices. The aggressive monetary policy reactions following the attacks could well contain the deterioration of market sentiment to a limited period; but is unlikely to prevent a strongly negative impact on economic activity during the fourth quarter of 2001.

—while Japan is in recession—

Even though the economy is likely to have slipped back into recession in 2001, the Japanese government persevered with its plans for badly needed reforms. It moved toward some fiscal consolidation and began disposing of banks' nonperforming loans, acknowledging that short-term economic costs are the price for achieving long-term gains. Bad loans have continued to mount in the domestic banking system, rising by official estimates from 9.7 percent of GDP in fiscal 1997 to 12 percent of GDP in fiscal 2000.[1] Loan-loss reserve coverage of "risk management loans" dropped from 46 percent in fiscal 1997 to 24 percent as of fiscal 2000. Revised reporting criteria now commit commercial banks and other financial institutions to "mark-to-market" equity held as capital, revealing losses that have likely been substantial over the last years, and requiring additional scale-backs in the loan portfolio (see box 1.1). With the Nikkei at very low levels, this adjustment could be particularly sharp.

The economy will probably contract by 0.8 percent in 2001. With limited policy instruments other than structural reforms, only a recovery of exports can offset continued stagnation in consumption and fall-off in public works spending, to set the stage for eventual recovery in private investment.

—and Europe, led by Germany, weakens

The weakening in Europe has been unexpectedly sharp in the second and third quarters of 2001 (figure 1.2). Germany was the first to feel the impact of collapsing investment demand in the United States and East Asia. Its exports to those regions amount to almost 4 percent of GDP, more than for any other European country. The malaise in German manufacturing is depressing activity in other countries and other sectors. Moreover, it became increasingly clear that Europe could not escape the sharp cyclical global downturn in high-tech products. In particular the telecom sector, which had invested heavily in infrastructure and licenses for third-generation mobile communications, had to adjust its profit expectations. Trade volumes are falling rapidly across the region, reflecting the sharp downturn in global demand, as well as declining intra-European Union (EU) flows. Earlier strengthening of the dollar, remaining high levels of the oil price and the fall in equity markets—in addition to slowing world trade, contributed to this recent sharpening of the downturn in Europe.

The unexpected strengthening of the dollar during the spring, and high energy prices both added to inflationary pressures, and the European Central Bank (ECB) was hesitant to lower interest rates further, even when it became increasingly clear that such a step would be necessary to stabilize the economy. But the ECB reduced its policy interest rates by 25 basis points in late August, and lowered rates again as part of the coordinated policy response to the September 11 events.

Declines in equity markets and financing conditions in the United States appear also to have affected the domestic investment of globally active European firms. The EU has continued to be the major investor in U.S. equity and fixed-income markets, as well as in mergers and acquisitions (M&A) over the last years—accounting for some 70 percent of net foreign purchases of U.S. corporate bonds, 90 percent of equities, and over $125 billion in M&A during 2000.[2] Hence fall-out from slowing export market growth, accumulated losses in U.S. fi-

Box 1.1 Japan and the developing countries

During the 1970s and 1980s, East Asia's developing and newly industrialized countries found that links through Japan's goods trade, banking flows, direct investment, and official development assistance formed a cement that fostered robust advances in trade, financial integration, and growth within the region. During the 1990s Japan experienced a burgeoning problem of nonperforming loans in its banking system and meager output growth of 1.4 percent per year. Yet, Japan's impact on the region during bad times appears to be as strong as during the good times of the earlier decades.

Links through trade

	Japan's share in region's exports		GDP "exported" to Japan (percent)[a]	
World region	**1990**	**2000**	**1990**	**2000**
Developing E. Asia/				
NIEs	18.8	13.8	5.2	5.5
China	14.7	15.6	2.6	3.9
Korea, Republic of	18.6	11.1	5.0	4.0
Singapore	8.8	7.5	12.6	10.8
Oil exporters	23.6	24.4	11.4	13.1
North America	10.3	6.7	0.9	0.7
European Union	2.1	1.8	0.5	0.6
Major Latin America	6.8	3.0	0.6	0.5
Other major developing**	20.7	6.1	3.3	1.5
Other developing	10.3	5.7	0.8	0.7

Note: [a] Calculated as the share of total exports in GDP for country "i" times the share of Japan in country "i's" exports.
**Group includes Algeria, Arab Republic of Egypt, India, Islamic Republic of Iran, Morocco, the Russian Federation, and South Asia.

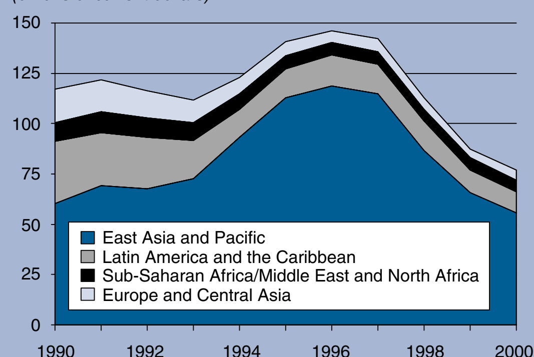
Source: IMF Direction of Trade Statistics, Japan ERISA, World Bank data, Economic Policy and Prospects Group calculations.

Japan has become less important as a destination for regional exports over the last decade, as evidenced by a 5 percentage point drop in export share for East Asia, and sharper fall-offs for other developing regions. This is indicative of relatively low growth of Japanese import demand and a diversification of export markets by Asian economies. However, the share of East Asian GDP, and particularly that of China "exported" to Japan, has risen slightly over the last decade.

On the financial front, however, the scale-back of Japanese commercial bank lending to developing countries has continued well beyond the retrenchments of the immediate post-crisis period.

Japanese commercial bank claims by developing region, 1990–2000

(billions of current dollars)



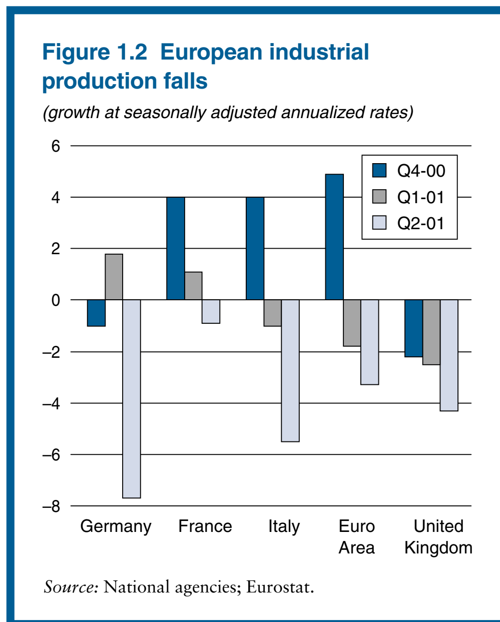
Source: Bank for International Settlements, Quarterly Report June 2001 and Annex tables.

Japanese lending to East Asia doubled between 1990 and 1996, rising to 4.4 percent of regional GDP, and as high as 21 percent of GDP in Thailand. A critical factor contributing to the upsurge in international lending was domestic—the demise of the traditional or "Main Bank" lending system within Japan itself, introducing more competition in the capital markets (Hoshi 2001). The financial crisis of 1997–98 yielded a swift decline in Japanese bank claims on the "Crisis-5" countries dropping by 30 percent between 1996 and 1998, representing a withdrawal of some 2.6 percent of GDP for these countries—although for Thailand it was 8.3 percent of GDP. From 1998 through 2000, Japanese claims on developing countries continued to fall, by 53 percent to the Asia-Pacific region and 12 percent for other developing regions. At present, the persistence of nonperforming loans in the portfolios of Japanese banks constrains its ability to generate new lending. Indeed, domestic lending by Japanese banks has fallen recently at 6 to 7 percent annual rates. Financial institutions have reduced overseas exposures in order to build up capital and increase funding for loan-loss reserves (Mori and others 2001). So Japan's share in developing countries commercial bank financing has dropped by *one-half* in the last decade, lessening the importance to emerging markets of further withdrawal of Japanese loans during the present downturn.

Note: Crisis-5 countries are Indonesia, Republic of Korea, Malaysia, the Philippines, and Thailand.

Figure 1.2 European industrial production falls

(growth at seasonally adjusted annualized rates)



Source: National agencies; Eurostat.

nancial markets, and unfavorable conditions under which to mobilize new corporate affiliations have come to exert increasingly adverse effects on the European business climate. The fall in equity prices also had a negative impact on consumer confidence, although wealth effects are, on average, less important in Europe than in the United States. Euro Area GDP growth is expected to fall to 1.5 percent in 2001, following strong output gains of 3.5 percent in 2000.

Rebound next year still likely, but probably later than earlier expected

Before September 11, there were early signs that a recovery in the manufacturing sector was underway in the United States. Figure 1.3 shows, for example, that manufacturing production, excluding high-tech production, had reached a trough, confirming information coming from the purchasing managers' index (NAPM). Since the terrorist attacks, that recovery has been postponed. But prudent use of the levers of economic policy is likely to bring about at least the beginnings of a rebound in 2002 for the United States and Europe. The United States has aggressively loosened monetary policy, with the Federal Reserve having lowered interest rates by 400 basis points in a series of nine cuts over the course of 2001, carrying the Federal Funds rate to 2.5 percent by mid-October, its lowest level since the early 1960s. European rates have also fallen, but not as swiftly. In addition, on both sides of the Atlantic increased fiscal stimuli are expected to augment consumption. However, the U.S. recovery, while expected to begin in the second or third quarter of 2002, will be reflected more in 2003 annual growth numbers than in those for 2002. Nonetheless, the U.S. recovery is unlikely to be as quick and strong as earlier thought, and the European recovery will likely lag one or two quarters. European manufacturers have been faced with large-scale unsold inventories, and it will take several quarters for this inventory cycle to unwind. With lower external demand than earlier anticipated, a buoyant export-led U.S. recovery has become less likely. U.S. consumer demand, put on hold after September 11, is expected to lead the recovery—if somewhat delayed. In Japan, there is no effective scope for monetary easing through interest rate cuts. Financial problems will continue to weigh heavily upon the Japanese economy, though a return to moderate positive growth in 2003 is expected with revival of world trade.

In the medium term, prospects for industrial countries remain favorable. Low inflation and improved structural policies in most industrial countries have created an environment in which the potential benefits from investment in technology can be reaped once the cyclical downturn has reversed. Oil prices averaging $25 a barrel are expected to return slowly to long-run equilibrium of under $20 a barrel, further underpinning growth in the industrial countries. And in Japan, the new government's tougher approach toward the "bad loan" problem should help the economy move gradually toward potential growth rates.

Under these assumptions, the forecast anticipates continued low growth rates in the United States, Japan, and Europe for 2002, 1.0, 0.1, and 1.3 percent respectively, but with strong acceleration of GDP growth advancing into 2003 (figure 1.4). [Weaker *annual* GDP growth

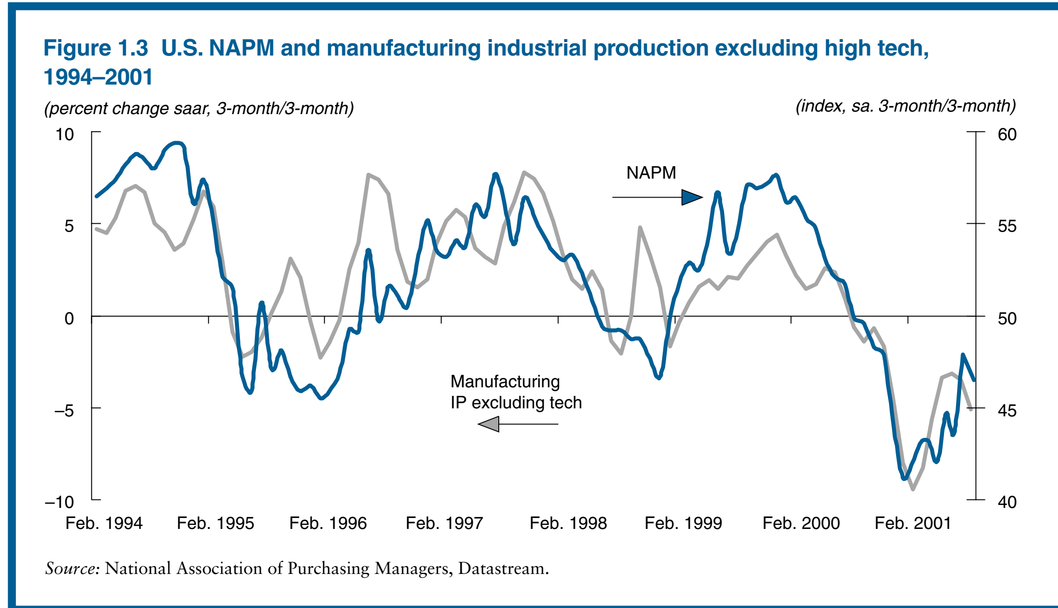


Figure 1.3 U.S. NAPM and manufacturing industrial production excluding high tech, 1994–2001

Source: National Association of Purchasing Managers, Datastream.

rates in 2002 are due in large measure to statistical effects related to the initial conditions for the year—a "carry-over" of sluggish or declining growth in the final quarters of 2001. A pick-up in the momentum of output growth across the major OECD blocs on a *quarterly* basis is anticipated to commence in the second and third quarters of 2002, in turn yielding positive "carry-over" effects and resulting in higher annual GDP figures for 2003.] The delayed recovery of these major locomotives of the global economy will transform the earlier-expected outlook for the developing countries. Trade and financial markets will be the two main channels through which these dynamics are transmitted. The next two sections look at the global environment through the lens of trade and finance, and a following section explores in detail the outlook for developing countries.

