

Global Outlook and the Developing Countries

The global economy continues to be weak

For the third year in a row the global economy in 2003 is growing well below potential, at an expected rate of 2 percent. The global slowdown that began in 2001 with the bursting of the equity-market bubble evolved into a subdued recovery during 2002. Initially, the sharp downturn in business investment was a critical factor behind sluggish growth, as corporations worldwide redressed the substantial financial imbalances that had emerged during the boom of the late 1990s. The pace of activity faltered again at end-2002 and early 2003 in response to events that undermined confidence: the buildup to war in Iraq, transatlantic tensions, persistent concerns about terrorism, and the outbreak of Severe Acute Respiratory Syndrome (SARS). Consumer and business confidence waned again—and so did spending.

Manufacturing production as well as GDP growth in the rich countries slowed considerably at the turn of the year. The momentum of goods production retrenched to negative territory, and G-7 GDP growth braked from an annualized pace of 2.8 percent during the third quarter of 2002 to 0.8 percent by the first quarter of 2003.

Developing countries faced a difficult environment in 2002 to mid 2003. Latin America's GDP contracted in 2002 because of political problems in Venezuela, investor concerns about Brazil in the run-up to elections, and fallout from Argentina's default. Per capita incomes will barely rise this year, despite an en-

couraging rebound in most countries of the region. Activity in South Asia is holding up well. Countries in East Asia lost some growth momentum due to SARS, but its apparent containment has opened the way to a resumption of rapid growth. Africa continues to underperform: although the region's commodity prices have firmed, they are still well below long-term trends. War has affected regional performance in the Middle East and North Africa; while many countries in Central and Eastern Europe are undergoing sluggish growth tied to lackluster conditions in Western Europe, especially in Germany.

Macro policy response has been strongly supportive, but it is approaching limits

Policymakers, particularly in the United States, reacted to the slowdown in 2001 with significant monetary easing and fiscal stimulus. The stimulus and the effects of automatic stabilizers prevented a sharper downturn in the global economy and helped improve the external environment for developing-country growth.

But the scope for substantial further macroeconomic stimulus is rapidly dissipating. Fiscal deficits threaten to become part of the problem instead of part of the solution, especially since a quick reversal of the deficit is not anticipated. The U.S. general government budget position (including Social Security), for example, shifted dramatically from a surplus of 2.3 percent of GDP in 2000 to a deficit of 3.2 percent as of the first quarter of 2003. The

Congressional Budget Office projects that the budget position is unlikely to return to surplus until 2012. In Europe, several large countries have breached the 3-percent-of-GDP fiscal deficit limits embedded in the Maastricht criteria for the common currency. And Japan has limited fiscal scope, given persistent deficits in the 6–7 percent range. Interest rates have been brought down sharply in the United States as well as in Japan, where they stand at an effective rate of zero. Following the recent 50-basis point cut in rates, Europe still has modest headroom for monetary easing should the European Central Bank choose to relax its inflation target. In fact, downward price trends in the United States and Europe have triggered concerns of possible deflation.

Activity should build gradually through 2004–05, but risks remain

Barring additional shocks, global growth should pick up to 3 percent in 2004, as firms in the rich countries make progress in adjusting balance sheets and begin to upgrade capital stock and replenish inventories (table 1.1). The financial headwinds that have constrained investment are apparently diminishing across the OECD centers. Early signs of renewed economic activity are appearing in the United States—including an upturn in orders, production, and exports, as well as firming equity markets. Yet conditions in Europe and Japan remain extremely slack. Improvement in confidence will prove the key to a revival in capital spending and growth. Following an advance of 4 percent in 2003, developing countries are likely to grow at 4.9 percent in 2004, grounded in a revival of world trade, the fading of global tensions, and the rekindling of domestic demand.

But risks to the outlook remain. First, the pace of stabilization in the Middle East remains uncertain. Second, SARS, though now apparently under control, could reemerge next flu season and would present challenges to policymakers worldwide, especially in China. Third, and more broadly, a reversal of the incipient investment rebound in the industrial

countries cannot be ruled out, as investment growth dropped sharply during the first quarter of 2003. Finally, the U.S. current account deficit is surpassing historic levels. During 2002, U.S. external financing needs claimed 10.3 percent of the savings of the rest of the world—more than double the levels of 1998. Moreover, the composition of finance also shifted toward short-term flows: net FDI flows were negative by almost \$100 billion; U.S. banks' overseas lending had ceased; and foreign official inflows (most from East Asia) increased to nearly \$100 billion, from \$5 billion in 2001. A sudden reversal in these short-term flows could undercut U.S. and world growth. The 25 percent fall of the U.S. dollar against the euro in the last 18 months represents at least a partial adjustment.

Structural reforms could boost confidence

With scope for additional macroeconomic stimulus fading, the focus of policy in the rich countries should arguably shift toward structural reforms that help restore business and consumer confidence. These could include efforts to resolve the nonperforming loan problem in the Japanese banking system and to achieve positive inflation rates there; addressing corporate governance and related issues in the United States, and needed labor market reforms in Europe. A rekindling of multilateral consensus on economic policy would also contribute to renewed confidence, which had been shaken by geopolitical tensions and security concerns.

Intensified trade underpins strong developing country growth in the long run

One important and ongoing program is the Doha Development Agenda, where progress could do much for near-term sentiment and eventually for global growth. Intensified trade relations during the 1990s and the increasingly global nature of production and distribution have sharply increased productivity in tradable sectors and drastically changed trade patterns, laying the foundation for future growth. Productivity growth in manufacturing sectors that compete in international markets

Table 1.1 Global growth should accelerate, but risks persist
Global conditions affecting growth in developing countries and world GDP

	Current estimate		Current forecasts			GDF2003 forecasts	
	2001	2002	2003	2004	2005	2003	2004
<i>Global conditions</i>							
World trade (volume)	-0.7	3.0	4.6	7.9	7.9	6.2	8.1
Inflation (consumer prices)							
G-7 OECD countries ^{a, b}	1.5	1.0	1.4	0.9	1.4	1.4	1.3
United States	2.8	1.6	1.9	1.2	2.3	2.5	2.3
Commodity prices (nominal \$)							
Commodity prices, except oil (\$)	-9.1	5.1	6.9	1.1	1.5	8.2	2.3
Oil price (\$, weighted average), \$/bbl	24.4	24.9	26.5	22.0	20.0	26.0	21.0
Oil price (percent change)	-13.7	2.4	6.3	-17.0	-9.1	4.3	-19.2
Manufactures export unit value (\$) ^c	-4.5	-0.1	4.0	-0.4	1.5	5.6	-0.1
Interest rates							
LIBOR, 6 months (\$, percent)	3.5	1.8	1.0	2.0	3.8	1.7	3.2
EURIBOR, 6 months (Euro, percent)	4.2	3.4	2.1	2.1	3.1	2.4	2.3
GDP (growth)^d							
World	1.3	1.9	2.0	3.0	2.9	2.3	3.2
Memo item: World GDP (PPP) ^e	2.3	3.0	3.1	3.9	3.8	3.2	4.1
High-income countries	0.9	1.6	1.5	2.5	2.4	1.9	2.9
OECD countries	1.0	1.6	1.5	2.5	2.3	1.8	2.8
United States	0.3	2.4	2.2	3.4	2.8	2.5	3.5
Japan	0.4	0.1	0.8	1.3	1.3	0.6	1.6
Euro Area	1.5	0.8	0.7	1.7	2.1	1.4	2.6
Non-OECD countries	-1.1	2.4	2.1	4.1	4.4	3.0	4.3
Developing countries	2.9	3.3	4.0	4.9	4.8	4.0	4.7
East Asia and Pacific	5.5	6.7	6.1	6.7	6.6	6.4	6.6
Europe and Central Asia	2.2	4.6	4.3	4.5	4.1	3.7	3.7
Latin America and the Caribbean	0.3	-0.8	1.8	3.7	3.8	1.7	3.8
Middle East and North Africa	3.2	3.1	3.3	3.9	3.5	3.7	3.9
Oil exporters	2.9	3.2	3.9	3.9	3.3	4.0	3.7
Diversified economies	3.8	2.8	2.4	3.7	3.8	3.1	4.2
South Asia	4.9	4.2	5.4	5.4	5.4	5.3	5.2
Sub-Saharan Africa	3.2	2.8	2.8	3.5	3.8	3.0	3.6
Memorandum item							
Developing countries: excluding China and India	1.7	2.0	3.1	4.1	4.1	2.9	3.9

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 U.S. dollars.

d. GDP in 1995 constant dollars: 1995 prices and market exchange rates.

e. GDP measured at 1995 PPP (international dollar) weights.

Sources: Development Prospects Group, baseline, July 2003 and GDF 2003 forecasts of March 2003.

is traditionally 1.5 percentage points higher than economy-wide productivity growth. This differential has increased to 2.5 percentage points during the last decade. Sharp technological progress in manufacturing was partly an autonomous process—driven by advances in computer technology—but was also trig-

gered by increased competition on a global scale. Developing countries as a group have benefited from the intensification of trade in manufactures and associated productivity gains, as the share of manufactured goods in their exports increased from 20 percent in 1980 to more than 70 percent in 2001.

Under a set of favorable but plausible assumptions, developing countries are expected to experience an acceleration of per capita income growth through 2015. The East Asia region is an exception because its already high growth of 6 percent annually over the last decades will be difficult to maintain, as economies mature and the gap with high-income countries narrows, even though it is likely to remain the fastest-growing region in the developing world.

Poverty remains a challenge, especially for Africa

Broad acceleration of per capita growth would translate into a sharp reduction in the incidence of poverty, from 28.3 percent in 1990 to a projected 12.5 percent by 2015, meeting, on average, the millennium development goal (MDG) of 14.8 percent. However, the gap between strong and weak performers will remain large. Even if Sub-Saharan Africa could turn falling per capita incomes into annual increases of 1.6 percent—as assumed in the baseline scenario—its rate of growth would be less than one-third the rate of growth that is expected in East Asia. The relatively poor performance of Sub-Saharan Africa makes the MDGs for that region especially challenging. For example, under the baseline scenario the percentage of people living on \$1 per day or less will be only 42.3 percent in 2015 instead of 24 percent as targeted by the MDGs.

The industrial countries: Deficits, confidence, capital spending, and the dollar

Confidence is the key to the long-awaited breakthrough to growth

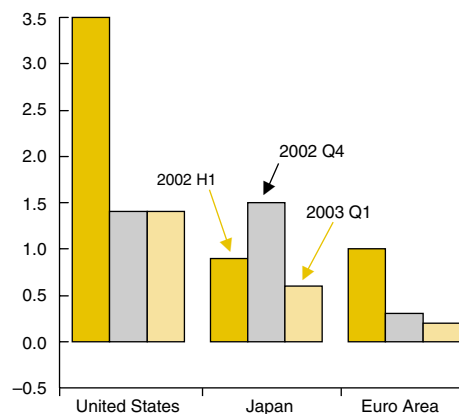
The high-income OECD countries have faced substantial difficulties in overcoming the legacies of the second half of the 1990s, including the equity market downturn. The recovery that began in early 2002 faltered after the summer of that year as the rebound in investment showed signs of weakness. Government ex-

penditure could not continue to grow at the high rates achieved in the early phase of recovery, though deficits continued to widen. Late in 2002 and through early 2003, U.S. consumption, a major driver of global demand, slowed from an earlier pace of 4 percent to near 2 percent—partly as a reflection of the dramatic drop in consumer confidence on the eve of the Iraqi conflict and partly in reaction to high oil prices and weakening of the dollar. By the first quarter of 2003, GDP growth had slowed from generally stronger first-half 2002 rates to 1.4 percent (saar) in the United States, to 0.6 percent in Japan, to 0.2 in the Euro Area (figure 1.1).

Manufacturing output advances slowed discernibly at the turn of the year, and intensified during the spring. Growth momentum in goods production suffered a “double dip,” to stand at -1.2 percent for the Euro Area, -2.0 percent for Japan, and -2.3 percent for the United States as of April-June 2003 (figure 1.2). The end to combat in the Iraqi campaign helped to boost U.S. consumer confidence from nine-year troughs reached in March; but response of consumers in Japan and especially in Europe was muted, despite an incipient up-

Figure 1.1 Growth in the OECD countries falters

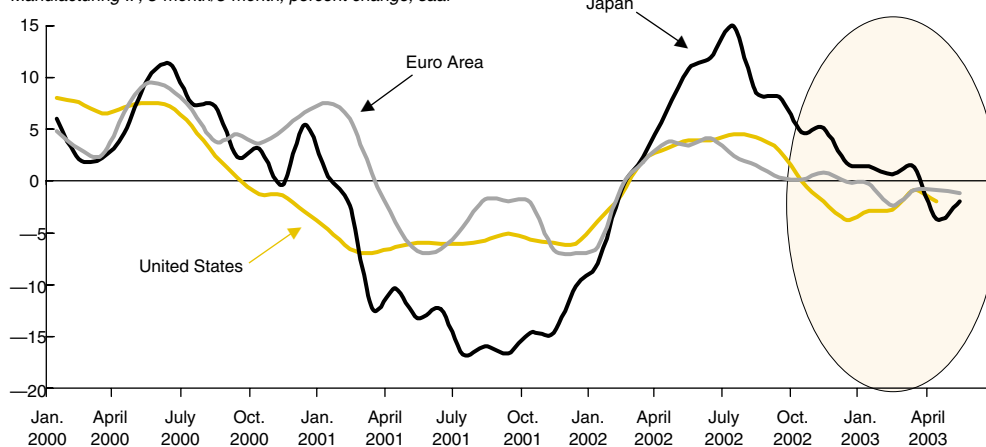
Quarter/quarter, percent change, saar



Sources: National agencies and Eurostat.

Figure 1.2 OECD manufacturing shows a distinct “double dip”

Manufacturing IP, 3-month/3-month, percent change, saar



Sources: National agencies and Eurostat.

turn in equity markets. Rather, focus returned to the set of weak fundamentals underlying sluggish growth in the rich countries—notably substantial debt overhangs in the U.S. corporate, household, and, increasingly, government sectors.

The sharp depreciation of the dollar began to yield shifts in the contribution of net exports to GDP growth (table 1.2). In the United

States, a contribution of -1.0 percentage points during the first half of 2002 changed into one of $+0.9$ percentage points in the first quarter of 2003. The opposite occurred in Europe and Japan. There, during the first half of 2002, net exports added respectively 0.9 and 1.4 percentage points to GDP growth, but these rates turned around in the first quarter of 2003, to -1.8 and -0.2 percentage points.

Table 1.2 Weak fundamentals underlie sluggish growth in the rich countries

Recent developments in GDP and components, United States, Euro Area, and Japan (percent)

Growth	United States				Euro Area				Japan			
	H1-02	H2-02	Q4-02	Q1-03	H1-02	H2-02	Q4-02	Q1-03	H1-02	H2-02	Q4-02	Q1-03
GDP	3.5	2.7	1.4	1.4	1.0	1.1	0.3	0.2	0.9	3.0	1.5	0.6
Private consumption	3.5	3.0	1.7	2.0	0.0	1.6	1.4	1.7	2.0	1.5	-0.2	0.8
Fixed investment	-2.8	0.7	4.4	-0.2	-3.2	-0.9	0.9	-4.8	-5.3	1.0	3.2	-1.9
Government	5.7	3.0	4.6	0.4	3.3	2.0	1.2	1.4	2.4	1.7	0.4	2.5
Growth contributions												
Private consumption	2.4	2.1	1.2	1.4	0.0	0.9	0.8	1.0	1.1	0.9	-0.1	0.4
Investment	1.0	0.9	1.0	-0.9	-0.5	-0.2	0.7	0.8	-2.0	1.5	0.1	0.0
Fixed capital	-0.5	0.1	0.7	0.0	-0.7	-0.2	0.2	-1.0	-1.4	0.3	0.8	-0.5
Change in stocks	1.5	0.7	0.3	-0.9	0.2	0.0	0.5	1.8	-0.6	1.2	-0.7	0.5
Government	1.0	0.5	0.8	0.1	0.7	0.4	0.2	0.3	0.4	0.3	0.1	0.4
Net exports	-1.0	-0.9	-1.9	0.9	0.9	0.0	-1.4	-1.8	1.4	0.4	1.6	-0.2

Note: H=half year; Q=quarter year.

Sources: National agencies, OECD, and World Bank data.

Although the depreciation of the dollar and turnaround in U.S. exports was a movement toward more balanced conditions, weak demand in external markets now poses special challenges for Europe and Japan. For the latter, the near-term effects of SARS in East Asia will likely exact an additional toll on exports.

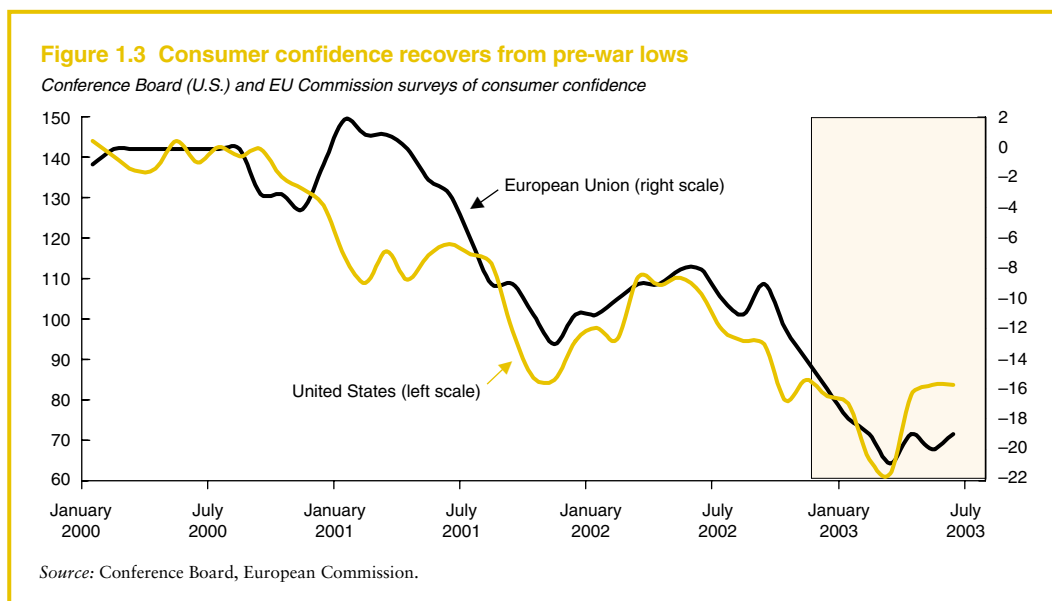
Recently, the issue of deflation has emerged in the United States, and more so in Europe in the wake of 25 percent currency appreciation and flat output growth there. Labor market conditions continued to deteriorate across the OECD centers, with expectations widely held for a more prolonged period of sub-par growth in the global economy.