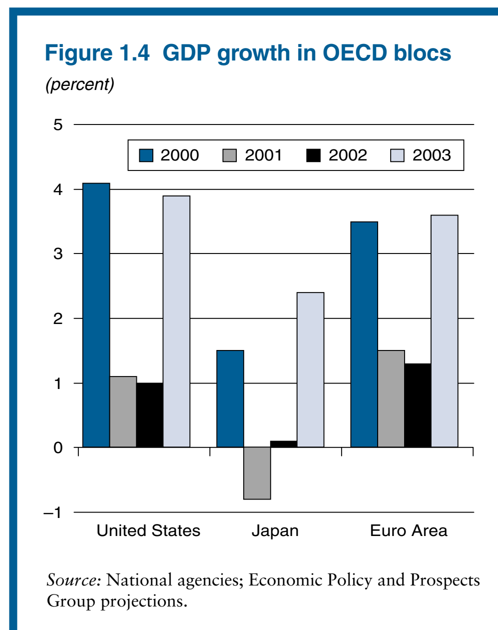
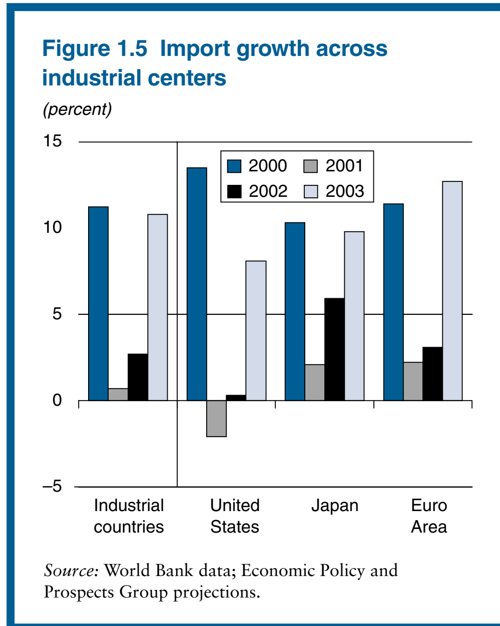


Figure 1.4 GDP growth in OECD blocs

Source: National agencies; Economic Policy and Prospects Group projections.

Global environment: trade

Downturn hits manufacturing exporters— The industrial country–downturn has led to the sharpest deceleration of world trade on record, from an extraordinary 13.3 percent advance in 2000 to a crawl of 1 percent growth in 2001. Import demand in all three industrial regions slowed sharply, with the steepest decline in U.S. imports (figure 1.5). U.S. investment in equipment declined by 4.5 percent



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

after growing by over 11 percent last year. With almost 30 percent of such investment being imported, and 40 percent of total investment consisting of high-tech products, this was a major force behind the slowdown of world trade and the collapse of the global semiconductor market. Indeed, U.S. imports of capital goods dropped at an annual rate of 32 percent during the first half of the year.

The terrorist attacks on September 11 restrained trade flows further, exacerbating the sharp cyclical downturn. Security concerns translated into higher freight rates,[3] and limited air travel greatly hindered the shipment of perishables and high-tech products.[4] The impact on trade in services was significantly larger, with tourism and business travel sharply lower.[5]

Growth of exports from developing countries plummeted from over 19 percent in 2000 to 2 percent in 2001. East Asian export growth fell more sharply still, from 25 percent to 0.5 percent (table 1.2). These effects are so pervasive because developing countries are now more than ever linked to global trade cycles in manufacturing. Countries increased trade as a share of their economies, and increased their share of the global market during the 1990s. In doing so, many developing countries diversified away from commodities to manufactures, and further, into high-tech products. The share of manufactured goods in developing countries' exports increased from 60 to 80 percent over the last decade, while the share of capital goods increased from 27 to 42 percent (figure 1.6).

—and commodity exporters

Commodity exporters have been hard hit by price declines. Although the number of countries that are highly dependent on commodity

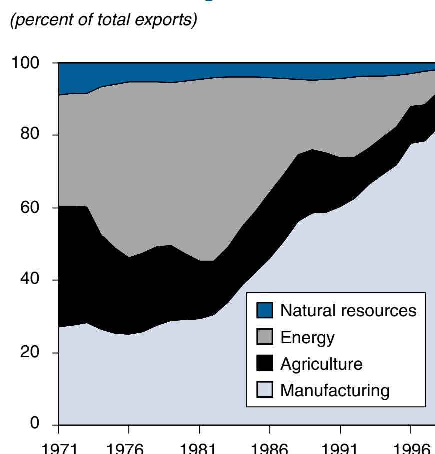
Table 1.2 Merchandise export volumes, annual average percentage change

	1999	2000	2001	2002	2003
World	4.1	13.5	0.3	3.7	10.3
High-income countries	4.1	11.9	–0.2	3.3	10.5
United States	3.9	11.3	–2.1	4.6	11.9
Euro Area	3.2	12.2	2.2	3.0	11.0
Japan	4.0	12.9	–7.7	4.0	11.8
Low-middle-income countries	3.8	19.2	2.1	5.0	9.7
East Asia and Pacific	9.7	25.5	0.5	6.4	11.5
South Asia	7.5	12.3	3.0	7.0	7.6
Middle East and North Africa	–2.6	8.0	2.1	4.1	5.8
Europe and Central Asia	–2.6	18.9	6.1	2.8	8.4
Latin America and Caribbean	–0.8	12.0	1.9	3.8	9.3
Sub-Saharan Africa	0.0	8.8	3.4	2.9	6.4
Memo: Developing x ECA	5.3	19.2	1.2	5.5	10.0

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

Figure 1.6 Export shares for developing countries excluding transition economies

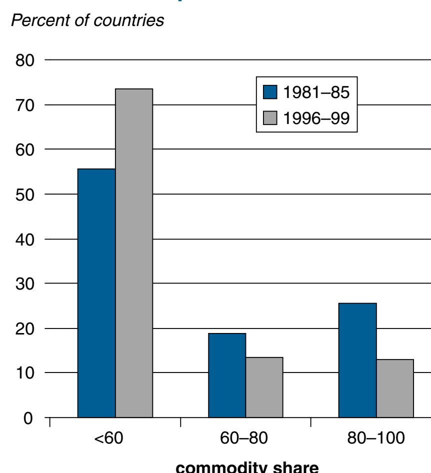
(percent of total exports)



Source: U.N. Commodity trade statistics (COMTRADE).

Figure 1.7 Distribution of countries by share of primary commodities in total merchandise exports

Percent of countries



Source: Staff calculations using UN COMTRADE data from WITS system.

exports is declining, for more than 10 percent of developing countries commodities exports account for over 80 percent of total merchandise exports (figure 1.7).

Non-oil commodity prices are projected to fall by about 9 percent in 2001 following a 1.3 percent decline in 2000. Substantial increases in the supply of commodities such as coffee, vegetable oils, and timber, and currency weakness of major exporters relative to the U.S. dollar,[6] also contributed to the fall of commodity prices. In the case of metals, the price declines come in spite of production cuts, particularly in aluminum, but also in copper and other metals.[7] Using its market power, the Organization of Petroleum Exporting Countries (OPEC) was able to sustain, at least in the short run, prices around $25 a barrel. However, slackening demand, especially after September 11, clearly will exert downward pressure on price. OPEC's reassurance that it will guarantee sufficient supply quickly, eased market concerns after September 11, but the possibility of future supply disruptions in the aftermath of the terrorist attacks has not disappeared, keeping uncertainty at exceptionally high levels in the short run.

World trade expected to rebound later in 2002—

As noted in *Global Development Finance* (*GDF 2001*), earlier cyclical downturns in the world semiconductor industry have been brief, largely due to technological advance and rapid inventory liquidation. More generally, faster depreciation rates of capital goods appear to have shortened the investment cycle, while lower inventory ratios have reduced the structural importance of inventory cycles. Combined with the positive impact of lower interest rates on demand for durable goods, the changing technological characteristics made a recovery of manufacturing production in the United States before the end of 2001 probable—and the first signs of a rebound were visible before September 11. However, the terrorist attacks have now rendered such a scenario of quick recovery unlikely. Although the mechanisms behind the recovery remain unchanged, a delayed upturn is more plausible now.

As a recovery in the United States begins to gather pace by mid-2002, increased investment and Information and Communications Technol-

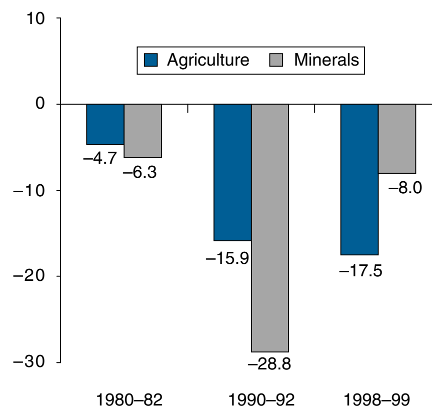
ogy (ICT) equipment spending should feed through to import demand, setting the stage for a pick-up in world export growth, mainly manifesting in robust 2003 annual growth rates (table 1.2). Expected growth of 4 percent in 2002 is followed by growth over 10 percent in 2003 in this projection. The rebound is likely to be fastest for East Asia, with growth rates of 6.4 and 11.5 percent in the coming two years. The dynamics in the region reflect countries' specialization in high-tech products and the pronounced boom-bust cycles rippling through East Asia since the 1997–98 crisis. For regions depending more on commodity exports, export growth will be lower under these circumstances. For example, Latin American exports are expected to grow about 4 and 9.5 percent in 2002 and 2003, while Sub-Saharan Africa could see exports growing near 3 and 6.5 percent, lower than Africa's record growth of 2000, but still high relative to past trends.

—but commodity exporters remain vulnerable

After the sharp 9 percent fall in commodity prices in 2001, almost no rebound is expected for 2002, and only by 2003 are current losses likely to be made up. Market conditions continue to put downward pressures on commodity prices in local currencies, and the modest price rebound expected for 2002 is mainly based on expected currency movements. With manufactures export prices expected to increase by 4–4.5 percent per year, in light of anticipated depreciation of the dollar, commodity exporters are likely to experience further terms-of-trade losses. The decrease in the import-purchasing power of exports as a result of relative price changes might constrain consumption and investment demand, for instance because of reduced availability of intermediate manufactures or capital goods. Research on North-South business cycles suggests that up to 20 to 50 percent of output volatility for such countries may be explained by business fluctuations in developed countries (see, for example, Deaton and Miller 1996; Kouparitsas 1996; Kose and Riezman 2000). Figure 1.8 indicates that the negative impact during downswings on mineral exporters is generally larger than on agriculture exporters, reflecting the greater sensitivity of minerals demand to industrial production.

Figure 1.8 Episodes of world growth slowdown and agricultural and mineral export prices

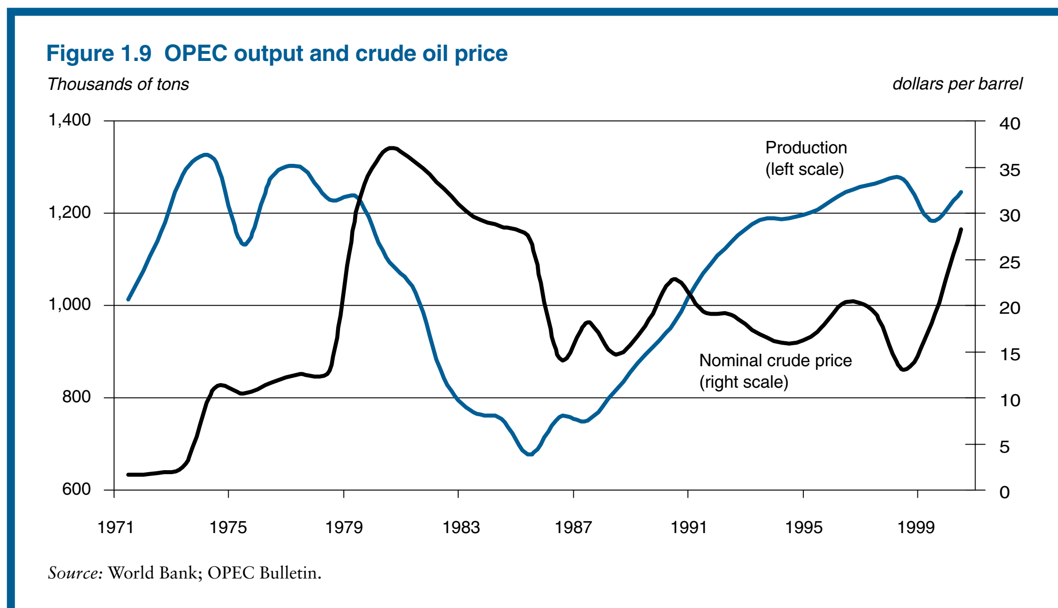
(difference in growth from the previous two years—percent)



Sample of 31 non-oil commodity dependent SSA countries, classified as mineral or agricultural exporters (see GEP 2000, Chapter 4, fn. 28 on p. 129 for details of coverage).

Source: Economic Policy and Prospects Group staff estimates.

Oil prices are expected to gradually decline to under $20 a barrel over the forecast period, due to rising supply competition from both non-OPEC producers and within OPEC itself. Earlier episodes, notably the second oil crisis during the early 1980s, show that, in the short term, it is possible to evoke large price swings with small supply shocks, but that large supply adjustments are needed to keep the price at high levels for a more extended period (figure 1.9). The sharpening of the downturn after September 11th and OPEC's policy reactions to avoid sharp price hikes in the wake of the terrorist attacks, have accentuated the expected downward trend.



Source: World Bank; OPEC Bulletin.

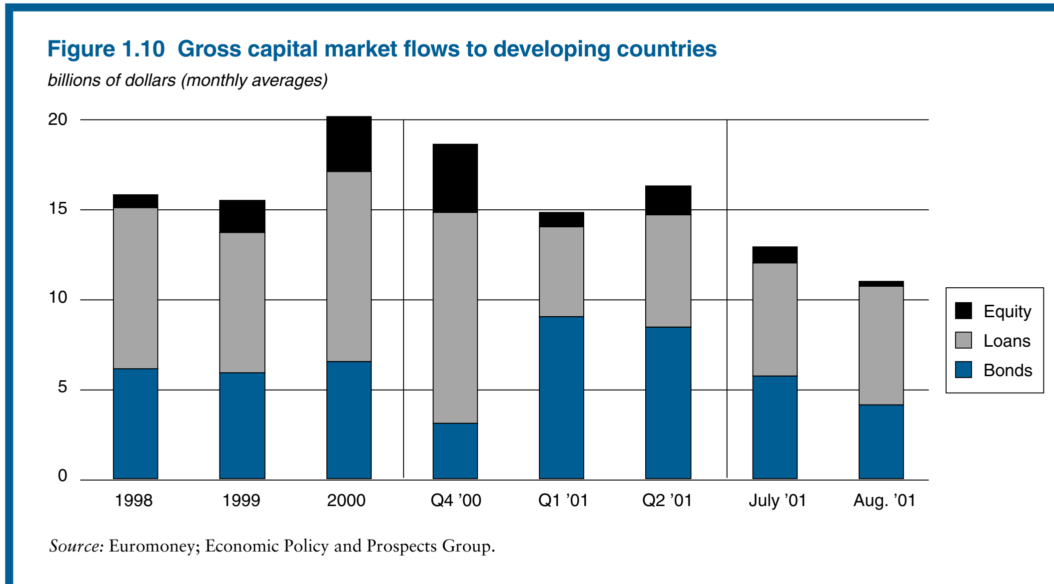
Global environment: financial markets

Increasing risk generally outweighs interest rate reductions—

The weaknesses of demand in the industrial countries had translated into lower interest rates before September 11, as authorities provided a more accommodating monetary stance. After the terrorist attacks, monetary authorities in the industrial countries swiftly eased monetary conditions further. These policies can potentially soften both the slowdown in the OECD region itself and the transmission of the downturn to developing countries, enabling the latter to benefit from lower international interest rates and a shift of capital flows away from industrial countries. However, the financial channel of transmitting growth dynamics from the major markets to developing countries produced higher spreads instead of larger capital flows in 2001, and contained a strong bias in favor of well-performing, creditworthy countries. This reflects the behavior of investors, who are now more risk-sensitive and discerning than they were in the years before the 1997–98 crises in emerging markets. Therefore, the benefits of lower OECD interest rates have been more-than-offset by higher risk premiums particularly for poorer performing countries.

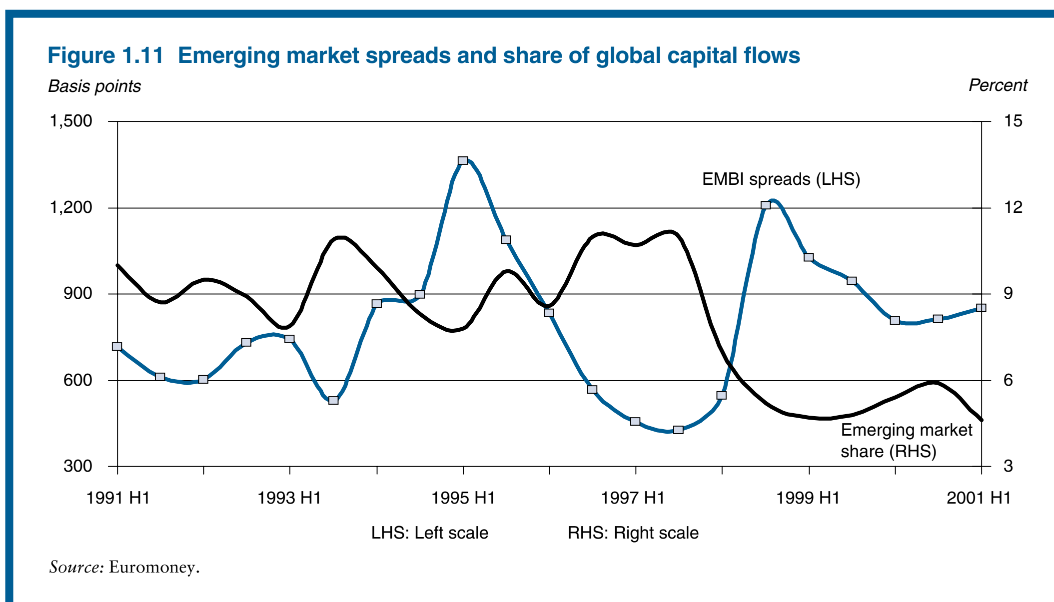
This is in sharp contrast to the 1991–93 slowdown in industrial countries, another episode of slowing growth and interest rate cuts. Then, when U.S. interest rates fell by 450 basis points cumulatively over three years, global gross capital market flows increased by 22 percent a year, albeit from very low levels born of the 1980s' debt crisis. Developing countries benefited from the increased liquidity with a similar increase in inflows by 32 percent a year.

In 2001, the opposite occurred when the Federal Reserve reduced policy rates by 400 basis points. After rising in 2000 for the first time since the 1997–98 crisis-ridden period, net capital flows to developing countries are expected to decline in 2001. Gross flows from international capital markets, which increased by over 30 percent last year, are down by near 20 percent (year on year—y/y) in the first half of this year (figure 1.10). Foreign direct investment (FDI) flows have continued to fall



(by 4 percent [y/y] in the first quarter) from their peak in 1999, and official flows are not expected to post a significant rise in 2001.

The difference between the current downturn and the recession a decade ago is the risk perception of private investors. Toward the end of the 1991–93 recession, investors were generally optimistic about new investment opportunities in emerging markets after many developing countries eased capital market restrictions. The spreads were relatively low and developing countries' share in global capital flows were increasing (figure 1.11). This year, the spreads were high and even rising toward the middle of the year, reflecting the heightened risk perceptions of the markets. As a result, the already



small share of developing countries in global capital flows has declined further.

—but mainly because of financial tensions in some large emerging markets—

Although aggregate net capital flows are on the decline this year, the reduction comes mainly at the expense of a few large recipients, notably Brazil, Argentina, and Turkey. Investors shunned the latter two countries on the worry of default on their public debt. Brazil, which received FDI flows of over $30 billion a year in 1999 and 2000—more than covering current account deficits—has seen a marked fall-off in FDI to $15–20 billion in 2001. A worsening of the external environment for Brazil—weak export market growth, low commodity prices, and rising spreads due to contagion from Argentina—and a domestic energy crisis have limited the country's access to capital markets.

Market reactions in the first weeks after the terrorist attacks showed a similar pattern. Spreads on Brazilian and Argentine bonds increased by more than 150 basis points, but the average increase for all other emerging economies was just 60 basis points, only slightly more than the decline in international interest rates (LIBOR).

Capital market financing to developing countries other than Argentina, Brazil, and Turkey declined by 9 percent in the first half of 2001, contrasted with a 20 percent decline including these three countries. Bond issuance, that seems to have benefited from the lower interest rate environment, grew by 75 percent excluding the three countries, and by 35 percent for all emerging markets.

Countries that usually had difficulty in accessing the global bond market in the past few years were successful during "windows of opportunity" that opened up periodically in the first half of 2001. These episodes usually occurred when interest rates fell sharply in the industrial countries—thereby increasing liquidity in the market—and when difficult conditions in key developing countries abated. June 2001 was one such month, when gross capital flows surged to over $21 billion, with countries that had little success in accessing the market much in the past year raising relatively large sums. For example, a private Russian corporation successfully issued a bond—the first access in a year—while large sums were raised by the Arab Republic of Egypt ($1.5 billion), Malaysia ($1 billion), and Hungary ($0.9 billion). Moreover many small issuers with less-than investment grade credit ratings either tapped the bond market (Jamaica, Lebanon, Romania, and the República Bolivariana de Venezuela) or obtained syndicated loans (Chad, El Salvador, Estonia, Gabon, Peru, and a Russian bank that received a loan for the first time since the 1998 crisis in that country).

These "windows of opportunity," however, alternated with periods when they were closed decisively. Investor sentiment deteriorated sharply in July, with average spreads rising by nearly 200 basis points in response to adverse developments in Argentina and Turkey. Although spreads also increased for several Central European and other Latin American countries, the contagion was limited. The terrorist attacks and threats of further violence will likely yield a further decline in private flows to emerging markets in 2001, both capital market flows and foreign direct investment. Capital market commitments could drop to some $160 billion—a third below 2000 levels. FDI to major emerging markets had declined from $61 billion in the first half of 2000 to $56 billion in the first half of 2001, and the attacks have raised the likelihood of a further downturn: they have greatly increased the uncertainty involved in traveling to supervise foreign subsidiaries; raised the cost of globally integrated supply chains due to higher insurance rates and enhanced security measures at the border; and demonstrated that these supply chains are vulnerable to interruption.

Capital flows are unlikely to recover in 2002

Although near-term gross capital market flows are notoriously difficult to forecast, the global political and economic environment seems too uncertain for a rapid upturn in capital flows to

developing countries. In the short run, emerging markets' share of private flows—which increased rapidly during the last decade—is likely to drop sharply as private investors seek safe havens. By 2003, however, the right mix of continued low interest rates, a rebound in world trade and reduced risk perceptions could generate a recovery of capital flows, and perhaps an increase in developing countries' share of global flows. Yet private market flows will probably be much more selective than in the past. Investors, with memories of financial crises in East Asia and elsewhere firmly in mind, will remain more discriminating. Capital flows are thus likely to reward good policies in some countries, but continue to constrain growth in others. Moreover risks remain weighted to the downside, as default by a major emerging market would escalate risk premiums for the majority of developing countries.