From this set of initial conditions, a breakthrough to stronger growth will hinge on a restoration of confidence among consumers and businesses. Under these circumstances, and in an environment of low interest rates (coupled with moderate gains in financial markets), the standard factors that boost investment after a recession—increasing obsolescence of the capital stock, improved expectations for demand—are likely to yield a gradual upturn in the pace of investment growth, and with it a resumption of economic recovery. Indeed, some

signs of revival in the U.S. economy are now emerging, but the worst may not be over for Europe and Japan.

Consumer spending has slowed

From late 2002 to early 2003, anticipation of war in Iraq provided a “non-economic” overlay to the fundamental factors dampening consumer sentiment. Consumer confidence plunged to near-record lows on both sides of the Atlantic in the months leading up to war (figure 1.3). Though the estimated sensitivity of personal spending to changes in sentiment is surprisingly small, the relationship suggests that for the United States, the decline in confidence since late 2000, tied to economic conditions and war jitters, yielded a fall-off in consumption of a cumulative 1.2 percent, or \$75 billion (box 1.1). Recovery of U.S. sentiment since that time, boosted by incipient gains in equity markets, has been moderately encouraging. However, the Conference Board index flattened-out in May and fell in June (to 83.5) to bring the measure to its level of late Fall 2002. European confidence has recovered little, as economic growth slows and developments in Germany in particular have deteriorated markedly.



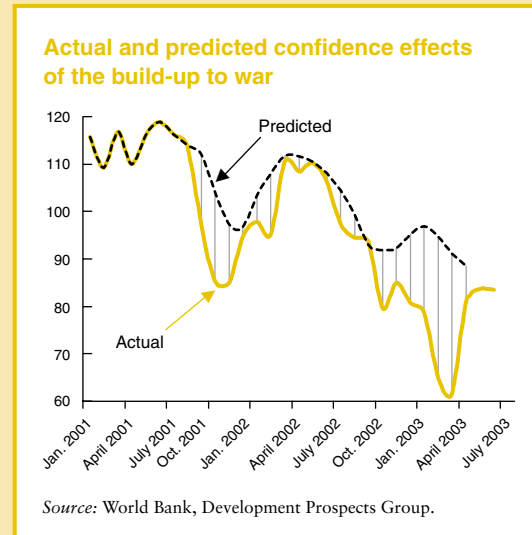
Box 1.1 Consumer confidence and U.S. private consumption

The U.S. consumer accounts for more than two-thirds of U.S. and 20 percent of world expenditure, and has contributed nearly one-third to total world GDP growth since the onset of slower growth in 2001. Consumers seemed able to shake off the depressing effects of lower confidence during this period. The bursting of the stock market bubble, with its contractionary effects on household wealth, slowed consumption and growth and revealed substantial overinvestment in telecommunications and other high-technology industries. These developments left confidence levels vulnerable to short-term events, which came in the form of the Iraq war.

The Conference Board's index of consumer confidence was down 20 percent on average in the first eight months of 2001 and dropped another 25 percent after September 11. Yet in the fourth quarter of 2001 consumers flocked back to the malls in response to generous incentives and spending surged by 6 percent (saar). By mid-2002, confidence had recouped most of the losses suffered after September, but as war in Iraq seemed more likely, confidence tumbled again, dropping a further 45 percent by March 2003, when military action began.

Economic and noneconomic determinants of confidence. The impact of noneconomic factors such as 'terrorist threats' and 'war jitters' on consumer confidence and spending can be significant. Moreover, their dynamics are different from traditional economic factors insofar as they can appear and reverse suddenly. For instance, the Conference Board's index soared 32 percent in April 2003 after a quick resolution in Iraq.

The decomposition of consumer confidence into economic and non-economic components is not straightforward. By definition, the economic component should track coincident and leading indicators such as unemployment, household debt, and stock prices. However, objective proxies for war jitters or perceptions of terrorist threats are problematic. Thus, instead of measuring the role of non-economic factors directly, we take the indirect route of regressing confidence on a set of economic variables and interpreting the residual as representing the non-economic component.¹ The results are illustrated in the figure. Note the large negative residual that appeared after September 11, 2001, although this



turned out to be short lived. But, starting in the fourth quarter of 2002 and first quarter of 2003, economic factors began yielding a sustained and substantial over-prediction. The mean squared prediction error is more than five times larger after September 2002 than before—compelling evidence of the war jitters story. By March 2003, when the war began, confidence was only two-thirds of what economic conditions alone would have indicated—the biggest discrepancy since the first Gulf War in 1991. In April, however, confidence rebounded sharply, narrowing the discrepancy to only 9 percent.

The impact on consumer spending. Many studies have found that variations in consumer confidence help to explain aggregate consumer spending, above and beyond what household disposable income and wealth can predict alone, though the effects are relatively small. A simple regression carried out for the purposes of this study yields a typical result, which implies that a 1 percent increase in confidence would raise real consumption growth by .023 percent over the subsequent year. Using this estimate, a cumulative 1.2 percent reduction in consumption, or around \$75 billion since late 2000, is attributable to the fall in confidence.

(Box continues on next page)

Box 1.1 *(continued)*

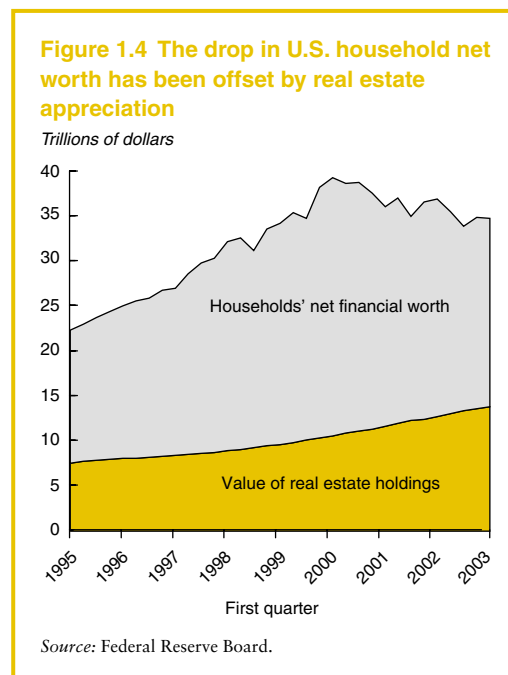
What happens next? The equation predicts that the 30 percent improvement in confidence after the war, if sustained, could add as much as an additional $30 \times .023 = 0.7$ percent, or around \$45 billion to consumption levels over the next year. It is likely that durables such as housing and automobiles would be the main beneficiaries. But the experience after the 1991 Gulf War sounds a note of caution. Then, too, confidence dipped sharply as the war approached, and surged by 36 percent in March 1991 following the ceasefire. Less than a year later, however, it had more

than given up this gain. The reason? Soaring unemployment. It was not until 1993 that U.S. consumption again recovered to near its long-run average growth rate. Moreover, our model attributes a cumulative 1.2 percent reduction in consumption since 2000 to confidence, but 9.2 percent to changes in income and wealth. In short, the future course of employment, income, and asset prices will be by far the most important determinants of consumption spending.

Source: World Bank staff.

Since 2000, spending in the rich countries has been buffeted by divergent trends in net worth; most households suffered sharp declines in the value of financial assets. In the United States and the United Kingdom, however, rapid appreciation of housing values has partially offset the deterioration in financial worth (figure 1.4). For example, U.S. households suffered loss of \$7.7 trillion in net financial worth since peak levels of the first quarter

of 2000—mitigated to \$4.4 trillion by real estate appreciation. Moreover, low interest rates have encouraged widespread refinancing and equity cash-outs to supplement flows of personal income and spending. On the other hand, rapid buildup of mortgage and other consumer debt has placed U.S. households in an exposed position should interest rates begin to rise with eventual recovery. At record levels of \$8.9 trillion, representing 80 percent of GDP or 111 percent of disposable income as of the first quarter of 2003, burgeoning household debt could hamper vigorous spending responses in later stages of the anticipated recovery.



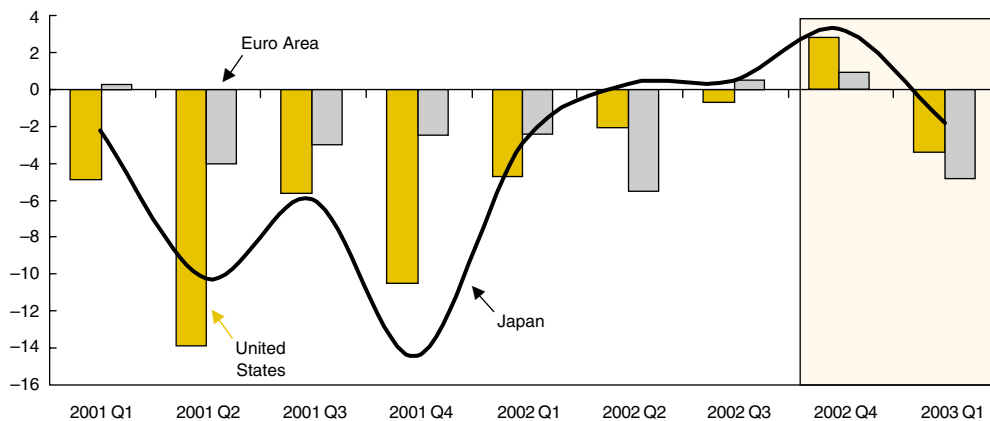
And the investment rebound relapsed

The sluggish pace of economic recovery is also linked to hesitant patterns of business capital spending, common across the industrial countries. After picking up to a 2.5 percent pace in the final quarter of 2002, G-7 fixed investment relapsed to growth of just 0.3 percent during the first quarter of 2003. U.S. business outlays dropped by a disappointing 3.4 percent, capital spending in Japan fell by 2 percent, and Euro Area investment plummeted by 4.8 percent, as that in Germany fell 6.8 percent (figure 1.5).

At midpoints of the business cycle, the prime mover for growth would normally transition from consumer spending and inventory building to more robust advances in fixed capital formation. Unlike in previous business cy-

Figure 1.5 Capital spending has been hesitant in all industrial countries

Real fixed investment, quarter/quarter, percent change, Q/Q, saar



Sources: National agencies and Eurostat.

cles, however, several factors have combined to inhibit a vigorous rebound in investment.

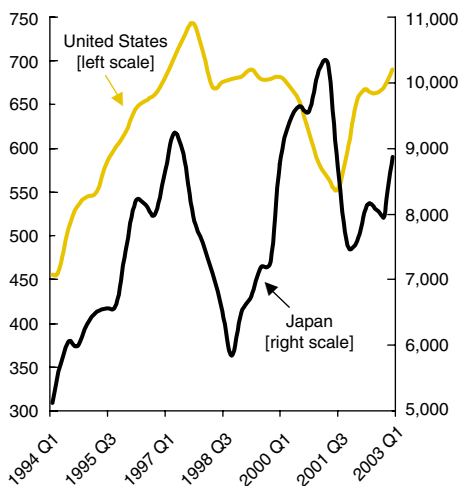
Corporate debt legacies of the 1990s' boom continue to curtail investment plans across the OECD. For example, U.S. non-financial corporate debt as a proportion of GDP rose from 38 percent in 1995 to 47 percent in 2002. Recent data, however, show U.S. debt rates stabilizing over the last quarters of 2002 and the first of 2003—a positive sign that adjustment efforts are beginning to yield fruit. *Corporate profits* fell 10 percent in the United States in 2001, while those of Japanese manufacturers plummeted 48 percent, reflecting onset of recession. The tortuous road toward restoration of profit growth has involved substantial cuts to capital spending and to employment over the last years. However, there is evidence that profits are staging recoveries in the United States and Japan, as well as in several sectors of industry in Europe. U.S. profits enjoyed a 15 percent rebound in 2002, but growth eased to a 5 percent pace in the first quarter of 2003. In Japan, profits of major manufacturers experienced a substantial comeback, rising 38 percent in recent quarters (y/y)—despite numerous challenges (figure 1.6). These developments offer additional evidence that the corner

to growth in capital spending, at least for the United States—and possibly for Japan—may be approaching.

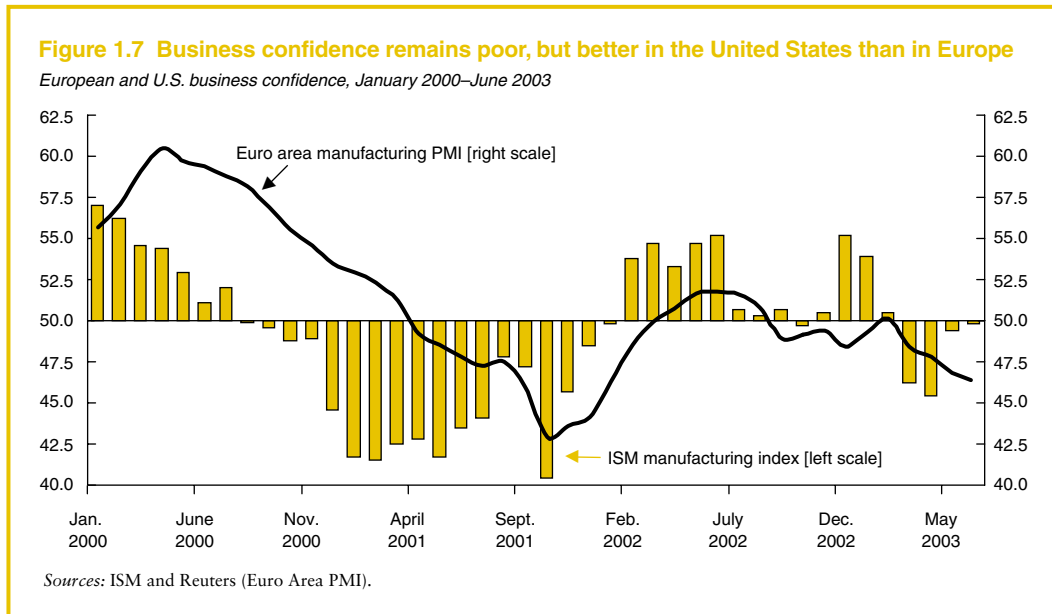
Business sentiment is now displaying distinct divergence between the United States and

Figure 1.6 Corporate profits have risen moderately in the United States and Japan

Adjusted profits in billions of dollars (2Q-ma) and trillions of yen (3Q-MA)



Sources: Department of Commerce, Bank of Japan, ESRI.



Europe and Japan, where assessments of conditions have worsened. The ISM survey covering U.S. manufacturing and non-manufacturing sectors fell below the 50 percent line that divides expansion from contraction during March and April—before manufacturing rebounded to 49.8 in June—and services sharply to 54.5 in May. In contrast, the composite PMI for the Euro Area entered the “contraction zone” in March, and fell further to 48.1 in June, reflecting declines in both services and manufacturing indicators (figure 1.7). It appears that financial conditions weighing against capital spending are easing across the OECD, and business sentiment is now reviving in the United States. Yet a key uncertainty persists: the robustness of future demand, which is strongly tied to the effects of policy.

After providing substantial stimulus, economic policy is reaching limits

On both fiscal and monetary fronts, policymakers in the rich countries injected significant stimulus, first to limit the global economic downturn of 2001, and over the last 18 months to foster conditions conducive for stronger recovery. On the *fiscal* front, the U.S.

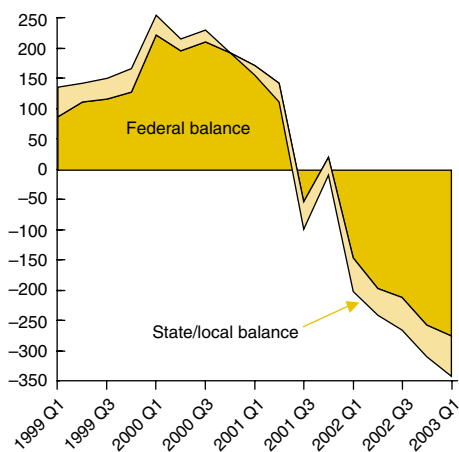
government’s general budget position shifted dramatically from a surplus of 2.3 percent of GDP in 2000 to a deficit of 3.2 percent during the first quarter of 2003. In part this reflects reduced revenues associated with sluggish activity and the operation of automatic stabilizers. But the shift to deficit has been more pronounced due to tax reduction and funding of the Iraqi campaign at the federal level, and by increasing shortfalls at the state and local levels (figure 1.8). Before the recent additional \$350 billion tax reduction was enacted, the Congressional Budget Office projected that the federal on-budget fiscal position was unlikely to return to surplus until 2012. Persistent deficits of such magnitude carry the potential to constrain growth in the medium term and beyond, largely as long-term interest rates rise in response to much-increased supply of Treasury securities.

Fiscal deterioration and the current account

The deterioration of the fiscal position has played a role in the doubling of the U.S. current account deficit from 2.3 percent of GDP in 1998 to 4.6 percent in 2002. The public-sector financial balance (saving less investment)

Figure 1.8 The U.S. fiscal deficit is widening quickly

U.S. federal, state, and local current fiscal balances, 1999–2003 (billions of dollars)



Source: Department of Commerce.

shifted from balance in 1999 to deficit of 3.6 percent of GDP in 2002, and further to a shortfall of 4.3 percent in the first quarter of 2003. At the same time, improvement in the private-sector balance (largely through compression of

investment), although substantial, was far from sufficient to make up the gap (figure 1.9a).