The outlook for developing countries

Although the slowdown in global economic activity is being led by the industrial countries, aggregate growth for developing countries is being adversely affected and expected to weaken from 5.5 percent in 2000 to 2.9 percent in 2001. Delayed recovery in the OECD area is likely to keep developing country growth in 2002 restrained to 3.7 percent. But stronger recovery in the advanced economies by 2003 should ignite a rebound to 5.2 percent growth in the developing world. However, there are considerable regional variations underlying these summary figures.

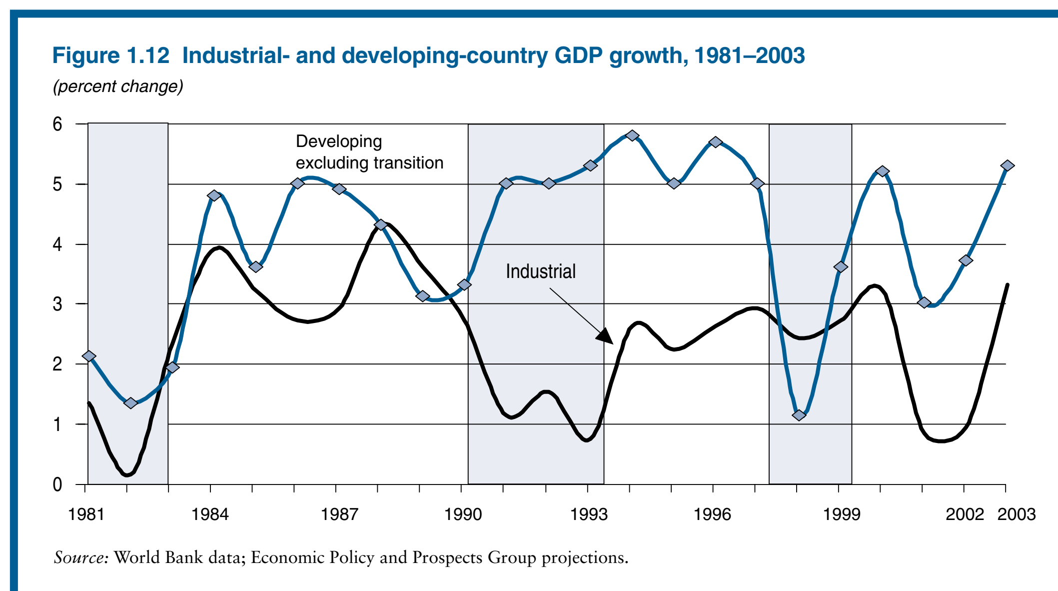
The Europe and Central Asia (ECA), and Latin America and the Caribbean (LAC) regions have been hardest hit by the deteriorating global environment in 2001—although conditions in these regions have been clouded by difficult financial and economic developments in Turkey, Argentina, and Brazil, respectively. Latin America in particular will begin 2002 within a challenging external environment, with the United States likely in recession, commodity prices falling sharply, international tourism collapsing, and capital-market risk aversion heightened. Only by mid-2002 will recovery gain some underpinning, as the United States and the Euro Area emerge from their slumps. Economic prospects for the Middle East and North Africa (MNA) region—which, after Sub-Saharan Africa (SSA) suffers the smallest reduction in near-term growth—are expected to deteriorate further in 2002, as oil prices continue to fall and other commodity prices drop relative to the cost of manufactures imports. The East Asia and Pacific (EAP) region is anticipated to be first among developing regions to show a recovery in exports in late-2001 and early 2002, as the group was the first to suffer from the collapse in high-tech trade flows. South Asia (SAS) is expected to experience a less pronounced cycle, as the region is relatively less integrated with the global economy. But GDP growth at 4.5 percent in 2001 corresponds with the 1997 low registered by the region. (See appendix 1 for more detailed discussion of the regions).

Diverse impacts of industrial countries' slowdowns

Historically, the effects of downturns on developing countries have been quite diverse (figure 1.12). Financial conditions are discriminating factors that potentially even reverse the sign of the impact. In the early 1980s, the developing countries followed the industrial countries into recession; after the second oil crisis the industrial countries tightened monetary policy to bring inflation under control. Higher interest rates generated severe debt-service problems for oil-importing developing countries that had accumulated foreign debts, and the downturn in the developing countries was almost as deep as in the industrial world. Moreover, growth opportunities in highly indebted countries were limited for a longer period.

In the beginning of the 1990s, growth in developing countries, excluding the transition group, accelerated despite recessions in the United States and Europe. It was again monetary transmission that played an important role. With inflation under control, the indus-

Figure 1.12 Industrial- and developing-country GDP growth, 1981–2003
(percent change)



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

trial world pursued an accommodative and more predictable monetary policy. Encouraged by major reforms in developing countries—including the opening up of capital markets—international capital diversified away from industrial country markets and found its way to those developing countries that undertook major reforms. This enabled many low- and middle-income countries not only to escape the downturn, but to grow at significantly faster rates than the high-income countries—until the East Asia crisis brought about a sudden reversal in capital flows.

Although the current downturn resembles that of 1991–93 rather than the 1982 episode, developing countries today are more adversely affected by falling import demand in the industrial countries. This is because trade linkages have become increasingly important. And in the aftermath of the East Asia crisis, a sharp rerouting of capital flows from industrial countries to developing countries (as occurred in the early 1990s) is less likely. On the other hand, developing countries are now better equipped than 20 years ago to absorb negative external shocks, benefiting from diversification and domestic reforms associated with integration into the global economy. The structural improvements in many developing countries justify the expectation that they will return to relatively high growth rates, once the global economy recovers from the current slowdown.

Current downturn follows region-specific channels on developing country growth

A probable consequence of the simultaneous downturn in the industrial world is that a broad range of developing countries will face an abrupt ending to the strong recovery that followed the financial crises. GDP growth is expected to drop by 2.6 percentage points in 2001, with serious downside risks, discussed in the next section. Apart from an 11 percentage point drop in export *market* growth, and sharp fall in non-oil commodities—implying substantial terms of trade losses—developing countries face a decline in capital inflows of almost 20 percent and spreads are again on the rise after a steady decline since the financial crises (table 1.3).

The regional impacts follow closely the export patterns that vary significantly across regions, both the commodity composition of exports, and the orientation of exports across various markets in the industrial and developing worlds (figures 1.13 and 1.14). Countries

Table 1.3 All developing countries: key indicators
(annual percent change unless indicated)

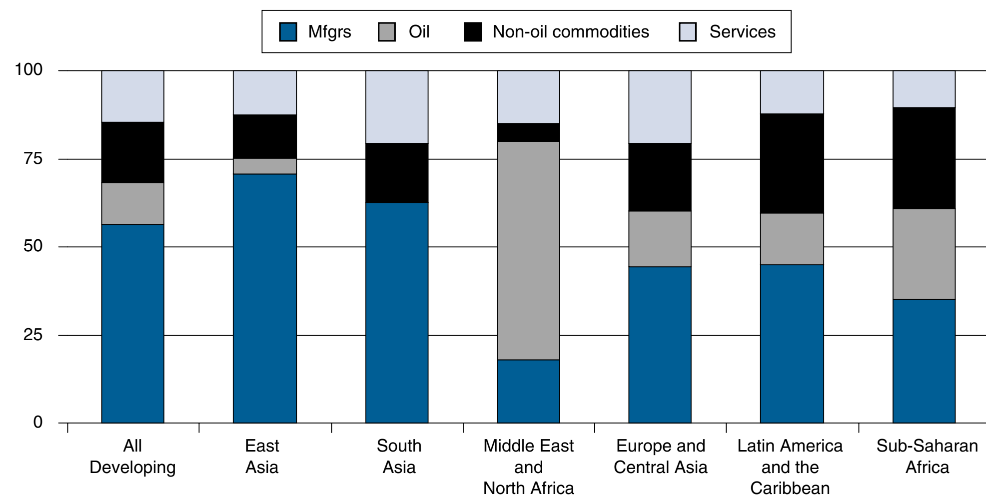
	1990–99	2000	2001	2002	2003
Export market*	7.5	13.4	2.3	4.4	9.4
Merchandise export volume	7.4	19.2	2.1	5.0	9.7
Terms of trade (percent of GDP)	–0.2	0.5	–0.5	–0.5	–0.4
International market spreads (avg. bp)	807.6	707.2	733.6	. . .	. . .
Gross capital market flows	15.2	28.8	–18.5	. . .	. . .
Real GDP	3.2	5.5	2.9	3.7	5.2

*merchandise import growth in destination countries, weighted by export shares of exporting countries.
. . . Not available
Source: Economic Policy and Prospects Group.

in East Asia—and to a lesser extent Latin America—with large manufacturing exports, were the first to feel the impact of the collapse of import demand in the United States and Japan. East Asia's high-tech laden exports (about one-third of total shipments from the region) were especially adversely affected as demand for computers, telecommunications equipment, and other semiconductor-based capital goods dissipated. Now, increasing weakness in Europe and declining commodity prices put additional pressure on countries in Central Europe, Sub-Saharan Africa, and Latin America.

External debt-to-export ratios, and the composition of the debt (private or official) differ widely across regions (figure 1.15), and can largely influence the severity of the impact. The more difficult external environment is especially worrisome for highly-indebted countries relying on private capital flows, such as Argentina, Brazil, Turkey, and Indonesia. At a regional

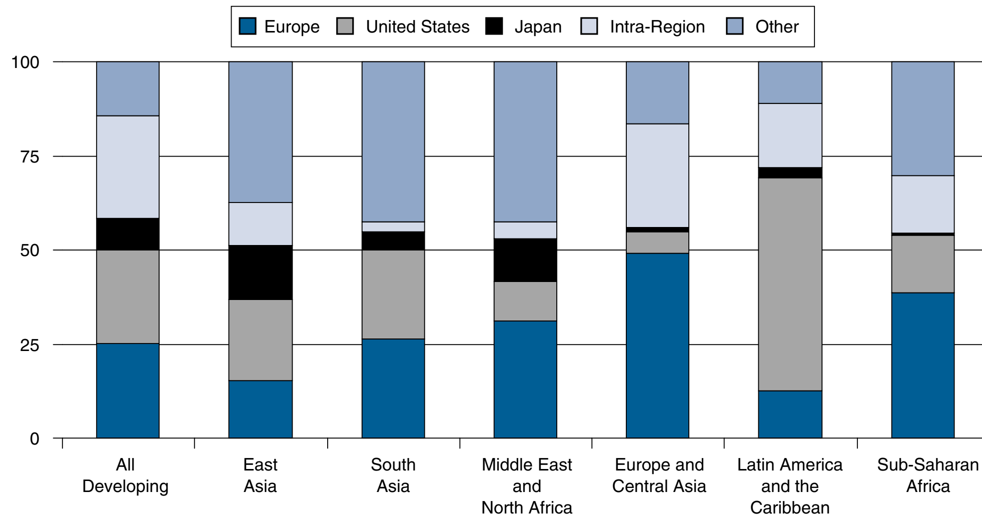
Figure 1.13 Composition of developing-country exports
(average export shares, 1998–2000—percent)



Source: U.N. COMTRADE database.

Figure 1.14 Major destinations for developing-country exports

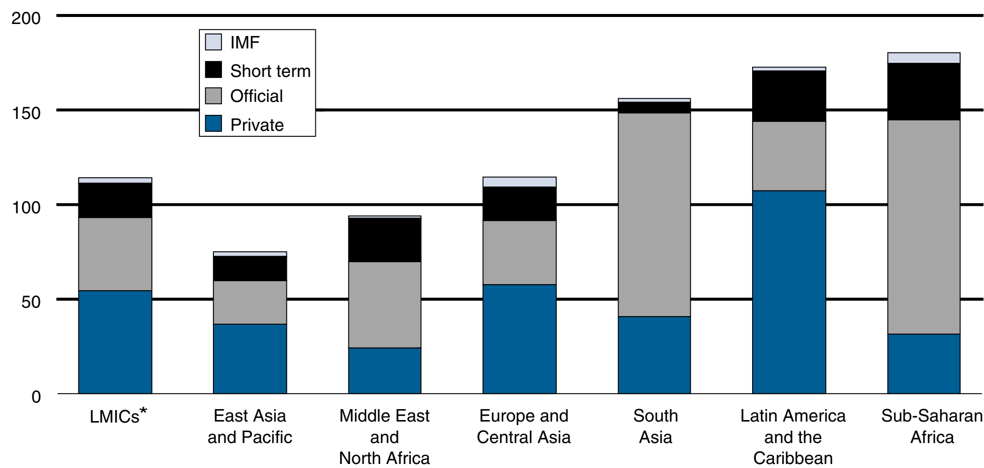
(average export shares, 1998–2000—percent)



Source: International Monetary Fund; Direction of Trade Statistics.