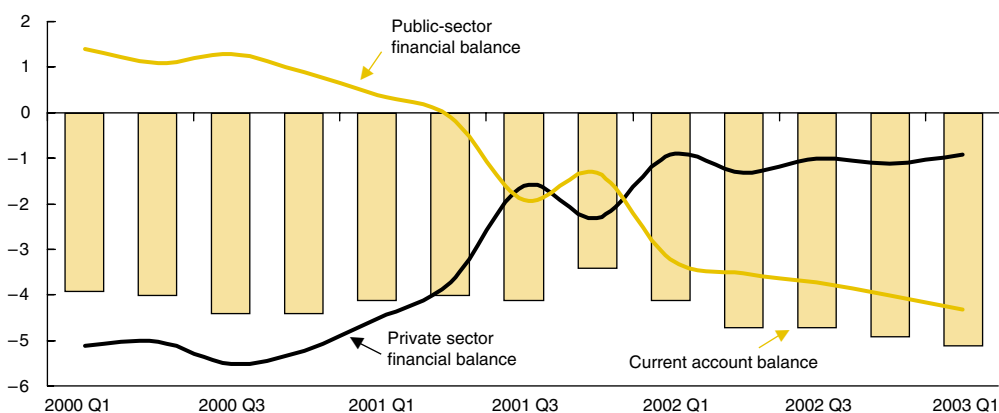
Aside from the underlying savings-investment imbalance that drives the need for foreign capital, the widening of the U.S. external deficit is attributable to several factors. Booming domestic conditions during the second half of the 1990s attracted imports at a growth rate of 10 percent annually, while the strong dollar and only moderate growth in U.S. trade partners served to constrain export growth to 6 percent. In turn the trade balance deteriorated from a deficit of \$175 billion in 1995 to \$485 billion in 2002. Foreign capital flows funding the current account deficit have become increasingly volatile over the last years, shifting rapidly in composition and in region of origin. The effects of sustaining such capital inflows over an extended period remain a question of some concern (box 1.2).

The present level of the current account deficit, at 5.1 percent of GDP in the first quarter of 2003, is an historic record. Of particular concern is the unprecedented level of deficit occurring at an *early phase* of economic recovery, when external positions are normally closer to balance given only moderate changes in

Figure 1.9 The U.S. current account deficit is at record levels

a. The public sector balance is driving the deficit

Percent of GDP



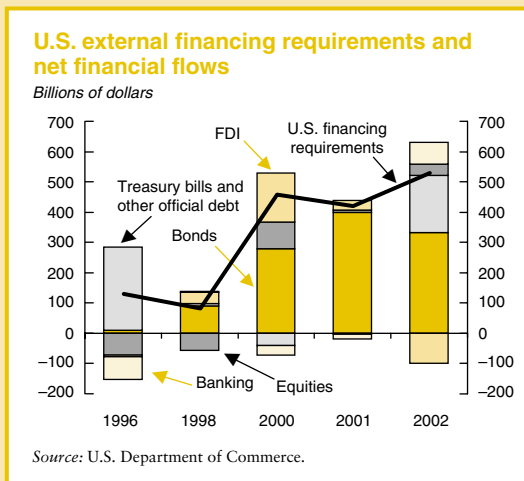
Source: U.S. Department of Commerce.

(Figure continues on page 13)

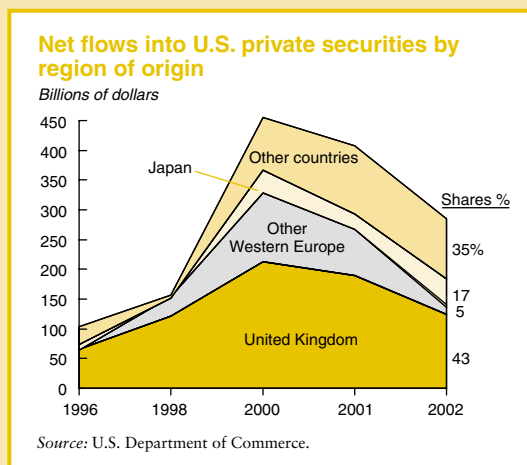
Box 1.2 Financing the U.S. current account deficit: From equity to debt

As the U.S. current account deficit more than doubled in dollar terms between 1998 and 2002 to reach \$480 billion, U.S. calls on international financial markets increased in tandem. The country's external financing requirement climbed to 4.6 percent of GDP in 2002, representing some 10.3 percent of the savings of the rest of the world. U.S. financing requirements largely have been smoothly met by net inflows from abroad. But the form of financing (that is, the composition of the net foreign-asset flow) has changed dramatically over just the last three years, while the region of origin of the inflow has shifted as well. The underlying nature of the capital inflow can, as demonstrated aptly in recent years, lead to questions of medium-term sustainability of the external deficit; while shifts in origin of flows can influence market expectations for adjustment in the value of the dollar against its major partner currencies.

During 2000, the final year of the boom, the United States required net inflows of some \$457 billion to cover its current account deficit. Financing was readily available, through increased mergers-and-acquisitions activity that yielded net purchases of corporate bonds of \$281 billion; complemented by strong \$160 billion in FDI flows and some \$85 billion attracted to 45 percent gains in NASDAQ (see first figure). Together the equity component of flows (FDI and stocks) accounted for more than 50 percent of requirements—a strong fundamental position. The onset of recession in the United States during 2001 was clearly a transition year for investor perceptions. The fall of equity markets (NASDAQ down 50 percent) forced a compression of the highly diversified flows of 2000, as equity and FDI dropped to negligible amounts and investors flocked into debt instruments. Long-term debt-related securities almost covered the U.S. requirement of some \$420 billion in the year. The transition in composition of inflows evolved more fully in the difficult environment of 2002. FDI recorded net *outflow* of almost \$100 billion; purchases of Treasuries by risk-averse investors increased by \$100 billion; a virtual cessation in overseas lending by U.S. banks yielded a net buildup in bank liabilities of \$70 billion; and foreign official assets (largely East Asian) increased by \$90 billion from an inflow of \$5 billion during the previous year.



The source of inflows to U.S. equity and “corporate” bond markets shifted over recent years (second figure). Although the United Kingdom’s status as a major financial hub for the European region dominates flows, a discernible shift is clear: from “other Western Europe” (Euro Area) and Japan as centers of demand for U.S. securities to “other countries” (East Asia and Latin America). During 2000, the Euro Area accounted for 25 percent of total net



(Box continues on next page)

Box 1.2 (continued)

foreign purchases, falling to 5 percent in 2002—a large decline in relative demand for dollar-based assets, tending to boost the value of the euro; in contrast Japan’s share increased from 9 to 17 percent, while East Asia and Latin America almost doubled their shares in purchases from 19 to 35 percent by 2002. Such a shift in the origin of funds may set the stage for future currency movements.

In looking ahead, the downshift in equity, persistence of large debt flows and dependence on volatile official reserve assets for some 20 percent of coverage, and the fall of the U.S. dollar against the euro, augur poorly for the inherent stability of financing in the short to medium terms. A “less than

virtuous” circle may result, as sources of finance become less stable. Greater volatility may be imparted to the dollar, leading in turn to higher and more volatile interest rates. When combined with perceptions of a persistently growing current account deficit, the confidence of foreign investors in dollar-denominated assets may be adversely affected.

Implications for the availability of finance for developing countries also arise from the increasing U.S. share of international capital flows. Although “crowding out” has yet to be in clear evidence, the potential for it exists should deficits continue to rise. The U.S. current account appears to have increased as a source of financial risk for the global outlook.

demand (figure 1.9b). In looking forward, with continued requirements for massive net inflows of foreign capital, the U.S. income-account deficit is likely to widen, while terrorism-related issues may continue for an extended period, pressuring U.S. services and net transfer positions. Yet assuming a gradual buildup of global

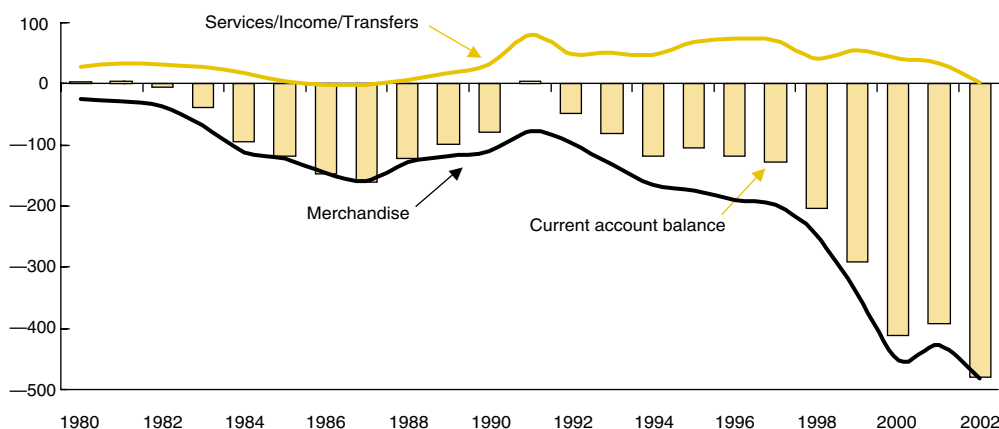
economic activity, an expected improvement in the goods balance should build, bringing about medium-term stabilization of the deficit in dollar terms, declining as a proportion to GDP.

Member states of the Euro Area have struggled to cope with the requirements of the Stability and Growth Pact of the Maastricht

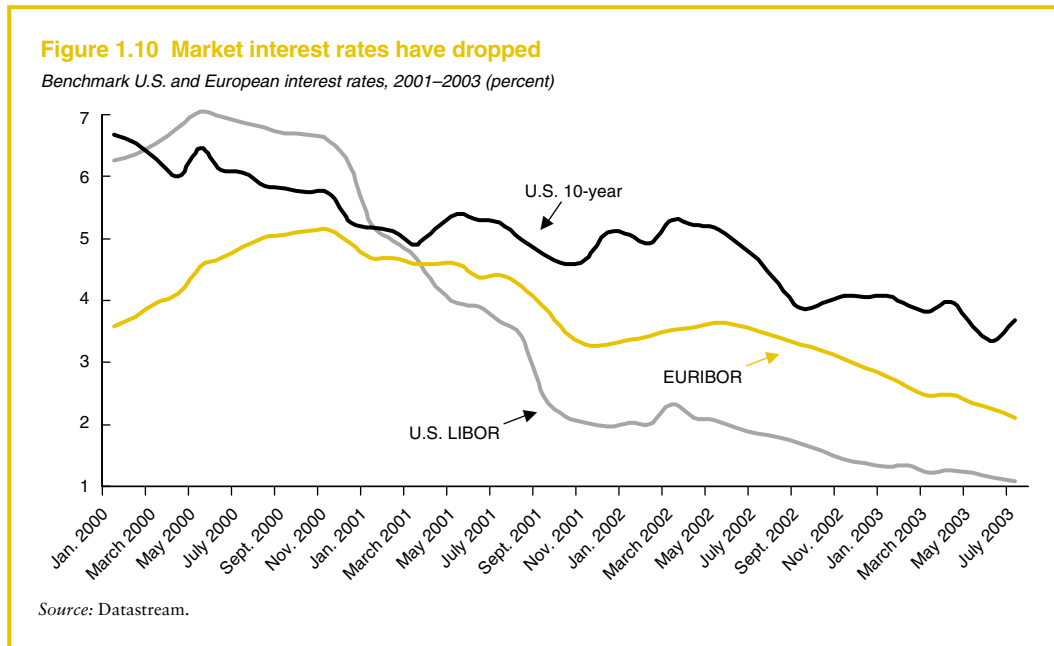
Figure 1.9 (continued)

b. The magnitude of the current account deficit is unprecedented for an early recovery phase of the cycle

Billions of dollars



Source: U.S. Department of Commerce.



Treaty, which, to set a foundation for the single currency, limits fiscal deficits to 3 percent of GDP and outstanding government debt levels to about two-thirds of GDP. During 2004 Italy is anticipated to join France, Germany, and Portugal in the group of countries that have breached the 3 percent limit. The consolidated balance for the Euro Area has deteriorated by 1.5 points of GDP over the period since early 2000, while that for Germany has shifted markedly from a 1.1 percent surplus to a 3.8 percent deficit. For the latter, especially, the tightening of policy to return to within the limits by 2005–06 is inopportune because economic conditions have deteriorated sharply; fiscal “austerity” only adds to these tendencies.

Japan’s fiscal stance continues to deteriorate, moving from a deficit of 6 percent of GDP in 2000 to 7 percent during 2002. Although public-sector investment outlays associated with public works and other traditional supplementary budget measures have been curtailed in recent years (falling by a cumulative 4.5 percent since 2000), more public monies have been allocated to shoring up the banking system and underpinning social safety nets

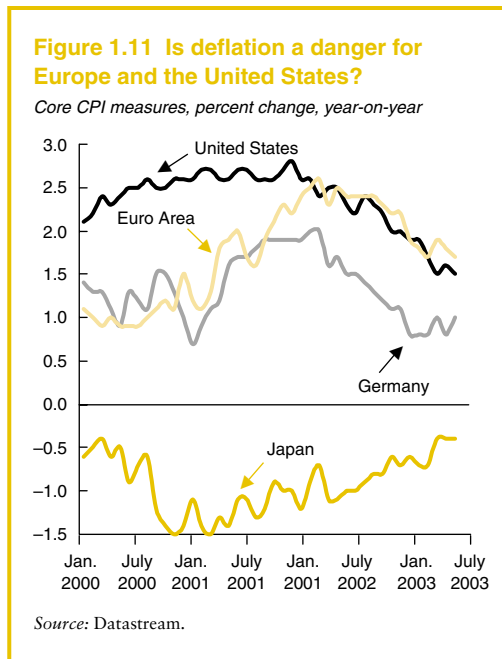
for those falling into unemployment. Japan’s public-debt burden, however, at some 150 percent of GDP, against the background of a rapidly aging demographic profile, suggests that a required movement toward balance in current budget terms will present considerable challenges to policymakers.

In *monetary* policy, authorities in the industrial countries have been aggressive—more so in the United States, less in Europe (figure 1.10). While operating with effective policy interest rates at zero, the Bank of Japan (BOJ) has proposed a wide range of policy measures aimed at easing the deflationary state of the economy. But evidence to date suggests that little has been achieved in this area. Aggressive easing of policy rates by the Federal Reserve, from 6.5 percent at end-2000 to 1 percent at present, clearly supported consumer and housing-related activity, though with little apparent effect on business capital formation. Consumption of durable goods, especially autos, has found support from record low interest rates. And mortgage refinancings have been spurred to new highs, placing extra disposable income into consumers’ pockets.

The European Central Bank (ECB) has adopted a more conservative approach to policy ease, given its central mandate of controlling inflation for the group of EMU countries. The ECB repurchase rate has been lowered in steps from 4.75 percent in late 2000 to 2 percent at present. The rapid appreciation of the euro has placed downward pressure on import prices, which eventually will compress prices at the consumer level, thereby creating an opportunity for the ECB to lower interest rates somewhat further. Policy in Japan has been geared, first, to lifting the economy from its deflationary state—which began in 1998 in the aftermath of the East Asian financial crisis and has intensified since—and to redressing the tenuous conditions in the commercial banking sector. Core consumer price inflation in Japan has ranged between -0.5 and -1.5 percent over 2000–03, defying the BOJ's attempts to support higher price levels through various measures. Broader money remains stagnant, as the decline in commercial bank lending effectively cancels intermediation through the economy. By intervening in the non-performing loan market (NPL), the BOJ now intends to expand the number of channels available to inject liquidity into the system, while supporting workouts of bad loans. The challenges are daunting.

Deflation risk? After two decades of disinflation in high-income countries, set off in the early 1980s by monetary tightening to curb self-enforcing inflationary pressures, a spread of deflation has become a real risk. While Japan is experiencing its fourth consecutive year of falling prices, core-CPI inflation fell to 1.7 percent in the Euro Area and eased to 1.5 percent in the United States in June (figure 1.11). As these measures of inflation probably overstate “true” inflation by 0.5–1 percentage points, the world's major economies could be balanced on the edge of deflation.

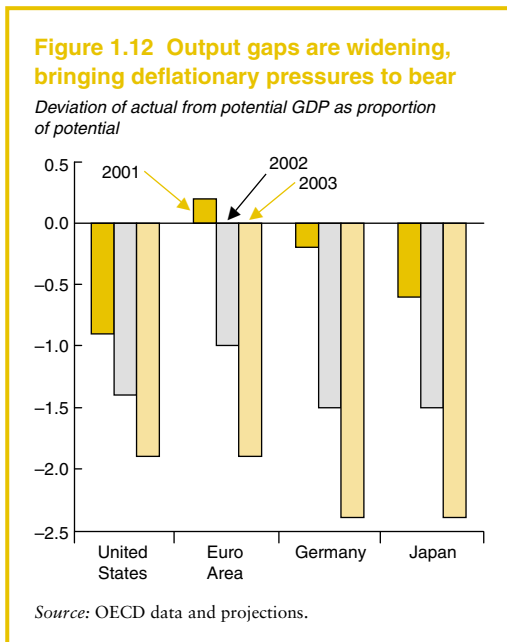
Deflation need not be damaging if it reflects gains from deregulation, technological advances and rapid productivity growth. Today, the computer and telecoms revolution, along with globalization, is pushing down prices. Yet



deflation can be dangerous when it reflects demand shocks, such as the bursting of an asset price bubble. These have the potential to set in motion a downward spiral of falling prices, delayed consumption, and declining profits and production.

Monetary authorities should shift their focus more decisively, if they have not done so already, from avoiding inflation to maintaining low inflation, fighting deflation as aggressively as they would high inflation. Asymmetric price targets and careful monitoring of output gaps are important ingredients in such a policy. Output gaps for the rich countries turned negative as of 2001 and have widened precipitously over the last two years (figure 1.12). OECD estimates place the U.S. output gap at 1.5 percent in 2002, rising to 2.1 percent during 2003. And the gap in Germany is particularly severe, shifting by a full point from 1.3 to 2.3.

However, as fiscal stimulus becomes quickly ineffective in the fight against stubborn underperformance, so, after time, can monetary policy. Both fiscal and monetary stimulus may at some point become part of



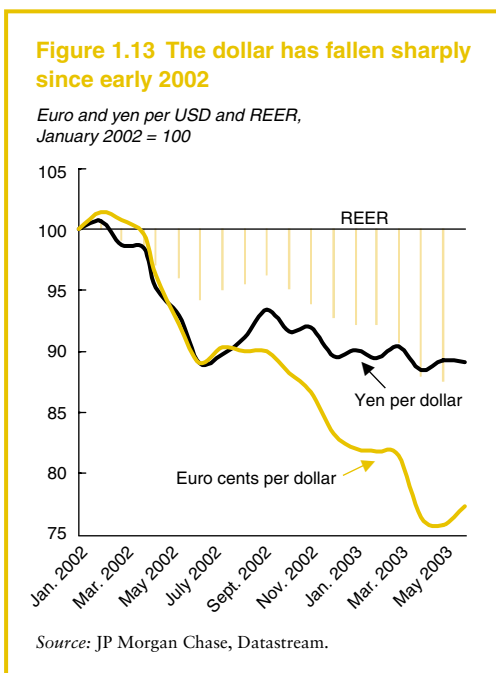
the problem instead of the solution. High fiscal debt could curb a recovery, and low interest rates for too long could encourage the accumulation of excessive debt that could increase debt service burdens once the economy starts recovering again. To the extent that market participants position their balance sheets around the expectation of low rates for an extended period, then the risk of sudden, violent movements in bond (and possibly currency) markets increases, not unlike what happened in 1993–94.

To avoid that underperformance, policies that address the structural foundations of economies become increasingly more important than macro stimulus. Such policies can not only address specific inefficiencies, but also provide a boost to confidence. A breakthrough in the Doha trade negotiations (see the end of this chapter) is an example of such structural improvements. Other examples are the strengthening of corporative governance, especially in the United States; labor and product market reforms in Europe; and decisive elimination of bad loans in Japan.

The dollar's fall means near-term pressure on growth, medium-term benefits

Recent developments in foreign exchange markets, reflecting an intensification of the dollar's decline from early 2002 peaks, have come to influence trends in OECD trade growth and the pace of economic activity. Over the period, the dollar has fallen by 12.5 percent on a real trade-weighted basis. But the 25 percent fall of the dollar vis-à-vis the euro—linked in part to diminishing European demand for dollar-denominated financial assets—is especially of concern to the future pace of growth in Europe (figure 1.13).

Euro-Area export prices expressed in dollar terms rose by 2.5 percent during 2002, but with the dollar's rapid fall they are anticipated to rise by nearly 12 percent in 2003. Growth of German and French exports fell sharply to negative territory (10 percent decline) as of early 2003. While diminished impetus from exports will detract from GDP advances, the stronger euro should imply a rise in real incomes, potentially supporting domestic demand. The 11 percent depreciation of the yen-



dollar rate poses complications, in a manner similar to Europe, for sustaining economic activity in Japan. Momentum underlying Japanese exports plummeted from 35 percent growth during spring 2002 to decline in early 2003, tied to a sharp 35 percent fall-off in shipments to the United States and slowing exports to Asia, from 45 to 3.5 percent rates. Authorities have been active in market intervention to slow the pace of dollar depreciation.

Ongoing realignment of currency values, however, will carry medium-term benefits. Recent moves are in a balancing direction, as the strength of the dollar over most of the 1990s raised the question of overvaluation against a longer-term equilibrium rate for the currency based on fundamental factors. The strong dollar contributed to the massive U.S. external imbalance, but at the same time maintained downward pressures on inflation, allowing room for substantial interest rate reductions. A medium term boost to U.S. competitiveness may be expected, provided that the dollar stabilizes or moves only gradually. Still, prospects for stabilization of the current account deficit remain at some risk.

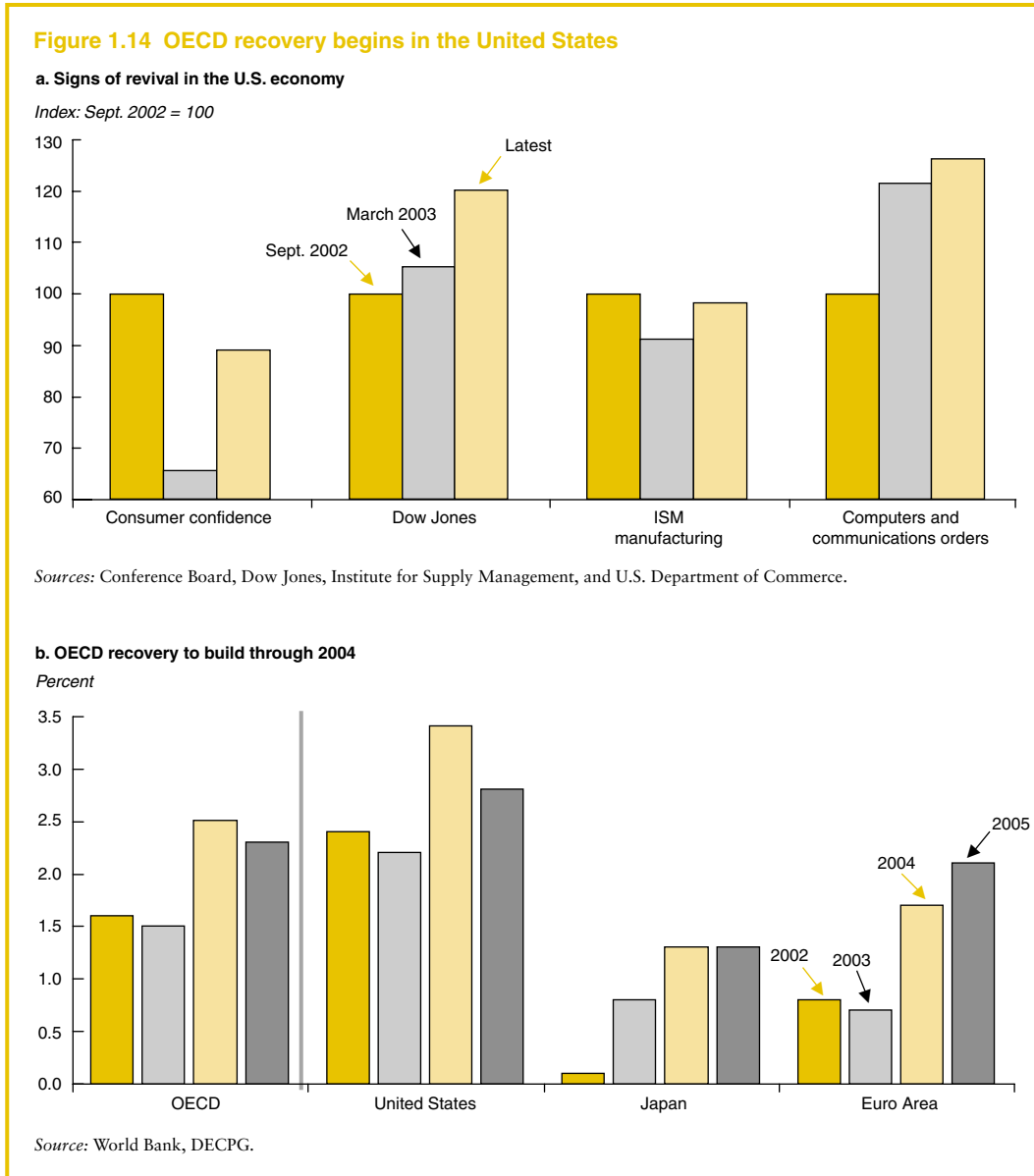
Expansion is likely by 2004

As *additional* impetus to growth from policy action is anticipated to be small, recovery among the rich countries will hinge on the effects of policy actions taken to date, and importantly, a restoration of confidence. The momentum of economic activity will likely build over 2003, reaching more robust proportions by 2004. Recovery should be paced by advances in the United States and by a return to stronger domestic demand in the emerging and high-income economies of East Asia. Revival of growth in the Euro Area will be tortuous, lagging that of the United States, and may find its focus in domestic rather than external demand. A lower dollar will help European consumers—as real incomes rise with lower inflation, and a virtuous cycle of stronger business output and eventually more substantial increases in capital expenditure could emerge.

The risk of weaker growth is substantial, however, given deterioration of conditions in Germany. Short-to-medium-term growth in Japan will be conditioned to a large degree by developments in export markets, especially in broader East Asia; the competitiveness of the yen; and the success or failure of policy in mitigating the deep-seated problems in the banking system.

Some positive developments have become apparent in the U.S. landscape. If sustained, these developments may augur well for gradual recovery. Since September 2002, consumer confidence has recovered moderately, while the Dow Jones index has recouped some 20 percent of its value (figure 1.14a). Manufacturing sentiment has improved and production risen, while sentiment for services has returned to its early fall levels. A possible upturn in the high-tech/semiconductor cycle has been underpinned by near 30 percent gains in orders for computers and communications equipment. And the effects of dollar depreciation may be coming into evidence as export momentum breached positive territory with a 3 percent advance from April to May. Yet the pace of consumer demand remains cloudy, and evidence for incipient recovery in capital spending is sketchy.

Against this background, the projections posit a subdued 1.5 percent growth outturn in 2003 for the high-income OECD countries, marking a 0.1 point deterioration of growth from 2002, largely because of sluggish conditions in the United States and particularly in Europe during the first half of the year. The advance in aggregate GDP is anticipated to rise to 2.5 percent by 2004—closer to long-term averages—as momentum builds in U.S. investment and output growth achieves 3.4 percent rates there. A revival in world trade toward 8 percent growth should help buoy performance in Europe and Japan. Interest rates will begin to respond to improved economic prospects, leading U.S. growth to taper off moderately into 2005, while Europe and Japan continue to register improvement, given the later start of their recoveries (figure 1.14b).



But downside risks have not disappeared
 Some of the global uncertainties related to noneconomic events—the war in Iraq and SARS—have eased, but have not completely disappeared. Prospects for eventual stabilization and resolution of developments in the Middle East remain uncertain, and the potential for adverse events remains, while SARS

will continue to present challenges to policy-makers worldwide (box 1.4). However, these uncertainties do not constitute the most serious risk to the global recovery. More important risks are to be found in the high-income countries.

A noteworthy feature of current global prospects is that many of the downside risks

originate in high-income countries, and that a strong recovery is not predicted for any of these countries in the near term. The rebound in the investment cycle, which is crucial to the overall recovery, remains uncertain. Although economic and financial conditions—low interest rates, rising equity prices, improved corporate balance sheets, and increased profits—are favorable for a recovery in investment, a lack of confidence could delay or even abort the rebound. Other risks are of a financial nature. The weakening of the dollar has, until now, been a movement toward equilibrium. But the dollar's fall is likely not enough to sustain demand for dollar-denominated assets, as the burgeoning U.S. fiscal and current account deficits are likely to call for an additional \$1.5 trillion in net foreign inflows over the period through 2005. A further sharp fall in the dollar could destabilize the recovery in the high-income countries. Additional risk may arise if vulnerabilities in the banking sector of the main industrialized economies intensify in response to deflationary pressures. Risks in the high-income countries call for decisive policy initiatives to improve the structure of economies. Moreover, uncertainties surrounding the recovery in high-income countries transmit to the international environment and to the medium-term outlook for developing countries, implying that expected improvement in developing-country growth should not be taken for granted.

The external environment for developing countries: Gradual improvement, but a bumpy road ahead

The external environment facing developing countries has been shaped by the set of recent developments in the rich countries as well as expectations for OECD growth and import demand. The evolution of trade prices, interest rates, and financial flows will play a major role in determining external balances, while influencing reserves and liability man-

agement decisions in emerging markets. Overall, the environment of the last few years has been a difficult one, but conditions should improve gradually through 2005 (table 1.3).

Although export market growth for developing countries chalked-up a meager 2.5 percent advance during 2002, export volumes for the group accelerated from nil in 2001 to 7.7 percent in the year, implying substantial gains in market share. As market growth rises toward a 7–8 percent range by 2003–05, emerging-market exports should continue to gain share and expand at rates around 10 percent. Trade prices bode well for improvement in export revenues during 2003, with terms of trade anticipated to rise by 0.4 percent, but moderation in non-oil commodity prices and in oil markets by 2004–05 should serve to dampen initial gains.

Advanced market interest rates are expected to trough during 2003, to rise moderately in 2004, and return to long-term average rates by 2005, a net increase of some 280 basis points from current 1 percent levels of US\$-LIBOR, and 100 points for EURIBOR, as European growth fundamentals remain subdued for a longer period. Meanwhile, there has been sharp compression in average emerging-market spreads, and a continuation of that trend would help keep the cost of capital for developing countries at moderate levels.

The near-term outlook for capital flows to developing countries is mixed, however, as continued restraint on the part of commercial banks in extending new loans is offset by much stronger trends in bond issuance. Gross capital market flows are anticipated to rise by some 9 percent in 2003. But FDI flows in the current economic and geopolitical environment, potentially exacerbated by the SARS epidemic in China (the major recipient country), are anticipated to experience no growth during 2003—an assessment that may prove somewhat optimistic. On balance, the outlook envisions an environment increasingly conducive for growth, but a potentially bumpy road for policymakers to navigate.

Table 1.3 The difficult environment for developing-country growth should improve*External factors affecting developing-country growth, 2001–05 (percent change, except as noted)*

	2001	2002	2003	2004	2005
OECD import demand	-0.7	1.7	4.1	6.3	6.7
Export market growth ^a	-0.2	2.5	6.8	8.0	7.7
Developing export volume	1.1	7.7	10.0	10.9	9.7
Non-oil commodity prices	-9.1	5.1	6.9	1.1	1.5
Oil price \$/bbl	24.4	24.9	26.5	22.0	20.0
MUV ^b	-4.5	-0.1	4.0	-0.4	1.5
Terms of trade	-0.7	-1.1	0.4	-1.5	-2.7
US LIBOR	3.5	1.8	1.0	2.0	3.8
EURIBOR	4.2	3.4	2.1	2.1	3.1
Emerging market spread (bp)	797	728	610	—	—
Financial flows (\$ billion)	326	293	309	—	—
FDI inflow	171	143	145	—	—
Gross capital market flows	155	150	164	—	—
Equity placement	7	11	12	—	—
Bond financing	62	55	70	—	—
Bank lending	86	84	82	—	—

— Not available.

a. Import demand in partner markets.

b. Manufactures Unit Value index, expressed in U.S. dollars.

Source: World Bank data and projections.

World trade is growing more slowly than expected in 2003, but fundamentals suggest a buildup of momentum into 2004

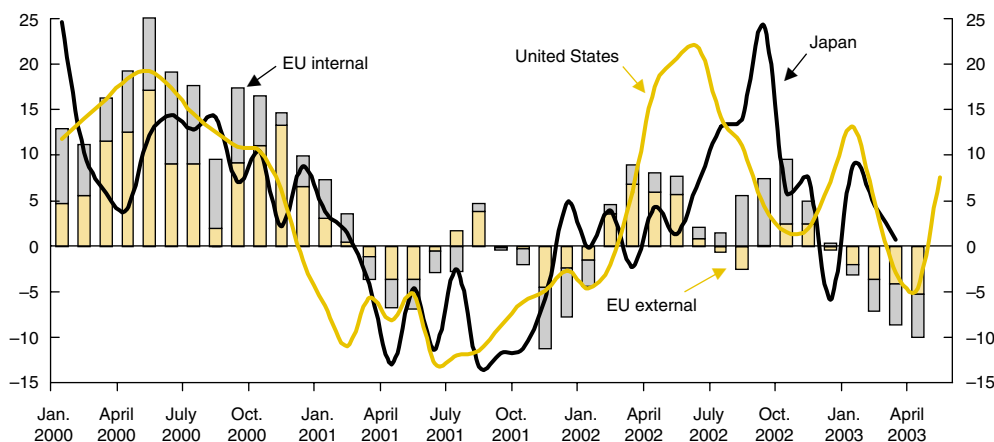
A decidedly soft patch in trade momentum developed over the second half of 2002 and through early 2003. Demand was bogged down by widespread weakness in the automotive, air travel, and technology sectors. And slackening of domestic demand conditions in the OECD countries compounded these trends. European import demand went through sharp compression: trade among EU member states especially affected by recession-like conditions on the Continent, and demand from outside the Union falling rapidly as well. After a pick-up to 12 percent rates at year-end, U.S. import volumes retrenched to a decline of 5 percent by April 2003—a pattern echoed by Japanese foreign demand—before rising again in May (figure 1.15). Against this background, following an advance of 3 percent in 2002, estimates for world trade growth in the current year have been marked down from 6.2 percent anticipated in spring 2003 projections to 4.6 percent.

A gradual advance in OECD industrial production and investment, combined with somewhat diminished strength in East Asian intraregional trade, underpin the anticipated recovery of trade volumes over the second half of 2003 and into 2004. And the medium-term outlook appears generally positive, as domestic demand in the rich countries, as well as low-and-middle income countries, should eventually rise in response to substantial policy stimulus. In contrast, the view for a revival of trade related to the global semiconductor cycle is uncertain at present. Sales may have reached a local peak, as unit shipments are now close to 2000 levels, while prices are likely to remain soft, reflecting the recent shift of production toward developing East Asia.

East Asia has been generating strong trade momentum on its own account, led by China. Chinese nominal imports (excluding oil) have grown at a compound rate of 12.2 percent since 1995, with much of the demand being met by regional producers. China's share in the merchandise exports of East Asia (Indonesia,

Figure 1.15 OECD-area imports have declined sharply since April 2000

U.S. and EU growth of merchandise import values, 3 month moving average, saar



Note: EU weighted intra- and outside-EU imports.
Sources: National agencies.

Republic of Korea, Taiwan (China), Malaysia, Thailand) has doubled over the last two years and quadrupled over the last ten (figure 1.16).

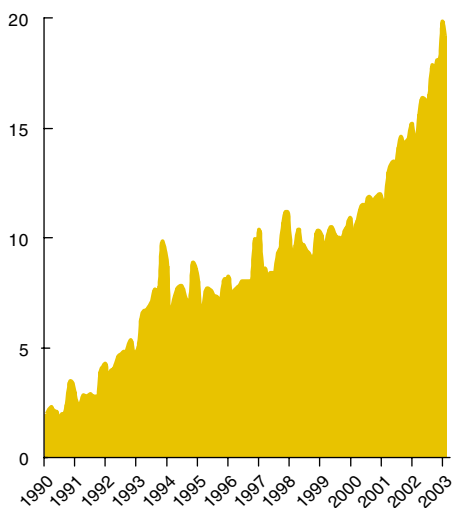
The dollar's weakness may improve merchandise trade balances for developing countries

For exporters who sell at a markup to local currency costs, dollar weakness implies higher dollar revenues per unit sold. Over the last two years developing countries' export prices have tended to grow at higher rates than those of high-income countries, yielding a cumulative improvement in the terms of trade. Yet, this development must be interpreted as a double-edged sword, with much of the improvement explained by higher oil prices.