Figure 1.15 Total external debt in developing countries, 2000

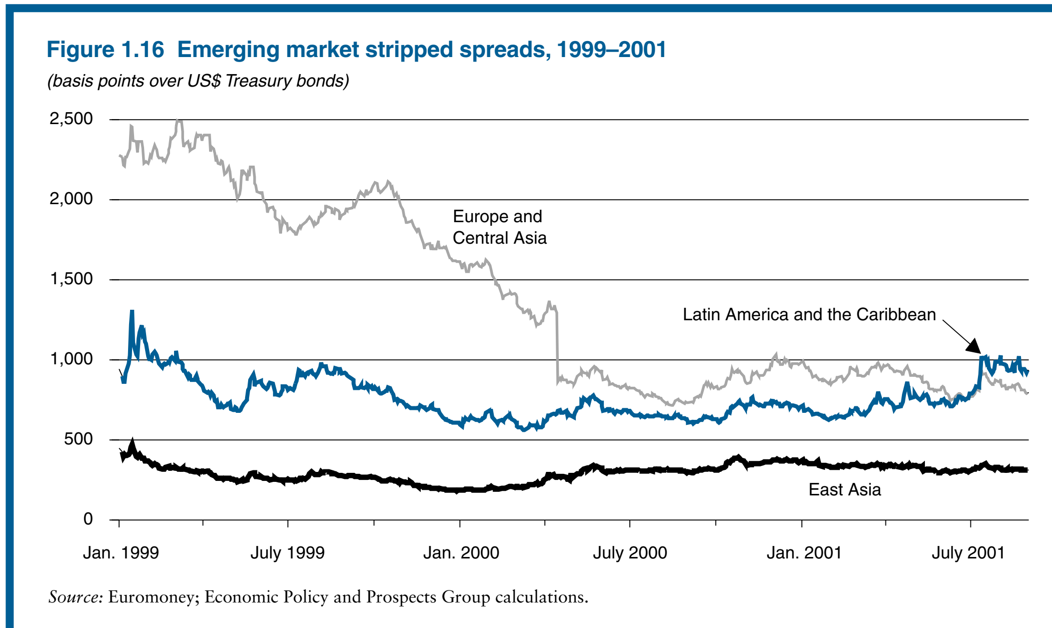
*(as a percent of exports**)*



Note: *Low- and middle-income (developing) countries. **exports of goods and services plus workers' remittances.
Source: Global Development Finance 2001, World Bank.

Figure 1.16 Emerging market stripped spreads, 1999–2001

(basis points over US$ Treasury bonds)



Source: Euromoney; Economic Policy and Prospects Group calculations.

level, Latin America has one of the highest debt-to-exports ratios, and at the same time the largest share of private debt in total debt. As a result, debt from private sources as a share of exports in Latin America is more than twice as large as in any other region. This makes Latin America particularly vulnerable. Potentially the region can benefit from lower international interest rates, but is at the same time most susceptible to reduced availability of funds for refinancing. This vulnerability translates into a larger increase in Latin American spreads than in other regions (figure 1.16). The heterogeneous debt picture across developing countries requires diverse policy responses. While for countries with large reserves and low debt, some macroeconomic easing may be warranted to stimulate the domestic economy; others face harsh, but ineluctable, fiscal adjustments.

Region-specific factors will complement coming recovery

Developments in the world economy, if they evolve as anticipated, will create a more favorable external environment for renewal of growth in developing countries later in 2002. Aggregate growth rates for the developing countries are likely to bounce back from their fall to 2.9 percent in 2001 to a projected 3.7 percent in 2002 and 5.2 percent in 2003. The dynamics of this cycle are likely to be much different from earlier downturns in the global economy—and to be heavily conditioned by structural changes in trade and financial markets.

Although the initiating factor driving recovery among developing countries will be the resumption of growth in the industrial centers, this should be augmented by conditions specific to developing regions and major countries. For example, an important factor rekindling growth in East Asia should be a recovery of intra-region trade, following the return of more buoyant demand conditions in the United States and Europe. In Central and Eastern Europe progress toward accession to the EU, albeit more protracted, should serve to underpin policy reforms and set the stage for more robust growth as Western Europe emerges from its slowdown. The degree of near-term success of reforms in the larger developing and transition economies—Brazil, China, India, Indonesia, and the Russian Federation—will also prove critical elements in the outlook, as these countries address issues ranging from fiscal and financial sector

reforms, privatization, or trade liberalization. China's imminent accession to the World Trade Organization could spur its growth and contribute to further global integration.

East Asia and Pacific . . . trade slump leads to sharp growth slowdown. . .

EAP experienced an unprecedented deceleration of exports in 2001, as noted in previous sections. Export growth plummeted 25 percentage points, mainly following the collapse in global high-tech markets and the fall in Japanese and U.S. import demand. Worsening of financial conditions, reflected in higher spreads, was limited to highly indebted countries such as Indonesia and the Philippines. Relatively low debt levels, current account surpluses, and large foreign reserves tended to insulate other countries from contagion.

The sharp drop in manufacturing exports resulted in significant output declines—close to recession levels in some of the small, open economies. However, carryover effects from last year resulted in positive annual growth rates for most countries, while continued strong, albeit somewhat less dynamic growth in China keeps regional growth near 4.5 percent in 2001.

The strength of next year's rebound will primarily depend on the vigor of the trade recovery and on policy responses to the deterioration of the financial environment. Signs that the high-tech markets have potentially passed trough levels are becoming clearer, but it remains uncertain whether the upswing in these markets will be as strong as they were during the last decade. And slower U.S. growth in the wake of September 11 developments will dampen near-term export prospects.

Export growth during the coming two years is expected to register 6.5 and 11.5 percent respectively. This is only 1 to 2 percentage points above export market growth, while in previous years the difference between export performance and export market growth was much larger, averaging 6 points over the 1990s, reflecting the high-tech specialization of East Asia. In that sense, the current forecast is a cautious view on near-term developments. Low inflation in most countries provides the opportunity for further monetary easing. However, strengthening of financial systems may be equally as important as domestic stimulus at the moment. Under cautious assumptions about trade recovery and domestic policies, and assuming no clear-cut financial crises, the forecast implies growth rates of 5 and 6.8 percent in 2002–03 respectively.

Latin America . . . global context and financial stress in Argentina exact a toll on growth

Developments during 2001 proved much more challenging than anticipated in the spring of the year, and have turned yet more adverse following September 11. Slackening world trade and weakening commodity prices contributed to slower growth in many Latin American countries. The region's merchandise export volume fell from a 12 percent advance in 2000 to about 2 percent, following a similar decline in export market growth. At the same time the region endured terms-of-trade losses, equivalent to 0.2 percent of GDP in 2001. For commodity-dependent Central American countries, this measure dropped by a full percentage point in the year. Caribbean countries were hit hard by a sharp reduction in tourism earnings after the terrorist attacks in the United States.

More important than the deterioration of the trade environment were changing conditions in financial markets. Rapidly declining U.S. interest rates provided a degree of relief for some highly indebted countries by reducing interest payments on debt. But international capital markets were less forthcoming than anticipated, and a number of countries had difficulties in financing maturing debt. Argentina's fiscal strains and Brazil's drought-induced shortage of hydroelectric power were among the domestic factors that created an inflammable mixture with the worsening of the external environment. GDP growth in the region was constrained to 0.9 percent—a decline of 2.9 percentage points from the 3.8 percent performance of 2000.

GDP growth in 2002 accelerates to 2.5 percent in the current projections. However, this point estimate is surrounded by a high degree of uncertainty, as it assumes that those countries under financial pressure in 2001 are able to avert further adverse developments. Latin America's high debt and continued large financing requirements will keep risk perceptions elevated, due to the region's strong reliance on volatile private capital markets. Argentina's struggle to establish sound footing for its fiscal position and debt burden continues to depress its immediate prospects. Many large countries are facing elections in 2002 (Brazil and Colombia), with the potential for domestic shocks remaining high. But macroeconomic management in many of the larger countries has improved steadily over the course of the 1990s, laying the groundwork for higher sustainable growth in the medium term.

In 2003, rebounding world output and trade activity should be supportive of a substantial recovery in Latin America, reflected in 4.5 percent GDP growth, powered in part by a revival of export growth to over 9 percent.

Europe and Central Asia . . . prospects worsened by EU downturn

The drop in export market growth from 12 percent in 2000 to 5 percent in 2001 was not as sharp for the ECA region as for others. This mainly reflects that the slowdown in Western Europe, accounting for 50 percent of ECA's exports, started half-a-year later than in the United States and Japan.

Despite the smaller than average drop in exports (about 13 percentage points), the deceleration of output growth was larger than in any other region, from 6.3 percent in 2000 to 2.1 percent in 2001. This reflects the combined outturns of a strong contraction in Turkey's GDP after recent financial upheaval; a return to more moderate growth rates in Russia—and other hydrocarbon exporters—after an unusually robust expansion of near 8 percent in 2000; and tight monetary policy in several Central European countries, notably Poland and Hungary, leading to appreciation of currencies during the first half of the year. With financial stress in Turkey, Western Europe needing time to recover, oil prices expected to decline, and a possible hiatus in progress toward EU accession,[8] a sharp and quick recovery of economic activity in the region is unlikely. In the Commonwealth of Independent States (CIS), GDP growth is expected to decelerate further to 3.2 percent in 2002, due in large part to the easing of oil prices. In the absence of high oil prices, significant institutional and structural impediments remain a constraint to achieving higher sustained rates of growth. GDP growth in the CIS is likely to achieve a 3.5 percent pace in 2003.

In Central and Eastern Europe, the potential for solid growth exists in the medium run. Two key assumptions underlying this performance are that the EU accession process stays, generally, on track—albeit with some transitory difficulties. And that Turkey is successful in reestablishing macroeconomic stability, paving the way for a recovery over the coming period, driven in part by strong export growth, due to some extent to the fall of the Turkish lire. A gradual recovery to stronger performance in the region would yield growth of 3 percent in 2002, rising to near 4.5 by 2003. Contagion from the financial strains in Turkey has been limited thus far, with average spreads following a downward trend. This development has been supported as well by higher oil prices serving to ease some of the financial tensions that caused the Russian crisis. Nonetheless, financial risks remain substantial and could drastically change the outlook.

South Asia . . . less affected by global slowdown

SAS, less integrated into the global economy, is generally less affected by the deteriorating global environment, although uncertainty is exceptionally high because the region could be directly affected by the ramifications of the terrorist attacks in the United States. GDP is projected to slow only moderately, from 4.9 percent in 2000 to 4.5 percent in 2001. Growth is

then expected to remain near a rate of 5.4 percent over the short-term forecast period. This reflects not only a relatively low level of global integration across much of the region, but also some positive domestic factors within many of the countries. Agricultural sectors, at least outside Pakistan, are expected to perform better than last year, when weather conditions were highly unfavorable. However, the most significant contribution to growth will be the continued buoyancy of India's large domestic service sector, which is expected to grow at about 8 percent over the next few years. Of course, the sharp deceleration in global trade has depressed growth in regional manufacturing production to only slightly above 1 percent, but because this sector accounts for approximately 25 percent of regional economic activity, the aggregate impact has been somewhat muted.

Government subsidies have been used over the last several years to cushion the impact of high oil prices and poor crop production on consumer prices—which in turn is being reflected in growing fiscal and current account deficits. For both India and Pakistan, central government fiscal deficits—of 5.3 percent and 5.8 percent respectively—have become major impediments to an acceleration of growth. India's fiscal deficit is considerably higher on a consolidated basis, including regional governments. Pakistan's fiscal woes are being compounded by its deteriorating current account position, which reflects higher oil prices and interest payments, as well as drought-affected declines in export revenues. This has come at a time of high levels of public debt and low foreign reserves, and Pakistan was forced to turn to the IMF to help finance the current account. Pressure on the current account may not ease in the short run, because a severe water constraint for irrigation is likely to significantly reduce cotton output, the main foreign exchange earner for Pakistan. Aside from economic developments, Pakistan's position on the "front line" of military action against Afghanistan will carry substantial near and medium term implications.