As a group, developing countries are net energy exporters; but within the group there are significant net importers, many of which have been experiencing deterioration in their terms of trade. Indeed, *two-thirds* of developing countries, with GDP of \$2.9 trillion (56 percent of total developing-country GDP) and population of 3.5 billion (75 percent of the developing world) are net energy importers. To a

Figure 1.16 China's share of East Asian exports keeps rising

Share in percent



Note: Chart shows Mainland China's 3-month moving average imports from Korea, Taiwan (China), Malaysia, Thailand, and Indonesia as a percent of total exports of goods from these countries to all destinations. All data in U.S. dollars for January of the respective year.
Source: Global Trends Team, national sources via Datastream.

Table 1.4 Developing countries' exports will grow faster than those of the high-income countries*Merchandise export volumes, 2001–05 (percent change)*

	2001	2002	2003	2004	2005
World	-0.7	3.2	4.6	7.9	7.9
High-income countries	-1.2	2.1	3.2	7.1	7.4
OECD	-0.5	1.5	2.6	7.0	7.4
United States	-5.9	-4.2	0.0	7.6	9.7
Japan	-8.3	7.3	6.7	7.0	6.5
Euro Area	3.2	1.1	2.1	5.7	7.1
Other high income	-6.8	7.1	7.7	8.1	7.3
Developing countries	1.1	7.7	10.0	10.9	9.7
East Asia and Pacific	-0.6	15.5	14.5	13.7	11.4
Latin America and Caribbean	-1.2	2.6	7.9	11.4	10.4
Europe and Central Asia	4.9	6.3	8.5	8.7	8.5
South Asia	2.1	-1.8	5.4	7.7	8.2
Middle East and North Africa	5.0	-0.2	4.2	5.5	5.2
Sub-Saharan Africa	2.5	1.2	2.7	5.4	5.7

Source: World Bank data and projections.

degree, the decline in terms of trade for net energy importers may have been moderated by price increases for non-oil commodities, but much of the improvement in price has been limited to a few products—among them cocoa, rubber, and coarse grains. True terms-of-trade gains for this group are likely to wait further softening in oil price and a firming in non-oil prices associated with global economic recovery.

The medium-term outlook for developing country exports is encouraging, given expected growth in export markets, combined with continuing pickup in market shares. East Asia is likely to dominate developing country trade flows over the forecast period, but better performance is anticipated for Latin America, Europe and Central Asia, and South Asia (table 1.4).

The eventual return of Iraqi oil exports will pressure OPEC and the oil price . . .

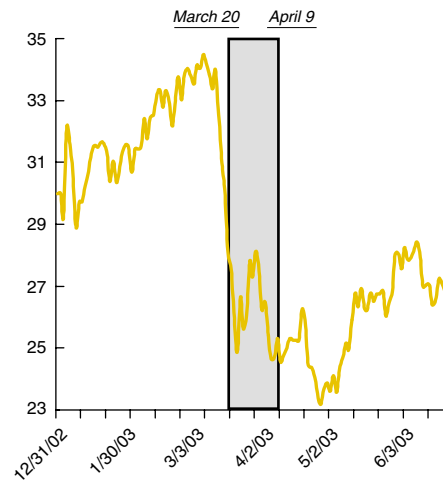
Oil prices averaged \$31.3/bbl during the first quarter of 2003. Fears of loss of oil supplies from war in Iraq, low stocks, strong weather-related demand, and sharply reduced exports from Venezuela all contributed to the price hike. In response to the rise, supplies from

other OPEC countries increased significantly. Saudi Arabia raised output to more than 9mb/d to help offset the prevailing and potential shortfall, and other OPEC members outside Venezuela added more than 1mb/d. The global oil price began falling shortly *before* the Iraq war began, as traders did not want to be caught short as the conflict commenced, particularly if a release of strategic stocks were to cause prices to crash as they did at the start of the Gulf War in 1991. Iraq's oil infrastructure was only minimally damaged during the war, and prices declined below \$25/bbl during April. But Iraqi exports did not resume shortly after the war's end, as widespread looting of oil field equipment and of service industries that supply the oil sector, such as electricity and water, significantly delayed restart of production. Global crude oil inventories have remained persistently low, particularly in the United States, as OPEC has well-managed sales of its surplus production into the market. While U.S. imports have risen, continued tightness in physical markets has caused prices to rebound to around \$27/bbl as of mid-June 2003 (figure 1.17).

Conditions surrounding Iraqi oil exports will likely be the most important drivers of oil

Figure 1.17 The price of oil fell sharply before the war in Iraq

Brent oil price \$/bbl



Source: DECPG Commodities Group.

prices in the near term. Iraq's production for domestic needs resumed quickly after the war, but export volumes were limited to pre-war storage that was shipped in late June. Oil exports are scheduled to resume in the third quarter of the year, but technical difficulties as well as recent pipeline explosions will initially constrain shipments to about 1mb/d. However, the risk of further disruption is high, and it is unlikely that Iraq will achieve pre-war production levels of some 2.5mb/d during 2003. A gradual return of exports should enable OPEC to curtail production in a timely manner and keep the oil price within its target band of \$22–28/bbl during 2003, particularly given the extremely low level of global inventories. Difficulties for OPEC could deepen in 2004 when Iraq's exports are anticipated to reach pre-war levels.

Initial investment in Iraq's oil sector will focus on refurbishing and improving efficiency of the present infrastructure. Limited growth in capacity could occur in 2004, but production is not expected to rise significantly above pre-war levels until 2005 and beyond. There are sugges-

tions to double or triple capacity, but such an endeavor would take several years to achieve and require substantial investment. Nevertheless higher capacity in Iraq, along with growing capacity within other OPEC members and significant expansion outside OPEC, is expected yield lower prices over the forecast period (box 1.3). Large increases in non-OPEC supplies that will capture much of the expected moderate growth in world oil demand are expected in the next several years. A "high-side" risk to the medium-term outlook for the oil price is that OPEC might exert stronger discipline to sustain higher prices. Such a policy, however, would raise incentives for non-OPEC producers to bring additional supplies to market.

But the dollar's decline and supply-side conditions outweigh the effects of the Iraq war on non-oil prices

Non-oil commodity prices have patently been affected by the war in Iraq—through increased freight costs, a buildup of inventories prior to the war, and the continuing reduction of stocks in the wake of military engagement. In addition, the war generally dampened consumer and industrial demand. Other factors, however, have been more important in influencing recent commodity price trends—among them the weakening of the dollar, supply conditions in individual commodities, and extremely depressed levels of some commodity prices before the recent recovery. The index of non-oil commodity prices rose 5.1 percent in 2002 after having declined by a cumulative 33 percent from 1997 to 2001. Prices are anticipated to increase an additional 7 percent during 2003 and advance at a modest 1 percent per year for the following three years. But even after recovery in 2003, nominal prices will remain well below their peaks of the mid-1990s.

The recovery in agriculture prices is expected to be modest

The index of nominal agricultural prices rose 8.5 percent in 2002. It is projected to increase by 7 percent in 2003 and by a more modest 1 percent per year for the next three years. The

Box 1.3 OPEC struggles to achieve higher prices amid growing supply competition

Oil markets suffered minimal disruption as a result of the Iraqi conflict, as other OPEC producers, particularly Saudi Arabia, raised production in anticipation of reduced Iraqi output and to replace Venezuelan exports. Oil prices peaked at \$34.2/bbl just before the conflict commenced but quickly fell below \$25/bbl. Oil stocks have stayed persistently low and prices have since recovered.

Oil prices have been extremely volatile during the last few years, largely because of fluctuations in OPEC production. Beginning in 2000, OPEC has targeted a price band of \$22–\$28/bbl for its basket of crude. By and large the organization has been successful. With the exception of the post-September 11th slump, oil prices have averaged about \$27/bbl since late 1999. This compares with an average price of about \$17.6/bbl over the 1986–99 period when OPEC was mainly concerned with regaining market share.

OPEC's new strategy is to keep inventories low and prices high, but doing so requires it to both raise and lower production during the year because of the seasonal pattern of oil consumption. Typically the industry builds stocks in the summer for use during the peak-demand winter season. However, it is difficult to precisely anticipate demand and supply three to six months forward, and this can result in large imbalances and volatile prices.

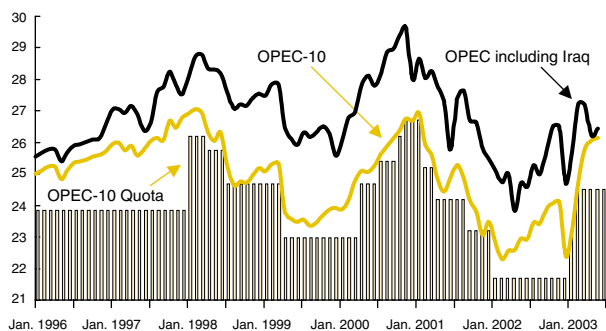
Achieving higher prices has been counterbalanced by loss of OPEC's market share. In recent years virtually all of the modest growth in world oil demand (less than 1 percent annually from 1997 to 2002) has been captured by non-OPEC producers—and much by the former Soviet Union. For OPEC 10 (excluding Iraq), its crude oil production as a share of total world supply fell from 35 percent in 1996–97 to 30 percent in 2002. Continued high oil prices will dampen future demand growth and, more importantly, stimulate development of non-OPEC supplies. Rising capacity within OPEC, desires for higher quotas (Algeria and Nigeria), and a recovery of Iraq's exports could strain OPEC's efforts to support higher prices.

Oil prices are expected to decline from \$26.5/bbl in 2003 to \$22/bbl in 2004 because of rising supply

competition and below-trend demand growth, and to fall below \$20/bbl by mid-decade. By 2006–07, significant new supplies from West Africa, the Caspian, Russia, deepwater-areas of the Atlantic basin, and elsewhere are expected to come on stream and, coupled with rising capacity within OPEC, exert severe downward pressure on prices. A risk to the forecast is that OPEC could maintain strong production discipline over the next few years to keep prices at or above \$25/bbl. To achieve this goal, however, the

Before and during war in Iraq, OPEC raised production and quotas

Millions of barrels per day, January 1996–July 2003



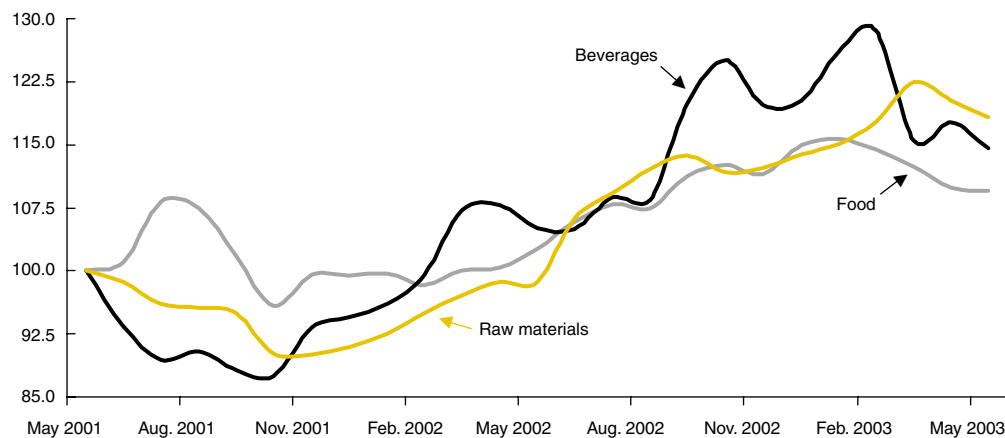
Sources: IEA and DECPG Commodities Group.

cartel would have to yield market share for higher prices. High prices would add to the growing pressures on world demand and competing supplies. In the end, it is probable that prices would still fall below \$20/bbl within a few years.

In the longer term, demand growth will be moderate, as it has been for the past 20 years, but new technologies, environmental pressures, and government policies could further reduce growth. Prices below \$20/bbl are sufficiently high to generate adequate development of conventional and unconventional oil supplies, and there are no apparent resource constraints far into the future. In addition, new areas continue to be developed (for example, deep-water offshore sites and the Caspian Sea), and development costs continue to fall because of new technologies, shifting supply curves outward.

Figure 1.18 Agricultural prices have begun to decline as crop prospects improve

Prices in US\$, indices May 2001 = 100



Source: DECPG Commodities Group.

advance in 2003 is driven primarily by the recovery of coffee, rubber, and vegetable oil prices after severe declines from 1997 to 2001. Most other agricultural commodity prices are expected to show only modest gains, however, because of high stock levels, excess production capacity, and slow demand growth associated with the modest recovery of global economic activity. Sharp increases in wheat prices at mid-2002 were quickly reversed as supply conditions in the United States improved and non-traditional exporters—Ukraine and Russia—increased international shipments. Other commodities, such as coffee and sugar, are burdened by large stock overhang; price increases are not anticipated despite historically low levels (figure 1.18).

Metals prices have undergone rallies over the past years but have faltered—mainly because of renewed expectations of weak demand. Recently, worries about the impact of the SARS virus on East Asian demand has also taken the luster out of metals prices. Inventories remain high for most metals and most markets are expected to remain in surplus this year. Nickel is the exception; stocks are low, there has been strong demand for stainless steel—

especially in China—and prices have risen quite sharply. Gold also posted higher prices tied to reduced producer hedging and concerns about U.S. equity markets and the dollar. Although production cutbacks have been made for most metals, idle capacity will haunt the market even after the anticipated recovery in demand is finally underway. Metals prices are expected to increase by about 6 percent per year for the next two years, after decreasing by about 3 percent in 2002. Copper, the most balanced market among base metals, could tilt into deficit next year along with nickel. Other metals are expected to remain in surplus for a longer period, unless further production cuts occur, and prices are likely to lag behind that of copper during the recovery.

Financial markets have shown some surprises

The divergence between the sharp rally in developing countries' fixed-income asset prices and the fairly tepid capital flows in response to those prices has been the hallmark of market-based financing during early 2003. This development was not expected at the start of the year (see World Bank 2003). While asset prices

have evolved along expected trends—though more sharply and swiftly than anticipated—advances in gross capital flows have been lower than expected—and lower than warranted by the spectacular pickup in market prices.

The rally in developing-country debt prices that commenced in fall 2002, once concerns over elections in Brazil and Turkey had faded, gained momentum through mid-2003. As investors pursued yields higher than those in industrialized countries, the availability of capital for investment in developing-country debt increased swiftly, outpacing demand for debt financing from developing-country borrowers. The outcome was not new volumes of financing but a sharp adjustment in benchmark prices. These dynamics played out differently than they have since the late 1990s, when low industrial-country yields failed to promote a surge in availability of capital for developing countries (because investors were focusing more on credit risk than returns).

Benchmark spreads on emerging markets dropped from a peak of 869 basis points in September 2002 to 500 basis points by mid-year,

the lowest level since 1998 (figure 1.19). The decline in spreads for several countries that had attracted investor concern was more spectacular. Benchmark spreads for Brazil, Argentina, and Uruguay declined by 1,700, 1,300, and 700 basis points, respectively over the period. Spreads on Turkish debt, which had escalated to 1,100 basis points by end-March 2003, dropped close to 700 basis points by mid-May. Gains in fixed-income prices stand out more clearly when benchmarked against the volatility and performance of global equity markets, which returned, on average, barely any gains between October and mid-May, even when taking into account the fall of the U.S. dollar.

Despite the narrowing of benchmark spreads, gross market-based capital flows to developing countries lost some ground during the early months of 2003 after mustering strength late in 2002 (figure 1.20). During the first quarter, capital flows slumped to \$34 billion, down about 14 percent over fourth-quarter levels. After a strong start to the year, flows eased in February and dropped further in March. But a revival in both bond issuance and banking lending during April–May brought

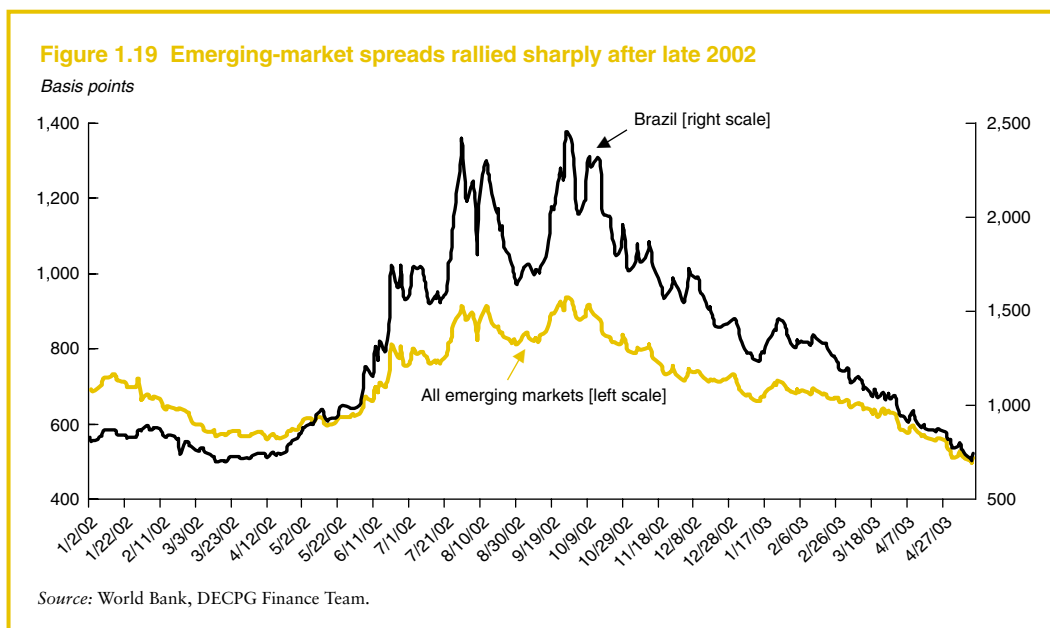
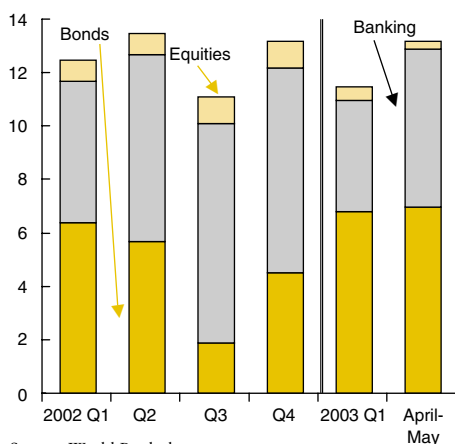


Figure 1.20 Bond issuance dominates capital market flows in 2003

Billions of dollars, monthly averages



Source: World Bank data.

flows to a rate of \$40 billion, comparable to the patterns established during the second quarter of 2002. The ups and downs in overall capital flows were led by bond financing, which is sensitive to short-run developments. A noteworthy feature in bond financing was the easing of access for Latin American borrowers compared with 2002. Brazil was able to come to the market with a \$1 billion issue after being absent for a year. However, the major portion of bond issuance from Latin America has been accounted for by investment-grade-rated countries. Contrasted with 2002 outturns, bank lending to developing countries has remained subdued, with monthly lending standing some 20 percent below comparable 2002 levels, as banks of almost all domiciles have been slow in extending credit to developing countries.