Risks are substantial for the region. Political uncertainty hangs over Afghanistan, and ineluctably implies future uncertainty for the subcontinent. Structural problems also entail risks. Financial strains in India and Pakistan, left unattended, would significantly reduce the opportunities for the region to benefit fully in coming years from a recovery in the global economy, and jeopardize the promise of regional growth. The ending of a preferential trade agreement with the United States—which accounts for 30 percent of Bangladesh's exports—may damage the Bangladeshi clothing sector, but this will probably be more than offset in 2002, when Bangladesh will receive duty-free access to European markets for its garment exports.

Middle East and North Africa . . . high oil prices and reprieve from drought boosts near-term growth

Oil revenues—which account for almost two-thirds of the region's export revenues—provide the MNA region with a short-term outlook that is better than other regions. In 2001, the oil-exporting countries benefited not only from strong export revenues, but also improved fiscal positions and higher rates of investment. Among the diversified exporters, agricultural production and rural incomes received a strong boost from a reprieve of long-standing drought conditions in some parts of northern Africa. Growth in Morocco, for example, is anticipated to accelerate strongly after consecutive years of stagnant or declining output.

While higher oil prices and recovery from droughts in 2001 have provided a fillip to growth, the delayed recovery in industrial countries will significantly reduce the external impetus to growth at end-2001 and into 2002. World demand has slowed, and oil prices are expected to fall to $21 per barrel by 2002. Growth in the oil-dominant economies will slow to 2.3 percent in 2002. The diversified exporters are similarly affected. Demand is now slowing sharply in the EU—the dominant export market for the countries of the *Maghreb*—and in the United States, of importance to several countries in the *Mashreq*. Lower income

growth and the erosion of confidence after September 11th will also affect tourism and related sectors in the region in a substantial fashion. For some of the diversified exporters, increasing levels of public debt make it relatively hard to cope with the current deterioration of the external environment. Increasing spreads threaten to worsen debt dynamics for several countries. Growth in the diversified exporters should improve in 2003, as external conditions become more favorable to exports and tourism—although the improvement in the international context is expected to be gradual. And the MNA region will face increasing competitive pressures as the countries of Central Europe enjoy greater access to the EU.

Sub-Saharan Africa . . . suffering from low commodity prices

In 2001, the world economic slowdown temporarily derailed SSA gradual recovery from the late 1990s slump. Average growth across the region slowed to 2.7 percent from 3.0 percent in 2000, and with population growing at 2.5 percent, per capita GDP barely increased at all. Despite generally better supply conditions in commodity producing sectors, weak demand in industrial countries held export volume growth to 3.4 percent. Services, including tourism also felt the impact, growing at 3.6 percent. A widespread deterioration in terms of trade compounded the difficulties for many countries. Agricultural and mineral commodity export prices plummeted due to a combination of weaker demand and a delayed supply response to the price surge of 1995–97. Oil prices also weakened, although oil exporters continued to benefit from buoyant terms of trade and strong foreign investment demand. Not surprisingly, oil exporters average growth of 3.6 percent significantly outperformed the rest of the region, where growth registered 2.6 percent for the year.

Given the steep decline in developed countries activity toward the end of 2001, and the prospect of a sluggish recovery in the first half of 2002, the near term outlook for SSA is pessimistic. The forecast anticipates 2.7 percent growth in 2002, with per capita incomes again flat. However, the recovery in developed countries is expected to gather pace over the coming year and set the stage for a strong rebound in 2003, with growth rising to 3.9 percent. Non-oil exporters should see a substantial improvement in performance, as commodity markets firm and prices stabilize or even rise modestly in real terms. By contrast, oil producers face sharply weaker export prices and declining terms of trade. Significant new capacity, especially in offshore development will help to offset the negative impacts by allowing production and exports to increase. However, spillovers to non-energy sectors will be limited and oil exporters' growth is expected to slow as the boom unwinds.

Risks to the outlook

The specter of a sharper slowdown in industrial countries haunts the outlook—

Risks to this forecast are unusually high. The terrorist violence in the United States in September will undoubtedly have negative short-run consequences for the U.S. and global economy. But it is difficult to predict the severity of the adverse effects because the response of consumers and businesses—and even future policies—are unknown. These uncertainties overlay structural risks that in other contexts would be more manageable. U.S. consumers may be less responsive to interest rates than on previous occasions as the stock market falls, high consumer debt, and heightened insecurity may render them more cautious; or foreign investors might become concerned about the persistently high U.S. current-account deficit, and impose an abrupt adjustment; these events in turn would delay the recovery of investment and its implied demand for high-tech imports. The European downturn may become more severe once market sentiment deteriorates further, or monetary policy does not ease sufficiently or have the expected effects. Japan's structural reforms may falter or exact a higher toll on economic performance, and cause the dip in 2001 to last into

Table 1.4 First year effects of a 2 percent of GDP decline in investment in the United States, Europe, and Japan
(percentage points impact on regional GDP)

East Asia and Pacific	Latin America and the Caribbean	Sub-Saharan Africa	Europe and Central Asia	Middle East and North Africa	South Asia
–1.5	–0.5	–0.9	–0.4	–0.4	–0.3

Source: Economic Policy and Prospects Group.

the next year. Thus, with the global economy in precarious balance, unforeseen shocks from whatever source are magnified and could push the global economy into recession.

What would be the consequences for the developing countries of a further slowdown in the industrial regions? We model simulations of synchronous downturns in the United States, Europe, and Japan. For each, the simulation assumes a decline in domestic investment of 2 percent of GDP, spread over four quarters, which is counterbalanced by monetary policy reactions, which leads to a shift in the business cycle. The monetary reactions follow historical patterns, with the United States quickly reacting to the fall in output with an accumulated drop of 2.5 percentage points in interest rates. European policy, much more focused on inflation, is less aggressive, and interest rates fall by 1 percentage point. In Japan, the scope for further lowering of interest rates is minimal as rates are close to zero in the baseline. The result of the differences in policy reactions is a weakening of the dollar both against the euro and the yen. Table 1.4 shows the first year effects of these simulated downturns on developing regions. East Asia is hardest hit followed by Sub-Saharan Africa. Indeed, the negative effects of a European recession on developing countries is generally larger than the impact of a U.S. or Japanese recession. A Japanese recession has fewer repercussions, due in part to the smaller size of Japan in world trade (see box 1.1).

The impact of a U.S. recession is mitigated by a strong monetary policy response and, more importantly, by the strong and widespread effects of that reaction. Latin American countries in particular may benefit from a sharp decline in dollar interest rates. The euro interest rate is less important than the dollar rate in the international financial system. Furthermore European trade linkages with Africa, Central Europe, and some Latin American countries are relatively strong. These features illustrate why the recent slowdown in Europe, on top of low or negative growth in the United States and Japan is especially worrisome for developing countries. The negligible short-term impact of the U.S. shock on Latin America as a whole is the outcome of very diverse country-specific effects, strongly negative for Mexico and positive for Argentina. The latter result is mainly driven by the weakening of the dollar in the simulations. However, this positive impact appears to be only temporary.

The medium-term dynamics of downturns in the industrial countries differ markedly. Figure 1.17 shows the impact on global GDP in the years after the shock. For example, the first year after the U.S. shock, global GDP is 0.6 percent lower than the baseline, and three years after the shock it has returned to baseline levels. So the impact is not a permanent change in the level of global GDP, but rather a shift in the timing of the business cycle. While the rebound after a U.S. downturn is likely to be quicker as a result of monetary easing, it may create tensions in the medium run because of the monetary impulses to the rest of the world. Lower interest rates potentially boost domestic demand in other countries to compensate for export losses. In the medium run this may result in inflationary tensions that give rise to a new downturn. The dynamics after a Japanese crisis show a different picture. Because of limited options for monetary easing, it takes several years

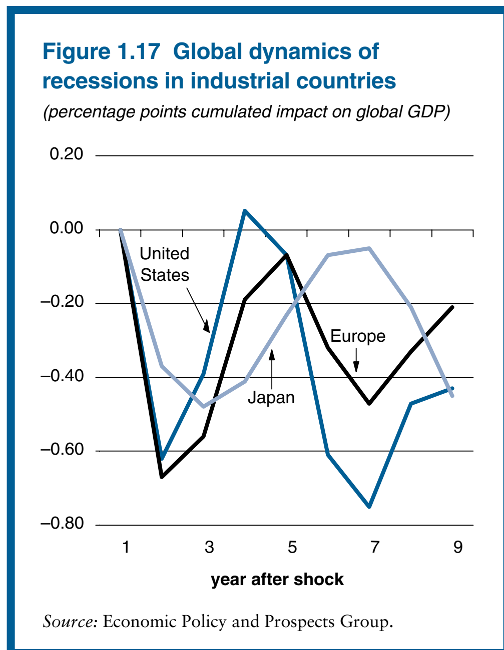


Figure 1.17 Global dynamics of recessions in industrial countries

(percentage points cumulated impact on global GDP)

Source: Economic Policy and Prospects Group.

to rebound, with a more protracted, but less pronounced, impact on the global cycle. The analysis suggests that a European recession gives rise to global dynamics somewhere in between the other two. Again we see that a European recession on top of a U.S. recession is potentially dangerous. It could lead to a more protracted rebound, while at the same time aggravating medium-term tensions.

—while financial instability is another risk

The previous analysis explored the effects of slower growth through the main international transmission mechanisms: trade and international interest rates. To illustrate the importance of financial flows (here, bank lending), we simulated a temporary withdrawal of short-term bank lending from the three industrial regions, along with a general increase in emerging market spreads and a country-specific increase in spreads, depending on the reduced net capital inflows in terms of import coverage. In four quarterly steps the short-term debt owed to industrial-country banks is halved, after which the original debt is gradually restored.

Table 1.5 Short-term claims of international banks outstanding in selected developing regions

(as of end December 2000; percent of annual imports of debtor countries)

Creditor	Japan	North America	Europe	Total
Debtor region				
Africa	2.7	4.6	33.6	40.9
East Asia and Pacific	3.8	1.5	11.9	17.2
Europe and Central Asia	0.9	2.0	26.4	29.3
Latin America and the Caribbean	1.8	10.8	36.9	49.5

Source: BIS; Economic Policy and Prospects Group.

Table 1.5 shows the short-term exposure of industrial countries' banks in selected developing regions as a percentage of the region's annual import bill. These economies account for two-thirds of all short-term borrowing by developing countries from international banks.

The data show that the claims of European banks are six to seven times larger than the exposure of U.S. and Japanese banks. Moreover lending by European banks is much more diversified, while Japanese banks are focused on East Asia, and U.S. banks on Latin America. Consequently, banking problems in Europe are potentially more disruptive for a broad range of developing countries than similar problems in Japan or the United States, albeit that the probability of European financial strain is much lower than of escalating tensions in Japan. The simulation results highlight the dominance of European banks and the large negative impact of a withdrawal of their lending on GDP in all the debtor countries considered (table 1.6).

Apart from the magnitude of the shock, domestic conditions in the borrowing countries determine the impact. The shock is more detrimental if reserves are low or foreign debt is high relative to exports. In general, the initial reduction in foreign funds is absorbed in three ways: by attracting alternative foreign capital at the cost of higher interest rates; by improving the current account at the cost of domestic

Table 1.6 Withdrawal of short-term lending by industrial-country banks to selected developing regions: the first-year impact on GDP

	United States banks	European banks	Japanese banks
East Asia	–0.1	–1.4	–0.1
Eastern Europe	0.0	–1.3	0.0
Sub-Saharan Africa	–0.1	–2.1	–0.1
Latin America	–0.4	–4.4	–0.1

Source: Economic Policy and Prospects Group calculations.

recession and by reducing foreign reserves at the cost of becoming more vulnerable to future shocks. For example, the Republic of Korea would replace, in the simulation, a quarter of the lost short-term capital by other capital inflows, reducing its capital needs by roughly 10 percent of the shock, and absorbing the remaining 65 percent of the shock by selling foreign reserves.

For countries with a low initial level of foreign reserves, such as Brazil, reducing reserves much further would not be a viable option. Therefore, the withdrawal of short-term lending would directly translate into a domestic credit crunch. For countries with high external debt, such as Indonesia, Argentina, or Brazil, an improvement of the current account is difficult because higher spreads result in higher debt service. This would put more weight on the contraction of the domestic economy.

Long-term prospects: growth and poverty reduction

Despite the weakening of growth and uncertain present context, long-term prospects remain relatively promising for developing countries. Moreover, it should be noted that the rate of GDP growth established by developing countries even in the sluggish global year 2002 (3.7 percent), contrasts favorably with historic experience—some 0.2 percentage points above the average performance of the 1980s, and 0.5 points above outturns for the 1990s. And longer term prospects hold the promise of continued bettering of historic performance, with advances in per-capita GDP rising to 3.6 percent over the period from 2005–2015, two full percentage points higher than the experience of the 1990s.

While the near-term outlook for developing countries is heavily influenced by the international business cycle and global environment, long-term development trends are more directly the result of economic fundamentals—savings, investment, population growth, trade and productivity improvements as well as policy in the various regions. Analyzing these factors allows us to study possible paths of development and ways developing countries might interact with the global economy over a longer period.[9] To do so, we create a long-term growth scenario and analyze its consequences for development.[10] This scenario allows us to test the realism of growth and poverty reduction objectives, given reasonable expectations about fundamentals and current policies. The scenario also provides a baseline against which to simulate policy changes. In chapter 6 we return to long-run analysis and use the baseline to analyze the effects of global reductions of barriers to trade.

Long-term growth: A baseline scenario

Income growth in the developing countries under the baseline scenario for 2005–15 would be 3.6 percent in per capita terms, more than 1 percentage point above the per capita growth rate of the high-income countries and 2 percentage points higher than during the decade of the 1990s (table 1.7). Developing countries are expected to benefit from reforms carried out over the past decade. The policy environment is much improved, especially in major countries in virtually all of the regions. Tariffs have come down sharply in the last decade, and as a result economies are more open, with trade ratios 50 percent higher than a decade ago. Macroeconomic policies are improved; because government budget deficits are lower now than in the late 1980s and median inflation rates have been halved. These efforts to improve policies constitute investment in better long-term prospects, and will allow regions to take ad-

Table 1.7 Long-term prospects: forecast and scenario growth of world GDP per capita
(annual average percentage change)

			Forecast	*Scenario*
			Medium-term	Long-term
	1980s	1990s	2000–04	2005–15
World total	1.4	1.2	1.4	2.1
High-income countries	2.4	1.8	1.8	2.5
OECD	2.5	1.8	1.8	2.4
United States	2.2	2.2	1.7	2.2
Japan	3.4	1.1	1.1	2.6
Euro Area	2.2	1.8	2.2	2.7
Non-OECD countries	3.7	3.8	2.3	4.2
Developing countries	1.5	1.6	2.8	3.6
East Asia and Pacific	6.1	6.0	4.8	5.4
Europe and Central Asia	2.7	–2.5	3.2	3.5
Latin America and the Caribbean	–0.9	1.6	1.5	2.6
Middle East and North Africa	–0.6	1.0	1.4	1.4
South Asia	3.5	3.3	3.5	4.0
Sub-Saharan Africa	–1.2	–0.5	0.9	1.5
Memorandum items				
Transition countries of ECA	2.7	–3.2	3.7	3.5
Developing countries,				
excluding ECA	1.4	3.0	2.8	3.7
excluding China and India	0.8	0.4	1.8	2.7

Note: Aggregations are moving averages, reweighted annually after calculations of growth in constant prices.
Source: Economic Policy and Prospects Group.

vantage of underlying momentum on economic fundamentals—savings rates, educational investments, population growth rates, and improvements in productivity. And the external environment is poised to provide a more supportive long-term context that redounds to the benefit of the developing countries.

The acceleration of growth in the developing countries seems, on first sight, somewhat more spectacular than it actually is. First, excluding the transition countries, the next five years feature a decrease of 0.2 percentage points relative to the 1990s, before accelerating by 0.9 percentage points to a 3.7 percent rate of per-capita growth. Second, about two-thirds of the acceleration is the result of so-called composition effects. Fast growing countries such as China have now a larger weight in the total than they had ten years ago, increasing the growth rate of the developing countries on aggregate, even without increasing its own rate of growth.

Internal factors and policies drive differing regional performance. *East Asian countries* would not be able to maintain the exceptionally high growth rates of the 1980s and early 1990s, but, on the strength of high savings rates and productivity, would continue its 30-year pattern as the most rapidly growing region. China's growth will naturally slow as its economy becomes larger and more modern, but still has scope to growth at 6 to 7 percent annually over the period (see World Bank 1997: *China 2020*). The countries in East Asia—should their savings rate persist at high levels—could well see capital accumulation account for nearly two-thirds of their overall growth rate, with about 30 percent generated by productivity increases. *South Asia* would follow a fairly similar pattern, although with somewhat more contribution from labor supply growth and less from technological improvement.

For *Latin America*, the scenario assumes that the latent, but undeniable, growth poten-

tial in Mexico, Brazil, and Argentina, as well as other economies, is progressively realized. Better fiscal management and greater hemispheric and global integration are likely to provide powerful forces that reduce debt burdens which in the past have shackled growth on the one hand, and, on the other, can unleash new productivity. The contribution of capital accumulation in Latin America will be about twice the contribution of productivity, with the contribution from labor supply growth less than 15 percent on average.[11]

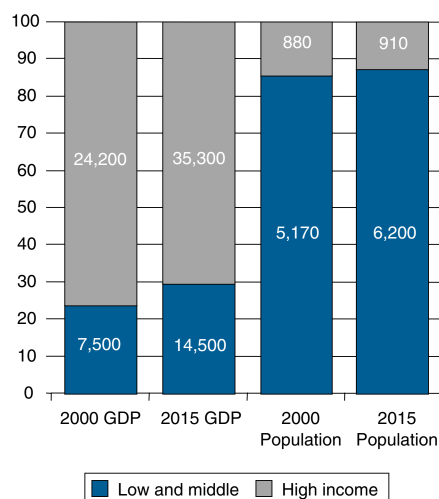
The countries of *Eastern Europe and Central Asia* are expected to grow quite rapidly, continuing a recovery from the transition-generated depression of the early part of the 1990s. Further openness among Central and Eastern European countries to trade and financial integration with the EU, together with the reestablishment of the conditions of peace in Southeastern Europe, should provide a favorable context for these countries to grow. Both Eastern Europe and Central Asia will rely extensively on productivity growth, with labor supply growth either stagnant or in decline.

While *the Middle East and North Africa* would improve rates of per capita growth relative to the historic period, growth under this baseline scenario is likely to make only modest impact on achieving the International Development Goals (IDG). Consistent with relatively high population growth rates, growth in the Middle East and North Africa will be accounted for by labor supply growth—between 25 and 40 percent. Productivity growth will have to be fairly sustained—between 35 and 60 percent of total growth—to achieve the IDG GDP targets.

The external environment is likely to be supportive. Even though today's environment is exceptionally weak, new technologies and further economic integration could indeed produce higher productivity-led per capita growth in high-income countries of 2.5 percent versus 1.8 percent during the 1990s. The *U.S. economy* is expected to recover to a long-term trend that is somewhat higher than in the medium-term forecast because of the effects of technology-driven

Figure 1.18 Income and population shares

(income in billions of 1997 dollars using market exchange rates, population in millions—percent)



Source: Economic Policy and Prospects Group and World Bank Data and Projections (Population).

productivity growth. *Europe*, with a lower initial level of integration, has somewhat greater scope for productivity improvements as it adopts new technology and becomes more integrated. *Japan* is expected to emerge from its current restructuring with a more efficient system of allocating capital, and this will allow it to regain a degree of growth momentum, even though its aging population profile adds more drag to its growth. If this scenario for the industrial countries is realized, capital flows to developing countries could well resume within the context of a high productivity, low inflation, low interest rate environment.

Between 2000 and 2015 world income would, according to the scenario, expand by 60 percent—some $18 trillion (in 1997 dollars) (figure 1.18). Income in the low- and middle-income countries would almost double, and account for over 37 percent of the increase in world output. Over 1 billion persons will be added to world population, reaching some 7.1 billion. Over 97 percent of the pop-

ulation increase will occur in low- and middle-income countries, with the high-income countries expected to add only around 30 million persons in total.[12]

Poverty trends

Growth will substantially reduce the number of people living in poverty. With base case growth, the total number of destitute poor, living on less than $1 per day, would decline to about 750 million persons in 2015, down from 1.15 billion in 1999 (table 1.8). The number of people living on $2 per day or less would decline by 600 million, from 2.8 billion to 2.2 billion. While this rate of poverty reduction would be sufficiently robust to achieve the target of reducing poverty by one-half in 2015,[13] not all regions would succeed. Sub-Saharan Africa would be far from reaching the goal even under this favorable growth scenario. Moreover, should growth in developing countries turn out to be less than the 3.6 percent per capita of the baseline scenario, the world as a whole would not reach the target.

Nonetheless, these projections would continue the reduction of the number of people living in poverty that began roughly about 1980. Up through the 1970's, long-term increases in population swamped the growth effects in the global economy and the number of people living below $1 day increased (figure 1.19).[14] However, since 1980 faster growth, particularly in China and South Asia, has contributed for the first time in recent history to a steady decline in the number living in destitute poverty. These new projections confirm that trend.

The new projections represent slight reductions in out-year poverty relative to last year's forecast. The changes largely reflect updated information on poverty and income distribu-

Table 1.8 Regional breakdown of poverty in developing countries

	Number of people living on less than $1 per day (millions)			Number of people living on less than $2 per day (millions)		
Region	1990	1999	2015	1990	1999	2015
East Asia and Pacific	452	260	59	1,084	849	284
Excluding China	92	46	6	285	236	93
Europe and Central Asia	7	17	4	44	91	42
Latin America and the Caribbean	74	77	60	167	168	146
Middle East and North Africa	6	7	6	59	87	65
South Asia	495	490	279	976	1,098	1,098
Sub-Saharan Africa	242	300	345	388	484	597
Total	1,276	1,151	753	2,718	2,777	2,230
Excluding China	916	936	700	1,919	2,164	2,040
	Head count index (percent)			Head count index (percent)		
Region	1990	1999	2015	1990	1999	2015
East Asia and Pacific	27.6	14.2	2.8	66.1	46.2	13.5
Excluding China	18.5	7.9	0.9	57.3	40.4	13.3
Europe and Central Asia	1.6	3.6	0.8	9.6	19.3	8.7
Latin America and the Caribbean	16.8	15.1	9.7	38.1	33.1	23.4
Middle East and North Africa	2.4	2.3	1.5	24.8	29.9	16.7
South Asia	44.0	36.9	16.7	86.8	82.6	65.5
Sub-Saharan Africa	47.7	46.7	39.3	76.4	75.3	68.0
Total	29.0	22.7	12.3	61.7	54.7	36.3
Excluding China	28.1	24.5	14.8	58.8	56.5	43.0

Source: World Bank staff estimates.

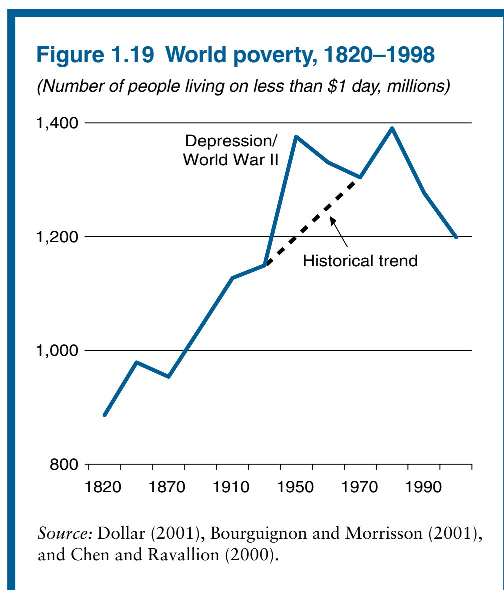


Figure 1.19 World poverty, 1820–1998

(Number of people living on less than $1 day, millions)

Source: Dollar (2001), Bourguignon and Morrisson (2001), and Chen and Ravallion (2000).

tion in several countries. The downward revision in out-year poverty is despite the adverse effect on poverty of somewhat lower long-term growth projections—the key economic determinant of poverty reduction. As discussed earlier in this chapter, the downgrading of the economic growth forecast reflects the effects of lower growth in 2001 and 2002, as well as minor revisions in long-term prospects for some countries.[15]

There are three factors influencing the current poverty forecast, reflecting updated information:

- The current forecast incorporates 31 new household surveys leading to a reduction in the assessment of the base-year level of poverty, with South Asia accounting for the greatest reduction, somewhat offset by higher poverty levels in Latin America and the Caribbean.
- Overall projected population growth in developing countries is slower, in large part due to the impacts of HIV/AIDS. This tragic epidemic particularly affects population growth in Sub Saharan Africa, which accounts for a significant part of the reduction in this year's poverty forecast.
- Revisions to the estimates of the relationship between economic growth and poverty reduction based on the new surveys, suggesting a stronger positive effect of growth on poverty reduction in several countries.[16]