Market-based capital flows to developing countries have so far performed below the estimates set out for 2003 earlier this year, by about \$2 billion a month on average. The subdued response of capital flows to the strong performance of asset prices can be traced to several factors: (a) uncertainty in the runup to the Iraq war, (b) renewed concerns over the strength of the economic recovery, and (c) in-

creased volatility in financial markets during the early months of 2003. Many borrowers avoided or postponed borrowing.

The demand for external debt financing by developing countries remained limited, as many (especially in East Asia) have learned to live with less debt, while others are being kept in check even though financing conditions have eased relative to 2002. Capital flows could strengthen during the remainder of 2003. Borrowers may (a) take advantage of favorable financing conditions and move up their financing targets; (b) establish benchmarks for the purpose of setting favorable pricing in the future, or (c) undertake liability management, given the improvement in terms of borrowing over terms on previously contracted debt. Novel aspects of financing are already being encouraged. Mexico arranged a \$2 billion bank loan to retire some of its Brady debt. And bond issues with collective action clauses have swiftly become more acceptable with relatively little or no premium. Mexico, Brazil, and South Africa issued bonds with such clauses between March and April.

The stimulus to developing-country capital flows from low industrial-country yields could persist over the short-to-medium terms, as yields in the G-3 countries are unlikely to rise sharply and swiftly even if they do turn the corner. Barring major fallout, investors may continue to grow less risk averse. Most of the vulnerabilities in emerging-market economies and in high-yield industrial-country markets have been exposed and have evolved through changes in market prices. Substantial fallout from the troubled Latin American borrowers was largely avoided. Foreign exchange reserve positions of developing countries in general are holding steady, and their dependency on external debt is falling. Vulnerability to adverse external shocks appears to have been reduced from the high levels of the last two years, and flexible exchange rates have helped in this area. And for several countries, the macroeconomic implications of accession to the European Union have vastly improved credit risk perceptions.

The developing countries: Back on track toward growth?

Developing countries appear poised for growth to resume at more rapid rates. Despite continuing geopolitical uncertainties and subdued conditions in the rich countries at present, developments in several areas are converging to support the expectation of a step-up in output growth. Should conditions in the external environment improve as expected over the next years, countries should have the opportunity to advance export-market shares and grow export volumes at more robust rates. International financial markets have become more accessible to developing countries, and compression of spreads has reduced the cost of raising capital. International reserves have risen to record proportions, especially in developing East Asia, providing a degree of cushioning against potential vagaries in global financial markets.

Developing-country fundamentals are improving

On the domestic front, fiscal positions have generally improved across developing regions, allowing a degree of stimulus to be undertaken to bolster domestic demand, and prospectively, more can be achieved here. While industrial production supporting both external and internal demand growth is currently mixed across regions, the seeds of firmer recovery appear to be fairly widespread. Inflation is moderating, and this trend should be enhanced as the oil price moves downward over the next years—and for several countries, currency appreciation will abet improved inflation performance. Finally, recent political and financial difficulties in Latin America appear to have moderated, though uncertainties persist. In contrast, developments in the Middle East and North Africa region (MENA) remain unsettled in the aftermath of conflict, and heightened uncertainty and risk aversion among exporters, investors, and tourists is likely to affect growth for the countries of the region for some time.

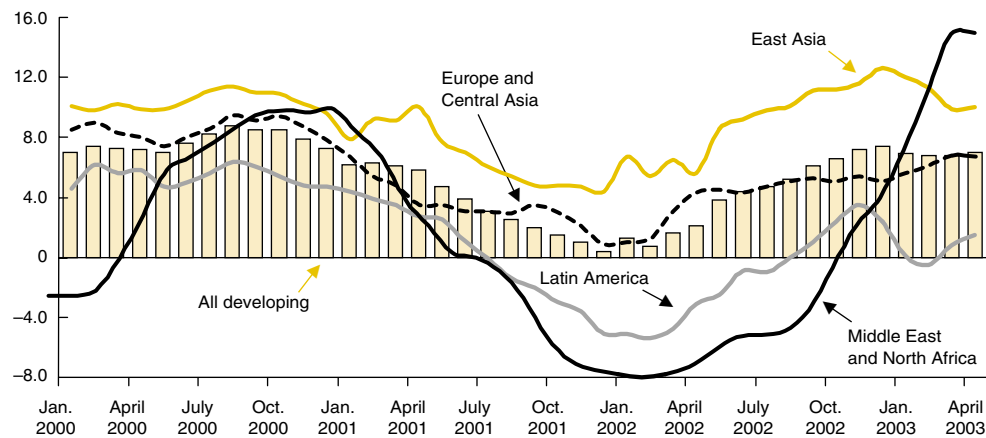
Recent trends in industrial production highlight the current mixed picture across key re-

gions, to a large degree, integrated with ongoing global developments. For developing countries as a group, output has recovered to 7 percent year-over-year rates from troughs experienced in early 2002 (figure 1.21a). The MENA region, which accounts for some 9 percent of developing-country value added, has enjoyed a 15 percent surge in crude petroleum and other energy production, as OPEC members have exceeded quota levels in expectation of the loss of Iraqi output. In contrast, some underlying influences of SARS may be discerned in drooping production figures for the East Asia and Pacific region (EAP), though other factors, including the slowdown of world trade and poor conditions in high-tech markets, are likely the more important elements at work. Latin America, meanwhile, is building on revitalization of output in Argentina, and earlier in Brazil and Mexico, but activity in the latter countries appears to have eased recently. Europe and Central Asia (ECA) has benefited from Turkey's dramatic recovery from its financial crisis of 2001, while hydrocarbon exporters in the Commonwealth of Independent States (CIS), including Russia, have ramped up oil and gas production to fill part of the gap left by loss of Iraqi crude oil. As some of the near-term distortions to production dissipate—the recovery now underway for low- and middle-income countries should firm and broaden over the coming quarters and into 2004.

Inflation has moderated for developing countries as a group, from recent peaks of 5.5 percent as of mid-2001 toward a 3 percent year-over-year pace at present (figure 1.21b). Improvement has been spearheaded by developments in the EAP region, where tendencies toward deflation in China (largely productivity driven), and easing of price pressures in most ASEAN countries have yielded a reduction of 3 percentage points in annual inflation, from 5 toward 2 percent rates. And developments in the ECA region have been quite promising as well, with a 4 point fall in CPI over the like period, from 6 to 2 percent, reflecting improvement in Turkey, Russia, and many of the countries of Central Europe. In-

Figure 1.21a Regional trends in industrial production are mixed

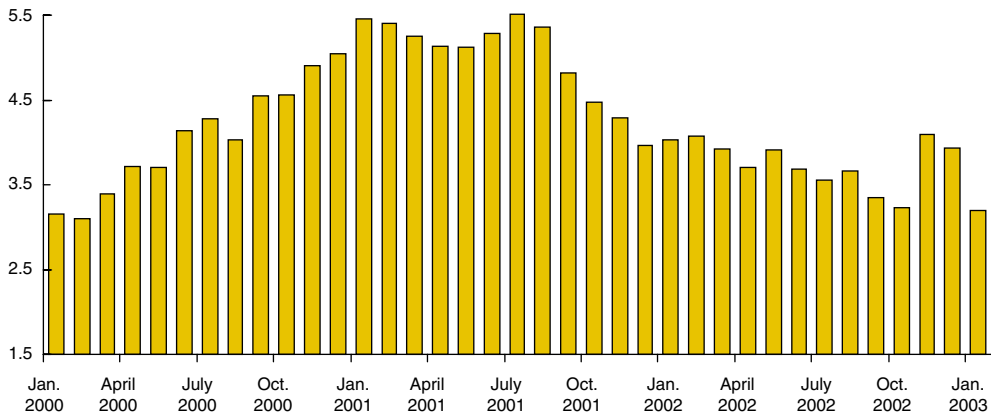
IP, 3-month/3-month, percent change, year/year



Sources: National agencies.

Figure 1.21b Inflation is moderating in the developing world

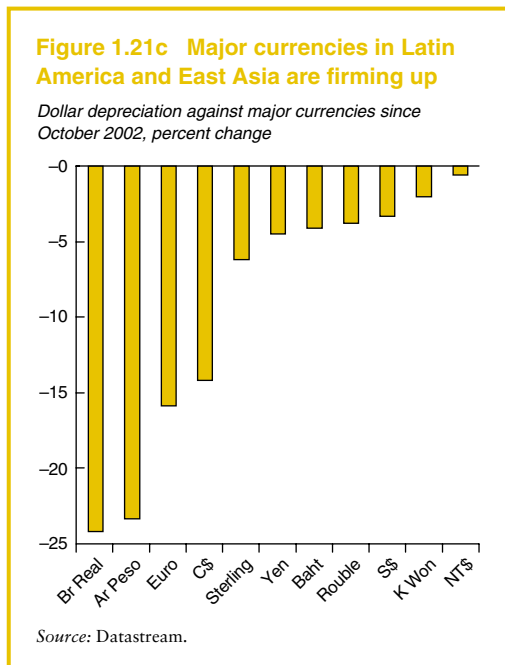
Consumer price index, percent change, year/year



Note: GDP weighted growth.
Source: National Agencies.

flation remains at moderate 3 percent rates in South Asia (SA), but has re-accelerated in Latin America and Sub-Saharan Africa, reflecting earlier currency devaluations in the former region, and adverse fiscal conditions and large-scale currency decline in several large African states.

The fall of the dollar vis-à-vis partner currencies has affected more than the cross-rates for the euro, yen, or sterling. Since October 2002, the brunt of dollar depreciation has fallen upon several Latin American currencies, importantly the Brazilian real and Argentine peso (20–25 percent appreciation), reflecting



in part strong rallies in financial markets in those countries, along with sharply narrowing spreads on benchmark bonds and fixed-income funds (figure 1.21c). Several East Asian currencies have also appreciated more moderately against the U.S. unit—notably the Thai baht and Korean won, while the Russian rouble has risen in like proportion. Currency appreciation in Latin America is likely to deliver mixed results: while serving to dampen export prospects—an important vehicle for economic recovery—appreciation will help to reduce inflationary tendencies in both Argentina and Brazil, providing room for needed interest rate reductions and a stronger foundation for domestic growth.

Growth should pick up across regions during 2004–05

Over the last years, GDP growth for the developing and transition countries has undergone dramatic shifts and suffered volatility associated with global business-cycle developments, as during the recessions of the early 1980s and 1990s. Several region-specific crises

and transformations also have induced sharp variations in aggregate growth—among them the Latin debt crisis of the early 1980s, the period of recession associated with transition in the former COMECON countries during the early 1990s, the East Asian financial crisis of 1997–98, and the Russian devaluation of 1997–98, and the global downturn of 2001 exacted a toll on developing country growth, but the deceleration of output has been much less dramatic than in earlier episodes.

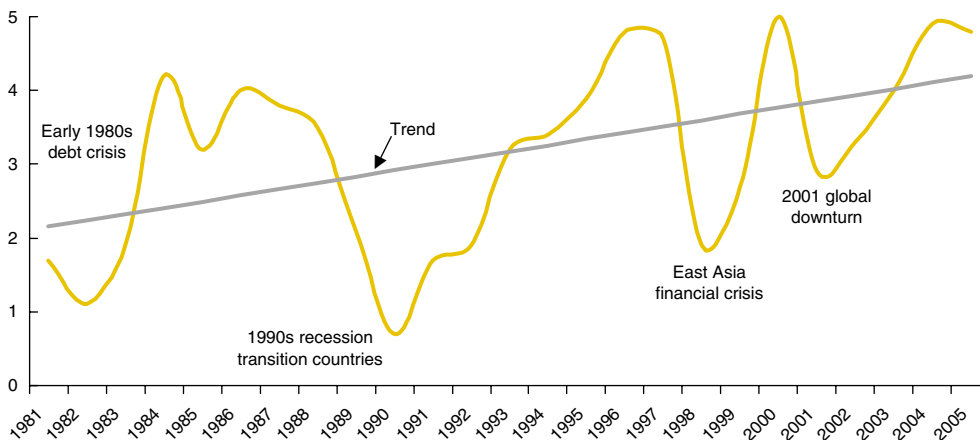
In the base-case projections, developing-country growth is expected to reaccelerate in all regions from the relatively sluggish performance of 2001–02 to an average GDP advance of 4 percent during 2003, reaching about 5 percent growth by 2004–05, consistent with previous peaks in 2000 and 1996–97 (figure 1.22). Latin America is expected to see the most substantial gain, as the region consolidates following the Argentine crisis. A return to stronger growth in India powers the South Asia region, while more moderate gains are achieved in Europe and Central Asia—tracking the slower pace of revival in EU activity. The pickup in growth will be lower in the Middle East and North Africa, where uncertainty regarding the regional political and economic situation is likely to persist, and in Sub-Saharan Africa, where only moderate gains in commodity prices and sluggish European growth play a role (figure 1.23).

SARS carries some adverse economic affects for the East Asian economy

The East Asia and Pacific region was able to overcome a retrenchment in world trade, a sluggish high-tech sector, geopolitical uncertainty, and soaring oil prices in 2002 to register solid 6.7 percent growth (figure 1.24). China and Vietnam, at 8 percent and 6 percent respectively, were the engines of the regional economy, as exports spilled over into domestic demand and generated strong demands for intermediate imports from other countries in the region, including Korea, Thailand, Malaysia, and the Philippines. The main exceptions to the

Figure 1.22 Developing countries are on track toward long-term growth

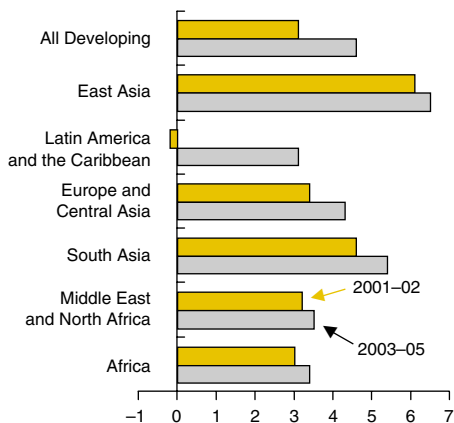
GDP growth, percent per annum, 1981–2005



Source: World Bank data and projections.

Figure 1.23 Growth rates in developing countries will rise through 2005

GDP growth, 2001–02 and 2003–05 (percent)



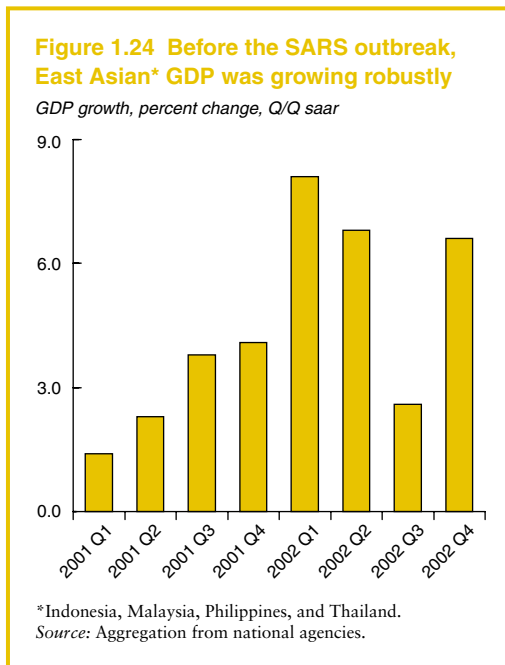
Source: World Bank Development Prospects Group.

buoyant performance were Hong Kong (China) and Singapore, which failed to capitalize on burgeoning intraregional trade, and Indonesia.

Growth in East Asia is expected to slow by more than half a percent to 6.1 percent in

2003, in part because of the outbreak of SARS centered in China and Hong Kong. According to favorable World Bank estimates, SARS may subtract about 0.5 percent from regional growth during 2003 through its effects on travel, tourism, and domestic consumption and investment (box 1.4). Some countries are likely to be more affected than others—because of high tourism shares in GDP or their importance as hubs of international trade. In Hong Kong (China) and Singapore, growth may drop by several percentage points from 2002 results. Meanwhile, growth in the Philippines is expected to ease because of consolidation of government finance, and Indonesia is vulnerable to a fall in confidence, especially in conjunction with high levels of household debt.

Though near-term prospects are muted, longer-term performance is expected to remain strong. In 2004, growth is expected to reach 6.7 percent based on a quick containment of the SARS epidemic, together with recovery in industrial countries and an upturn in the high-tech cycle. By 2005, the EAP region is expected to return to a long-term trend rate of output growth of around 6.5 percent.