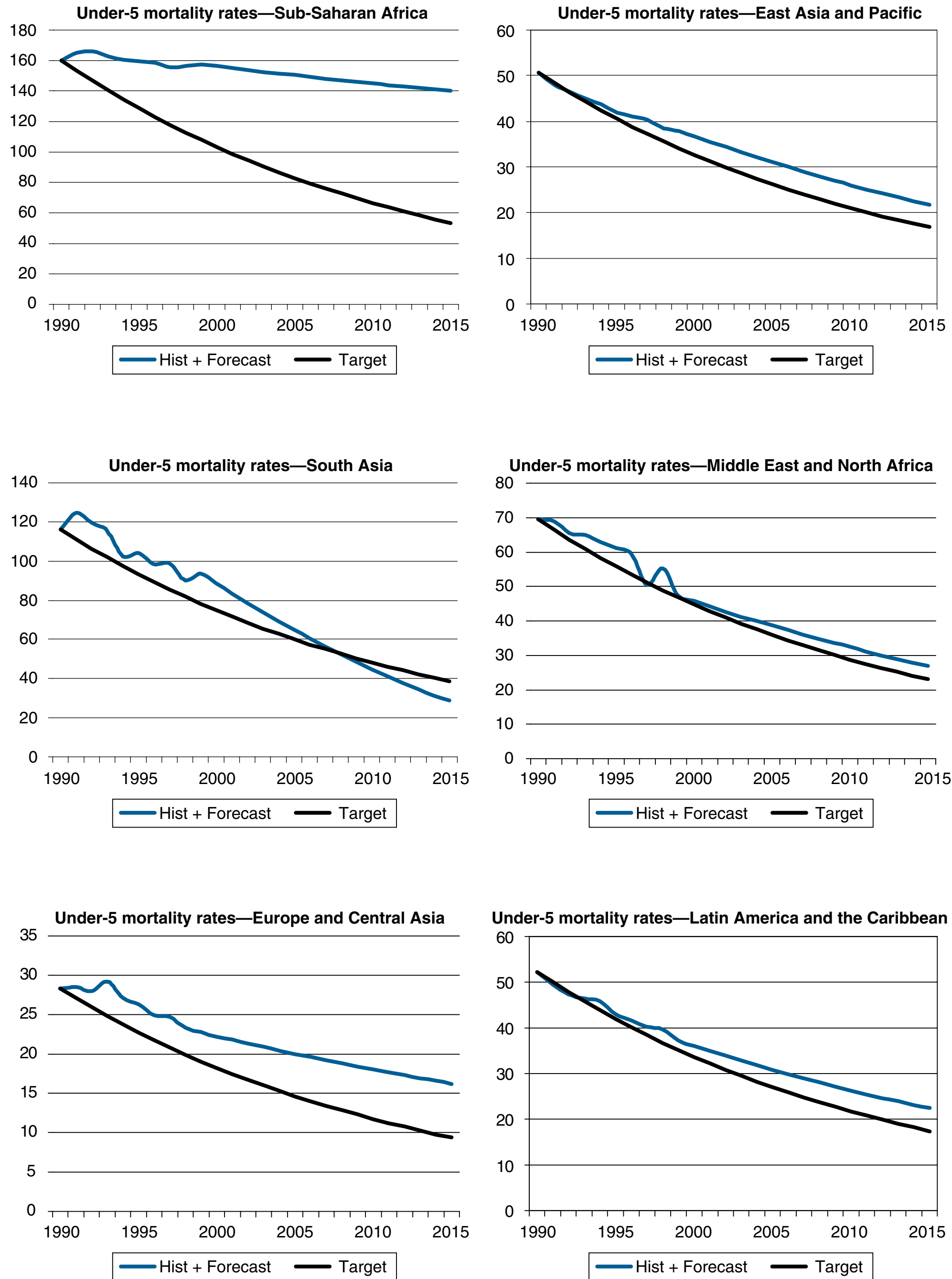
The long-term projection underscores the importance of achieving fast growth and distributing the benefits of growth equitably. Even under this scenario, the harsh reality is that over 2.2 billion persons will be living below the $2 per day income level in the year 2015—some 36 percent of developing country population. Without macroeconomic stability, improved governance and sustained structural reforms, including for example, improvements in the provision of public services and infrastructure, as well as enhancing the participation of the poor in growth, the pattern of growth that underlies the baseline scenario will not be realized, and millions more people will remain in poverty.

A faster rate of growth is possible. This report explores the potential for more rapid growth associated with an acceleration of global integration. Reducing barriers to trade in merchandise and services can accelerate growth if adequately supported by domestic policies and development assistance. These policies and their consequences, the focus of this report, are analyzed further in Chapter 6.

Under-5 mortality

One of the most important international development goals for 2015 concerns infant and child mortality. Are these goals likely to be achieved under the scenario of growth and rising incomes? To project under-5 mortality, we link long-term growth and urbanization, shown to be effective predictors of child and maternal health status and expected outcomes in under-5 mortality.[17] Figure 1.20 presents the baseline forecast and compares it with the official IDG target. The only region with a forecast achieving the goal is South Asia (SAS). Three of the other regions are likely within range of achieving the target: East Asia (EAP), Middle East and North Africa (MNA), and

Figure 1.20 Under-5 mortality—hopes and aspirations



Source: Economic Policy and Prospects Group; World Bank/Latin America Region staff.

Latin America (LAC). Europe and Central Asia (ECA) is not likely to achieve its target based on this scenario. And Sub-Saharan Africa (SSA) is well off the target path. SSA has already deviated significantly over the last decade, and the current forecast foresees little closing of the gap.

Conclusions

Both the short-term outlook and the long-term analysis underscore the importance of realizing accelerating growth. One way to create incentives to grow is for developing countries to deepen their participation in the global economy. And that is the subject of the remainder of this report.

Notes

1. Japan Financial Services Agency, January 2001, and *Japanese Banks 2000*, Japanese Bankers Association.

2. Source for data is U.S. Treasury. It should be noted that the United Kingdom accounts for about 50 percent of portfolio investment flows, channeling European and well as developing country and offshore funds into U.S. assets.

3. For example, major shipping lines increased freight rates to South Asia by 10 to 15 percent.

4. Notably, the share of U.S. export value shipped by air has risen from 25 percent a decade ago to 40 percent in 2001, with 75 percent of total high-tech exports moving by air.

5. For example, around 65 percent of holidays booked for the Caribbean had been canceled in the weeks after the attack.

6. For example, the Brazilian *real* depreciated 27 percent relative to the dollar in the first half of 2001, contributing to the 12.9 percent decline in soybean prices and 11.6 percent drop in vegetable oil prices in the same period. Indonesia's currency depreciated 21 percent (from December to April), which pushed dollar prices for palm oil and natural rubber down. Thailand, the world's largest rice exporter, had a year-to-date currency depreciation of 8 percent, contributing to a 9 percent decline in rice prices.

7. In the U.S. Pacific Northwest, 1.6 million tons of aluminum capacity has been closed—equivalent to 7 percent of world capacity—because of the electricity crisis in California.

8. Support for eastward expansion of the EU has waned markedly in existing member countries, a trend that was highlighted most recently by Ireland's "no" vote on the Treaty of Nice (which makes changes to the voting structure of the EU to accommodate a larger membership).

9. The main strategy in developing the baseline scenario is that GDP growth rates are given and the model solves endogenously for a technology parameter consistent with the GDP target. The following assumptions underlie the base-case scenario. The baseline assumes that population and labor supply growth is exogenous. The latter is proxied by the growth of the population aged between 15 and 65 years, and implicitly assumes that participation rates are constant. Agricultural productivity is fixed at 2.5 percent per year. Manufacturing productivity is assumed to be 2 percentage points greater than services productivity. International transportation margins decline by 1 percent per year in the baseline. Income elasticities are fixed at base year levels. This involves recalibrating the parameters of the consumer demand system between solution periods. Capital accumulation is modeled as the previous period's depreciated capital stock augmented by the previous period's level of investment (including net foreign investment). The model tracks capital vintages with substitution elasticities, typically lower for installed capital than for new capital. Countries with higher rates of investment will exhibit more flexibility over time. Foreign capital flows are fixed at base year levels (ensuring at least their sustainability). Fiscal policies are unchanged at their base year levels, except for direct taxation that adjusts to target a given fiscal deficit.

10. This is distinct from a forecast in the sense that unforeseeable positive or negative shocks—from technology, politics, or other sources—are virtually certain to occur, and will push up or down actual performance, especially at the regional level.

11. While one of the key outcomes of the baseline scenario is the endogenously determined productivity, many other variables of interest are generated endogenously in the baseline—relative factor prices, real exchange rates, terms of trade, bilateral trade flows, and the composition of demand and output.

12. The above analysis provides a framework for assessing the world distribution of income and rates of conversion, but says nothing about how this outcome is achieved or what policies are needed to help bring about these outcomes or even improve them. The analysis relies to a large extent on an applied general equilibrium model of the global economy. The model reflects key facets of economic theory—the most important being that supply equals demand. This framework ensures that all economic flows are fully consistent—at the individual, national, and global level. The model abstracts from some real world phenomenon, notably international financial flows are not modeled

explicitly, allowing differential rates of return across nations. Nor are there linkages between monetary phenomena and the real economy, for instance, when the model exhibits super-neutrality.

13. Reducing poverty by one-half in 2015 (compared with the 1990 level) is one of the key development goals (see for example http://www.paris21.org/betterworld).

14. Historical discussion based on David Dollar (2001), Bourguignon and Morrisson (2001) and Chen and Ravallion (2000).

15. The long-term per-capita consumption growth forecast for developing countries has dropped from 3.5 percent to 3.4 percent (average per cent change per annum), though with variation across regions.

16. The household surveys and national income accounts on which forecasts are predicated are undergoing continual review and methodological changes, especially for large countries, which can have important effects on overall poverty assessments. For example, the poverty levels for India may well be revised downward even further next year, once the new household survey has been thoroughly evaluated in conjunction with national authorities.

17. This is based on the pioneering work initiated by Quentin Wodon of the World Bank's Latin American Region. We link long-term GDP forecasts to econometrically estimated relations with selected International Development Goals (IDGs). The work undertaken in the Latin American Region has used panel estimation techniques to fit a relation between the IDGs and GDP and the rate of urbanization, two important determinants of health access. In order to allow for varying elasticities (with respect to income and urbanization levels), the LAC estimation procedure used spliced data. The forecast presented here uses a logistic function that has continuously variable elasticities (although with constant signs). The estimation procedure is based on pooled data on a regional level. It is assumed that the relation between per capita GDP growth and the rate of urbanization is uniform across countries within a region, although the elasticities themselves will be country-specific and related to the level of economic development.

References

Bourguignon, François and Christian Morrisson. 2001. "Inequality among World Citizens: 1820–1992." DELTA, Paris. Processed. (Available at http://www.delta.ens.fr/XIX/paper WD19.pdf).

Chen, Shaohua and M. Ravallion. 2000. "How did the World's Poorest Fare in the 1990s?" *World Bank Policy Department Working Paper* No. 2409. August. Washington, D.C.

Deaton, Angus, and R. Miller. 1996. "International Commodity Prices, Macroeconomic Performance and Politics in Sub-Saharan Africa." *Journal of African Economies* 5: 99–191.

Dollar, David. 2001. "Globalization, Inequality, and Poverty since 1980". Processed. Development Research Group, The World Bank, Washington, DC.

Hoshi, Takeo. "What Happened to Japanese Banks?" *Monetary and Economic Studies,* Institute for Monetary and Economic Studies, The Bank of Japan Discussion Paper Series No. 2000-E7:1–50, March 2001. Tokyo.

Kose, M. Ayan, and R. Riezman. 2000. "Trade Shocks and Macroeconomic Fluctuations in Africa." *Journal of Development Economics* 65: 55–80.

Kouparitsas, Michael A. 1996. "North South Business Cycles." Federal Reserve Bank of Chicago Working paper WP-96–9.

Mori, Naruki, S. Shiratsuka, and H. Taghuchi. 2001. "Policy Responses to the Post-Bubble Adjustments in Japan: A Tentative Review." *Monetary and Economic Studies* (Special Edition), February 2001. Institute for Monetary and Economic Studies, the Bank of Japan, Tokyo.

World Bank. 1997. *China Engaged: Integration with the Global Economy.* World Bank, Wash. DC.

———. 2001. *Global Development Finance 2001*. World Bank WDC.