Latin America shows signs of renewed recovery

Latin America showed increasing evidence of a recovery during 2003, after growth fell to -0.8 percent in 2002. In fact, the negative growth performance for 2002 results exclusively from severe contractions in Argentina, Uruguay, and Venezuela; and a regional average excluding these countries registers positive growth of 1.6 percent, underscoring that contagion had been limited. Industrial production returned to positive growth during the fourth quarter of 2002, up 5.6 percent, underpinned by gains in Argentina, Chile, and Brazil (figure 1.25). Falling yield spreads confirmed the impression of an improvement in financial health. In Brazil, for example, spreads declined from a peak of 2,067 basis points in October 2002 to 754 basis points by April 2003, as risk aversion eased among global investors. Though capital flows, especially bank lending, to Latin America and the Caribbean remain weak, the strengthening of several local currencies against the dollar (Argentine peso, Brazilian real, Chilean and Mexican pesos) has occurred in

parallel with improving investor sentiment regarding local equity and fixed-income markets. Though still dependent on an accommodating external environment, threats of financial crises and attendant spillovers appear to have receded.

In Brazil, President Lula da Silva's commitment to balanced macroeconomic policies has helped to restore confidence, and has already facilitated access to international finance, while additional support from the International Monetary Fund should be forthcoming. Meanwhile, rising consumer confidence and receding unemployment in Argentina indicate a growing consensus that the worst may be over. Yet inflation risks persist, and the credibility of economic policy will need to be established by the new president. Both countries continue to face the challenges of supporting growth in the context of tight constraints to fiscal and monetary policy. In contrast, the Republica Bolivariana de Venezuela restarted its oil exports following a strike-induced shut-in lasting some 60 days. But, there the political crisis appears to be unresolved and macroeconomic performance continues to suffer, with GDP declining by 9 percent in 2002 and forecasted to fall 14 percent for 2003. Peru's performance has been remarkable for 2002 and prospects for 2003 are still favorable, but recent political turmoil will potentially be a drag on growth and raise public deficits. Recent political unrest in Bolivia also had damaging repercussions, and in the Dominican Republic a massive bank fraud triggered the collapse of the second-largest financial institution, with potentially heavy financial and economic costs.

Given the extent of recent difficulties and remaining uncertainties, near-term growth prospects remain subdued. However, the longer-term outlook is more optimistic. Multilateral trade agreements and regional market-opening initiatives in the European Union (EU) and U.S. markets bode well for external performance. Exports are diversifying into areas such as tourism and other services. Macroeconomic stability and commitment to sound

Box 1.4 Economic effects of Severe Acute Respiratory Syndrome (SARS)

While the threat of Severe Acute Respiratory Syndrome (SARS)—a virus that spreads easily and has no known antidote—has shaken China, Canada, and the world at large, the spread of the outbreak has stopped and public panic has largely subsided. The outbreak seems to have been brought under control as a result of stringent public health measures in the affected countries, though there may also be a seasonal component to the disease. The economic impact should thus be concentrated in the second quarter of 2003, and is expected to be largely limited to the East Asia region, with a relatively small impact on global growth. As of end-June 2003, it is estimated that SARS had infected 8,450 people in 32 countries and to have killed over 800 people.

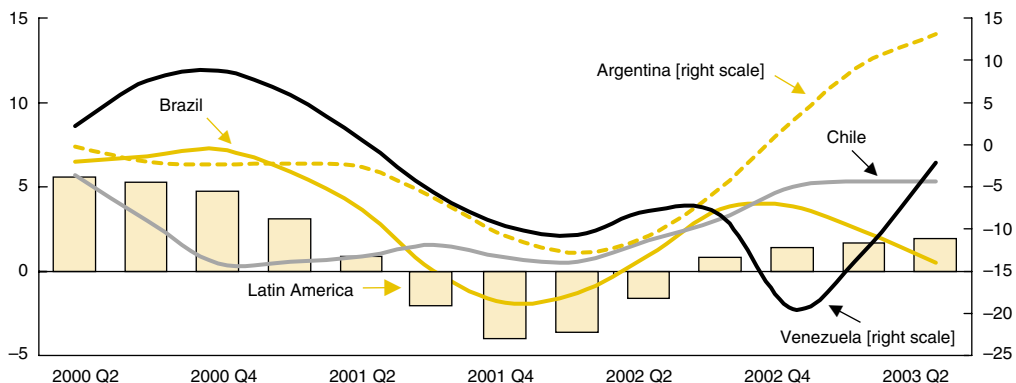
Short-term economic activity—particularly in ‘face-to-face’ exchanges such as in the retail sector—slowed in the most affected countries. Overall, the economic impact was largely transmitted through aggregate demand, but also to a lesser extent through supply mechanisms. Tourism and trade-related services declined as people became less willing to travel

to areas where there were SARS outbreaks. The airline industry was hit especially hard, as the SARS virus came at an already difficult time, following the September 11 attack and the war in Iraq, which already diminished vacation travel, in particular, but also corporate travel, given sluggish world growth. Manufacturing trade was also affected. International firms with production lines in affected countries suffered some interruptions to production because of restrictions on travel. Some (temporary) substitutions may have been made; however, sustained losses in market share are unlikely. Finally, the SARS outbreak temporarily depressed consumer and business confidence in the countries most affected, but containment of the outbreak should result in a quick return to pre-SARS confidence levels. The macroeconomic policy response to the outbreak is expected to be most evident in increased fiscal outlays through transfers and tax breaks, in addition to increased health care expenditures to respond to the outbreak.

Source: World Bank staff.

Figure 1.25 Argentina, Brazil, and Chile see strong upturn in production

IP, 3-month/3-month, percentage change, year/year



Sources: National agencies.

fiscal and monetary policies are becoming the norm and already yielding benefits in the form of less costly international borrowing and more robust domestic financial markets.

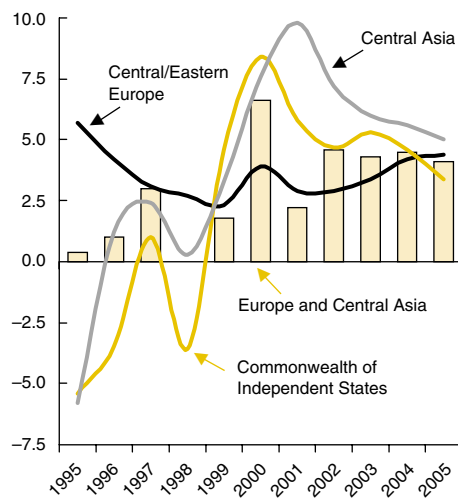
The outlook for Europe and Central Asia is mixed: greater EU demand, but flagging oil prices

Output expanded by 4.6 percent in the ECA region during 2002, primarily resulting from the strength of domestic demand, which more than offset lackluster growth in the region's main export markets. A number of economies enjoyed a pickup in growth during the year (Croatia, Estonia, Lithuania, Poland, Slovak Republic, Turkey, Armenia, Azerbaijan, Belarus, Georgia), though excluding Turkey activity was marked down about half a point to 3.9 percent. Output in the Commonwealth of Independent States (CIS) eased to 4.7 percent growth in 2002, from robust 5.8 percent outturns of 2001, and from the spike in growth of 8.4 percent posted in 2000. The critical factor in this development was erosion of stimulus to the Russian economy stemming from the *rouble* devaluation of 1998 and the rents from strong energy prices. In turn, diminished import demand from Russia—representing an important export market for the remaining CIS countries—contributed to the slowdown for the rest of the group. Activity in the Central and Eastern European Countries (CEECs), excluding Turkey, was unchanged in 2002 relative to 2001, at 2.9 percent. Including Turkey, growth averaged 4.5 percent for the group, a sharp upswing from contraction of 0.8 percent in 2001, reflecting a 7.8 percent recovery enjoyed by Turkey in 2002. For the CEECs, domestic demand was spurred by fiscal policy (Hungary, Czech Republic, Poland, Slovenia, Slovakia) and/or easing of monetary policy (Czech Republic, Latvia, Lithuania, Romania).

Aggregate growth for the region is anticipated to slow moderately to 4.3 percent in 2003, as a return to more modest advances in Turkey, under the burden of required fiscal consolidation and related issues, will carry some weight (figure 1.26). Among the CEECs,

Figure 1.26 Growth will cool in CIS while picking up in Central and Eastern Europe

GDP growth, percent per annum



Source: World Bank data and projections.

excluding Turkey, growth in 2003 is projected to ramp-up moderately (by 0.5 points) as a result of three factors: a gradual recovery toward year-end in the EU, the group's main export market; notable acceleration of growth in Poland (representing about 13 percent of the region's GDP); and expected improvement in growth performance in the Czech Republic, Slovenia, and Albania. An expected boost to consumer confidence is likely because of progress in the EU accession process.² Growth is projected to strengthen slightly among the CIS countries in 2003, as domestic demand has begun to firm in Russia, which in turn should support growth in other CIS countries dependent on Russia's import demand. ECA regional growth is expected to accelerate to 4.5 percent in 2004 and then to slow to 4.1 percent in 2005, reflecting divergent trends at the sub-regional level. Growth in the CEEC sub-region (including Turkey) is likely to accelerate from 3.5 in 2003 to 4.3 and 4.7 percent in 2004 and 2005, respectively, in part because of firming of external demand and significant inflows of FDI to new EU mem-

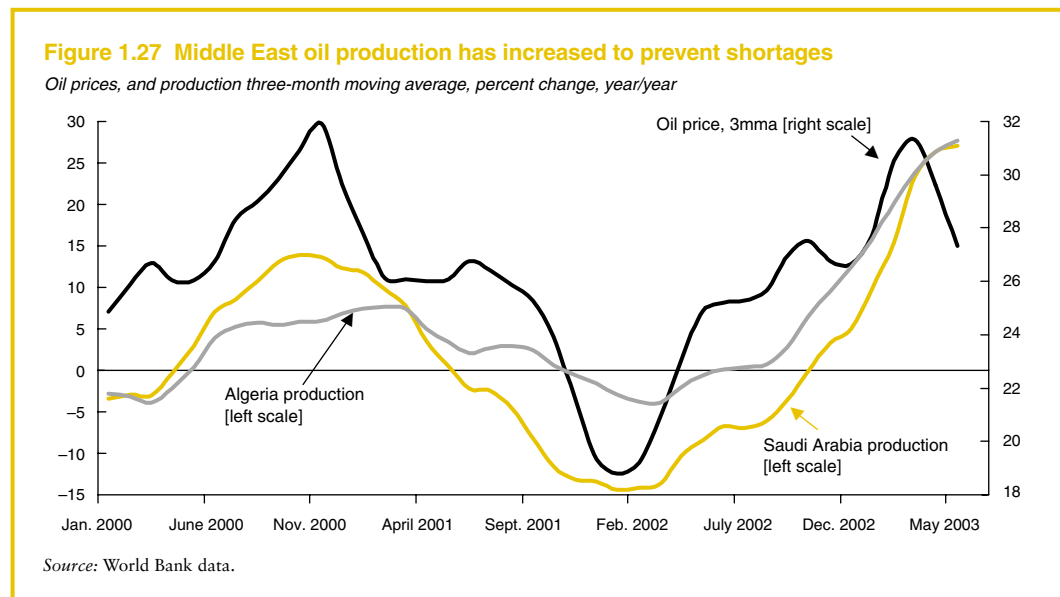
bers, in addition to EU transfers. Growth is likely to slow in the CIS from 5.3 percent in 2003 to 4.6 and 3.4 percent in 2004 and 2005, respectively, assuming a substantial fall in the oil price in both 2004 and 2005 and a decline in growth impetus through fiscal linkages, especially in Russia.

The war in Iraq and its aftermath are the key factors for the Middle East and North Africa region

The buildup to the war in Iraq and its aftermath have dominated events in the Middle East and North Africa region over the past year. The developments were, on balance, positive for oil exporters. The oil price surged, peaking at \$38/bbl, and production quotas were raised in early 2003 (figure 1.27). Buoyant oil revenues boosted economic performance by supporting higher fiscal expenditures. Elsewhere in the region, however, tourism and trade, not fully recovered from the effects of September 11, 2001, were further battered by the prospect of conflict in Iraq. The most affected countries were those closest to the conflict. Tourism in Jordan and Egypt was seriously affected; for Jordan, where tourism accounts for some 10 percent of GDP, the con-

sequences were particularly adverse. For Egypt, lower non-oil trade also affected revenues from the Suez Canal.

Short-term prospects for the region will be conditioned by political resolution in post-conflict Iraq. Uncertainties over the future of the country, with respect to governance, aid flows, and reconstruction, will continue to affect the region for some time. Nevertheless, growth should accelerate somewhat during 2003. The oil-exporting countries are expected to grow more quickly in 2003 as a result of fiscal pump priming and increased oil production quotas. For the diversified exporters, particularly Jordan and Egypt, a gradual recovery in tourism and other sectors affected by the conflict could unfold in the second half of 2003, but such recovery would be fragile. Other factors, not directly associated with recent developments in Iraq, will shape the near-term outlook. Egypt is suffering from a period of extended weakness in the domestic sector, and despite reforms to the exchange rate regime earlier in 2003, growth expectations for the year have dimmed as private investment remains subdued. Moroccan agriculture will provide a substantial boost to output in 2003 following the severe drought in that country. A



similar situation exists in Tunisia, where agricultural output fell by an estimated 11 percent during 2002.

The economic consequences of the conflict in Iraq will play out through its impacts on confidence and investment spending. A protracted process of reconstruction could exacerbate these problems. A downward trend in the oil price presents a further risk. With sluggish growth in world demand, oil prices could trend lower than anticipated, cutting exporters' incomes and putting fiscal expenditure programs at risk. Moreover, further political instability in the tense environs of the region cannot be ruled out, a development that would hamper investment and growth for an extended period of time.

A stronger external environment, upswing in agricultural cycle, should boost South Asian growth

Growth in the South Asia region slowed to 4.2 percent during 2002 from 4.9 percent in 2001, marking a downward revision from previous estimates, largely because of adverse weather conditions and declines in agricultural output in India, Bangladesh, and Nepal. Nepal experienced a plunge in tourism receipts and a sharp fall in manufacturing output, as domestic insurgency intensified. Pakistan and Sri Lanka both enjoyed a pickup in growth during the year linked to strong government spending in Pakistan; and for Sri Lanka, a recovery in the services sector and improved political stability tied to progress in peace talks and implementation of a year-long cease-fire. Current account balances for the two largest economies, India and Pakistan, posted surpluses and the region's aggregate external balance strengthened. A number of economies experienced a significant increase in remittances during 2002. These were driven largely by: incentives introduced by the Bangladeshi government to channel remittances through official sources; high interest rate differentials in India—reflecting significant government borrowing requirements there; and improvements in the security

situation and progress in macroeconomic stabilization in both Pakistan and Sri Lanka.

Growth is anticipated to accelerate throughout the region in 2003, to an average of 5.4 percent, assuming a return to trend agricultural production, a recovery in external demand, continued improvement in political stability and regional security, and a firming of domestic demand, especially in India (figure 1.28). In the medium term South Asian growth is likely to be sustained near 5.4 percent, assuming a continued recovery in external demand and establishment of normal trends in agricultural output. Bangladesh and India should benefit from an ongoing recovery in domestic demand. Both Pakistan and Sri Lanka are projected to enjoy continued macroeconomic stability and an associated acceleration of growth. Similarly, Nepal is anticipated to experience a pick-up in growth, assuming continued improvement in the security situation there, with a recovery in domestic demand and in tourism receipts.

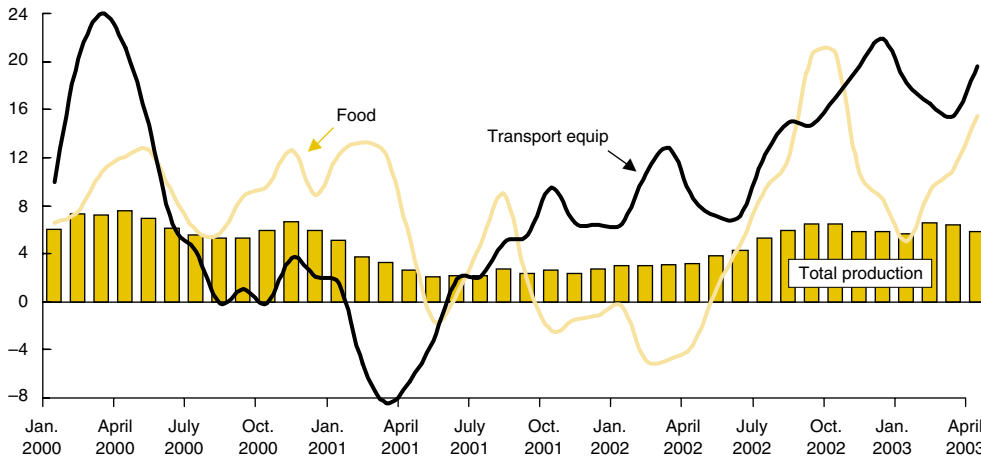
Furthermore, recently improved relations between India and Pakistan are hoped to lead to greater stability in the region, paving the way for increased business confidence and stability. The fiscal positions of the South Asian economies are forecast to improve moderately, assuming some progress in raising budget revenues (as a share of GDP) and improvement in the management of government expenditure. Inflation is projected to increase somewhat, albeit still at moderate levels, because of stronger growth and assumptions of a more accommodative monetary stance in many countries. Falling oil prices are expected to provide some offset to these domestic factors.

Sub-Saharan Africa maintains positive per capita growth in spite of a difficult external environment

A subdued world economy together with familiar problems of drought and civil strife held growth in Sub-Saharan Africa (SSA) to 2.8 percent in 2002. Import demand from Europe, the region's main trading partner, was particularly weak. Though most (dollar denominated) com-

Figure 1.28 Indian production of food and automobiles recovered sharply in early 2003

Industrial production, 3-month/3-month, percent change, year/year



Sources: Feri and national sources.

modity prices have rebounded from recent lows, terms of trade for non-oil exporters have recovered little of their losses of the past few years. At the same time, travel and tourism suffered not only from slower world income growth, but also from terrorist fears and the buildup to war in Iraq. As a result, foreign trade made a negative contribution to the region's growth. Domestic economies also slowed as poor weather or civil disorder disrupted agricultural production in countries containing over half the region's population, depressing incomes and demand. Notably, though, investment spending was relatively resilient. There were pluses to note as well. South Africa overcame the depressed tourism market to become the world's fastest growing tourist destination in 2002, with arrivals up over 20 percent. Non-traditional exports covered by AGOA preferences—transportation equipment, textiles and apparel, and agricultural products—registered strong growth despite the slowdown in the U.S. economy, indicating that with the right incentives and opportunities, SSA countries can be competitive. Most encouraging of all, according

to preliminary estimates 12 countries in the region achieved growth of 4 percent or better and average per capita income rose for a fourth successive year—the longest sustained rise in over two decades.

The region's largest economy, South Africa, registered relatively sound performances during 2002. Growth slowed toward the end of the year, but remained in positive territory as it has since 1999. Because of the increasing strength of the rand, foreign trade contributed negatively to growth, but domestic absorption was strong enough to offset that impact and growth overall reached 3.0 percent. Investment was particularly strong, up 6.5 percent in spite of high real interest rates. In Nigeria, the picture was mixed. The successful presidential election helped cement the fledgling democratic process; however, progress on fiscal and economic reforms continues to be frustratingly slow. Despite high oil prices, budget gridlock and a reduced OPEC quota held growth to only 1.9 percent. Progressively weaker oil prices over the next few years will put pressure on fiscal and external accounts, though expan-

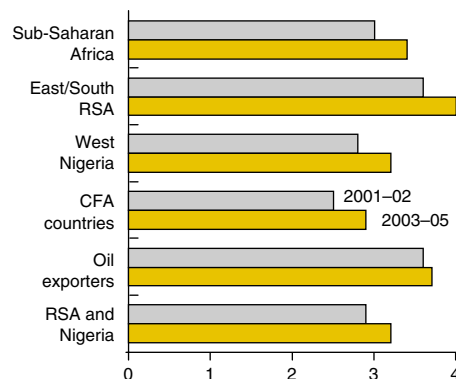
sion of the energy sector, especially of liquid natural gas (LNG), should sustain moderate real growth in the medium term.

In the medium term, the economic performance of Sub-Saharan Africa should benefit as the global recovery consolidates. Yet, with expectations for Europe at best moderate, the external impetus to growth will remain weak. For the region as a whole, growth is expected to remain unchanged at 2.8 percent in 2003, then rise to 3.5 percent in 2004. Both oil and non-oil producers will share in the acceleration. For oil producers—including additions to the list such as Côte d'Ivoire—rising capacity presages substantial growth in medium-term production and exports, even though prices and terms of trade are expected to fall sharply. Major energy-related infrastructure projects will further support demand. For the rest of the region, the recent rebound in commodity prices has largely run its course, but at least the expectation is for a measure of stability in key export markets at levels where exporters in Sub-Saharan Africa can continue to compete. With luck, better weather conditions will stimulate domestic incomes and expenditure as well (figure 1.29).

In the longer term, per capita growth is expected to average 1.6 percent—a substantial improvement on long-run historical trends, though barely half what would be needed to achieve the MDGs. The region continues to face immense development challenges from HIV/AIDS, to low savings and investment, poor infrastructure, shortages of human capital, and negative perceptions of international investors (box 1.5). Nor does the forecast anticipate any significant help from a reversal of recent terms of trade losses. But the region's most critical need is to re-establish civil order, where lacking, and to raise standards of governance and policymaking, for these are the most powerful predictors of economic performance. Here there is encouraging progress to report, with signs of institutional strengthening at both the country and regional levels. On balance, assuming a continuation of this trend, the forecast of positive, albeit moderate growth for the region should be achievable.

Figure 1.29 Growth in Africa is expected to improve modestly

GDP growth, 2001–02 and 2003–05



Note: RSA is Republic of South Africa.
Source: DECPG.

Trade, growth, and poverty in developing countries

World trade growth reached unprecedented levels in the 1990s, accompanied by accelerating flows of foreign direct investment (FDI). The sectoral and regional composition of trade changed dramatically with the spectacular growth of export volumes. While natural resource-based commodities—agriculture, oil and gas, minerals—were driving factors in developing countries' export growth in the past, more recent trade growth has been driven largely by manufactured goods—high-tech products as well as low-skill-intensive goods. These trends have led to stronger economic growth in many countries and significant reductions in global poverty.

Can these trends be sustained over the next 10–15 years? And can they be broadened to include countries that have not benefited from trade growth, but have very large proportions of poor people? The answer to both questions is “probably.” The long-term forecast anticipates that the MDG of halving the number of the world's people living in extreme poverty will be reached by 2015. Nonetheless, significant pockets of poverty will persist, and the goal will not be achieved in all developing regions.

Box 1.5 AIDS is taking a rising toll in Sub-Saharan Africa

Sub-Saharan Africa continues to be the epicenter of the AIDS epidemic. According to UNAIDS, 28.5 million Africans were infected in 2001 and 2.2 million died, lowering population growth by one-third of a percentage point. Given social and financial hurdles, treatment and care programs are likely to have at best a modest impact on the course of the epidemic. UNAIDS predicts 55 million deaths attributable to AIDS in Africa between 2000 and 2015 (UNAIDS 2002).

Although effective antiretroviral therapies have been developed, they are not in widespread use. Part of the explanation is cost. Providing these drugs to the entire infected population of Sub-Saharan Africa would cost nearly \$9 billion, about 70 percent of current official development assistance to the region. Nevertheless, it can be argued that such an expenditure, equivalent to just 0.04 percent of OECD GDP, would be cost effective from a development standpoint, by alleviating the burden on health-care systems and raising productivity (Moatti and others 2002). While more money is becoming available, it remains only a fraction of what is needed.

In addition to the financial obstacles to treatment, there is a deadly culture of denial to be overcome. In Botswana, the most afflicted country in the region, the incidence rate in the adult population is near 40 percent and life expectancy has dropped from more than 65 to less than 40. Yet a \$100 million partnership between the Bill and Melinda Gates Foundation and Merck to provide free antiretrovirals to all who need them has, so far, achieved only limited success. Less than 5 percent of Botswanans have been tested for HIV, and fewer than 0.1 percent of those thought to be infected are enrolled for free treatment.

Many researchers have explored the economics of HIV/AIDS using macroeconomic and CGE models. The magnitudes of impact appear surprisingly small, seemingly out of proportion to the human tragedy. From a macroeconomic standpoint, impacts of HIV/AIDS arise from:

- Slower labor-force growth and a higher proportion of younger, less-skilled, and less productive workers
- Lower productivity because of illness or worry on the job, or more time off work
- Higher costs to governments and employers of health care, training, and sick pay
- Reduced household savings after payments for treatment or funerals, and, simultaneously, less public and private investment because of financing constraints, uncertainty, and lower expected profits.

Quantifying these channels is not straightforward, but the preponderance of results suggests an overall reduction of per capita growth somewhere between 0.5 and 1 percentage point. This reduction is a significant cost to a region where long-term growth lies in the 0.8 to 1.6 percent per capita range, and it underscores Greener's point (2002) that economic policy is important so that better economic performance can offset the enormous devastation.

HIV/AIDS has major implications for public finance and the provision of health services. Even without the epidemic, African public health budgets, which average \$50 per capita, would be woefully inadequate. In addition, the disease may have major, though not well studied, implications for income distribution. An individual household is either affected or not; and for those vulnerable to being tipped into poverty by the loss of one or more breadwinners, the effect can be tragic. The threat posed by large numbers of homeless, uneducated, angry youths with no parents and no prospects may, in the long run, turn out to be the greatest cost of the epidemic.

Sources: Greener (2002), Moatti et al. (2002).

Trade performance over the 1990s was unprecedented

From several points of view, trade performance during the 1990s was unprecedented. The overall volume of trade accelerated relative to output, growing nearly 2.5 times faster than GDP, compared to an historical average of 1.5. Such increase in income elasticity was a global phenomenon, although it was clearly more pronounced in developing countries, which had experienced a sharp fall in trade during the debt crises of the 1980s, and a sharp boom just before the financial crises of 1997 and 1998 (figure 1.30).

The robustness of the recent trade expansion was highlighted following the East Asian financial collapse. Trade flows recovered from that crisis much more quickly than they did after the Latin American debt crises of the early 1980s. During the 1990s, developing countries' merchandise exports increased at an annual rate of 8.5 percent, up from growth trends of less than 2 percent during the 1980s. Despite the financial crisis of 1997, exports from East Asia increased on average by 13.4 percent per year during the decade, almost doubling the strong performance of the 1980s.

Within a decade export revenues in developing countries rose from less than 15 percent of GDP to almost 25 percent (figure 1.31).

The change in the composition of exports was a major factor underpinning growth

More remarkable than the overall growth of trade was the transformation in the product mix of exports. Developing countries now rely less on shipments of primary commodities than on manufactured goods. Whereas two decades ago developing countries derived 70 percent of merchandise export revenue from sales of primary commodities—agriculture and energy—the situation is now completely reversed, with 80 percent of revenue coming from exports of manufactures. Even exports from Sub-Saharan Africa are no longer primarily resource-based, as the share of manufactures in African exports has risen from 25 percent during the late 1970s to 56 percent today. Almost all of the increase was realized during the last decade.

With the rising share of manufactures in total exports, underlying high growth rates in most manufacturing sectors have an increasingly large impact on overall export growth. The shift toward manufacturing clarifies some

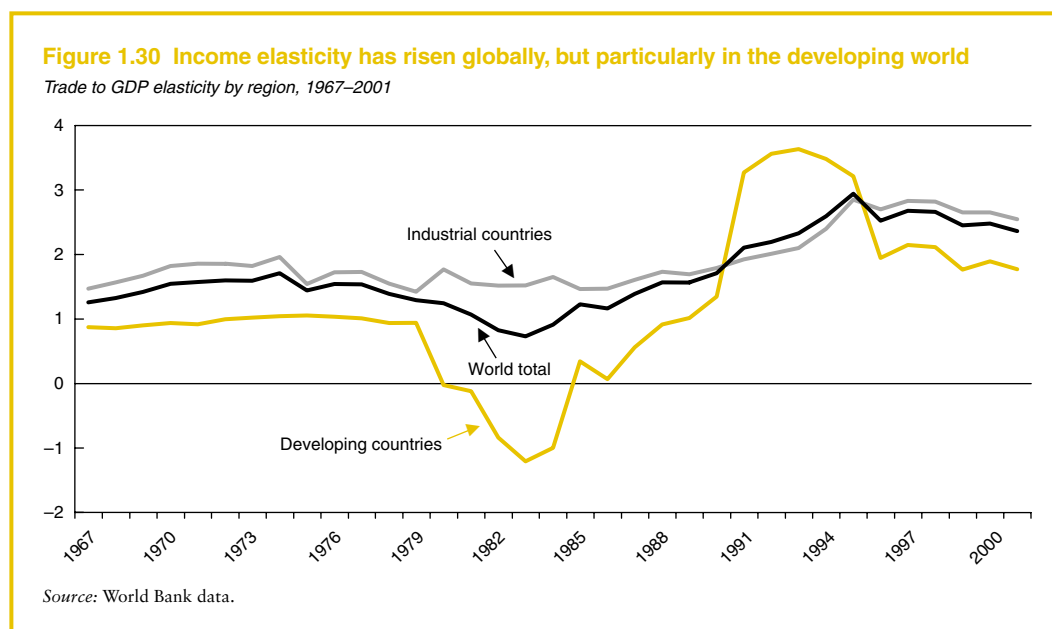
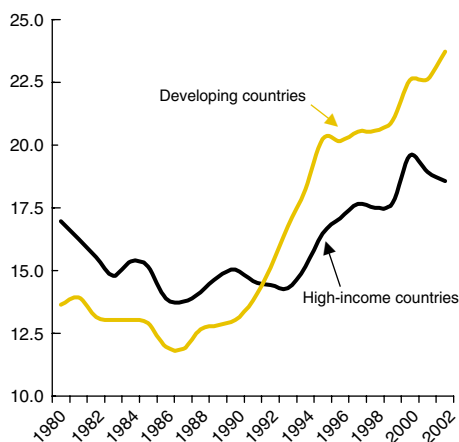


Figure 1.31 Export-to-GDP ratios have risen sharply in developing countries

Merchandise exports, percent of GDP, 1980–2002



Source: World Bank data.

of the regional differences in overall trade performance—growth has been fastest where the share of manufactured products in total exports was already large—and suggests that the acceleration of overall trade growth was not a temporary phenomenon, as the share of manufactured products is likely to increase further.

To illustrate the importance of the export mix, annual growth of export revenue during the 1990s for East Asia and Sub-Saharan Africa are calculated with different sectoral weights, while using *actual* growth rates at a sectoral level. Merchandise export revenue in Sub-Saharan Africa advanced at an annual rate of 5.4 percent during the 1990s. However, if the region had already reached the maturity of East Asia, with a significantly larger share of manufactures in total exports, the same sectoral growth rates—double digit for manufacturing and small for natural resources—would have led to 10.6 percent overall revenue growth. Alternatively, applying East Asian growth rates to Sub-Saharan shares would have led to 10 percent growth, instead of the 17 percent annual growth actually realized. This suggests that roughly half of the difference in overall growth between the two

regions was due to differences in sectoral growth rates, the other half to the larger share of manufactures in East Asia.

Such compositional effect will continue to influence overall growth numbers during the coming decade as the share of manufactured products rises further. Should all developing countries achieve the same growth of export revenue at a sector level as during the 1990s, overall revenue growth would rise to 20 percent per year, instead of the 11 percent realized annually during the 1990s. The composition effect of 9 percent a year applies to most regions, with regional effects ranging from 5.1 percent in Latin America to 10.6 percent in Europe and Central Asia.

Changes in the composition of trade can be traced to several factors

What accounts for the growth in manufactured exports? Will trade continue to grow at such robust rates? The driving forces are a combination of policy reforms, structural change in global production processes, and general economic trends related to continuous increases in real per capita incomes. The contribution of these various forces cannot be decomposed in a linear fashion, because some are tightly linked with others. However, because the strong links work in a virtuous circle, it is likely that the combined effects evident in current trends will continue into the coming years.

Policy reforms began in the 1970s in East Asia. They were later initiated in other regions, culminating in a rapid acceleration of reforms during the 1990s. A key element of the policy change was lowering of trade barriers in manufacturing—unilaterally, regionally, and multilaterally. But in all successful cases, change was embedded in broader domestic institutional reforms. Technological progress lowered transportation costs, improved communications and business practices, and made it possible to build global production networks. The last change radically altered geographic specialization patterns and intensified trade in intermediate products. Income growth triggered consumers' desire for more and newer varieties of

goods, creating markets for foreign products. These factors reinforced one another: Lower trade barriers triggered a new, global organization of production to take advantage of diversity in comparative advantage across the world. Desire for new products and a search for new markets provided a strong incentive for lower trade barriers. And importantly, technological progress and income growth were spurred by increased global competition and efficiency gains through global networks.

The decline in manufactures trade prices relative to domestic price deflators is a clear indicator of strong productivity growth in sectors operating on global markets. Prices of merchandise exports from high-income countries fell by almost 2 percent per year relative to domestic prices. This marked a significant acceleration of the price differential compared to the 1980s, when relative export prices fell 1 percent per year. A similar indication of accelerating productivity growth in sectors producing for global markets was observable in East Asia, where exports were already heavily concentrated in manufactures. In that region the price differential changed almost 2 percentage points during the 1990s. Though for other developing regions price trends are mixed—partly because of different specialization patterns, partly because of imperfections in domestic-factor markets—an acceleration of productivity growth in manufacturing sectors that compete in global markets appears to be a worldwide phenomenon.

While there are several key factors driving the changes in trade, there is no doubt that the sustained dismantling of trade barriers has been a primary driver. For example, the growth of production networks and their association with trade growth would not have been possible if trade barriers had remained high. Expanding the benefits of trade to a broader range of countries will require significant further decline in trade barriers, particularly for those commodities in which poor countries have a comparative advantage—agriculture and low-skill-intensive manufacturing. While expanding market access is not a sufficient condition to catalyze the

economies of poor countries, it is a necessary condition to be able to justify indispensable investments—in public and private infrastructure and education—to enable these economies to take off. The Doha Round will be a key complement to other more limited efforts to reduce trade barriers, for example, regional free trade agreements and unilateral reform efforts.

Greater trade will build on ongoing reforms to spur per capita growth in all regions

Intensified trade relations have laid the foundations for continuation of a virtuous circle in which access to new markets, increased competition, and productivity growth reinforce each other. Such an upward spiral would accelerate per capita income growth in many developing countries, especially those in which the effect of reforms is visible in certain sectors—even if not yet on an aggregate level. As competitive manufacturing sectors grow and reforms spread further, the results will become evident in economic figures over the next 10 years (table 1.5). The growing reliance on manufacturing will also reduce vulnerability to sharp and disruptive commodity cycles.

The impact of industrialization on productivity is reflected, for example, in the sharp acceleration of per capita income growth in Sub-Saharan Africa, from annual decline of 0.2 percent during the 1990s to an increase of 1.6 percent per year during the coming years. On the other hand, countries that, over the last decades, have experienced a rapid catching-up in productivity as a result of integration in global markets are bound to experience some slowdown, as the gap with the technological frontier narrows in some sectors. However, East Asia is still anticipated to outperform other regions, with average per capita income growth of 5.4 percent—lower than the 6.4 percent growth achieved during the 1990s.

As these fundamental structural shifts promote development, other conditions across countries are improving. Reduced imbalances in the external and internal accounts of developing countries have lowered their vulnerabil-

Table 1.5 GDP per capita will grow faster in the developing world than in the OECD area*Real GDP per capita, annual average percentage change, 1980s, 1990s, and forecasts*

	1980s	1990s	Forecast	
			Medium term	Long term
			2001–05	2006–15
World total	1.3	1.2	1.0	2.2
High-income countries	2.5	1.8	1.4	2.5
OECD	2.5	1.8	1.4	2.4
United States	2.2	2.2	1.5	2.5
Japan	3.5	1.2	0.7	1.9
European Union	2.1	1.7	1.5	2.3
Non-OECD countries	3.1	3.8	1.1	4.2
Developing countries	0.7	1.7	2.7	3.4
East Asia and the Pacific	5.6	6.4	5.4	5.4
Europe and Central Asia	0.6	-1.8	3.8	3.3
Latin America and the Caribbean	-0.9	1.7	0.3	2.5
Middle East and North Africa	-0.6	1.2	1.4	2.5
South Asia	3.6	3.3	3.4	4.1
Sub-Saharan Africa	-1.1	-0.2	1.0	1.6

Note: Aggregations are moving averages, reweighted annually after calculations of growth in constant prices.

Source: World Bank.

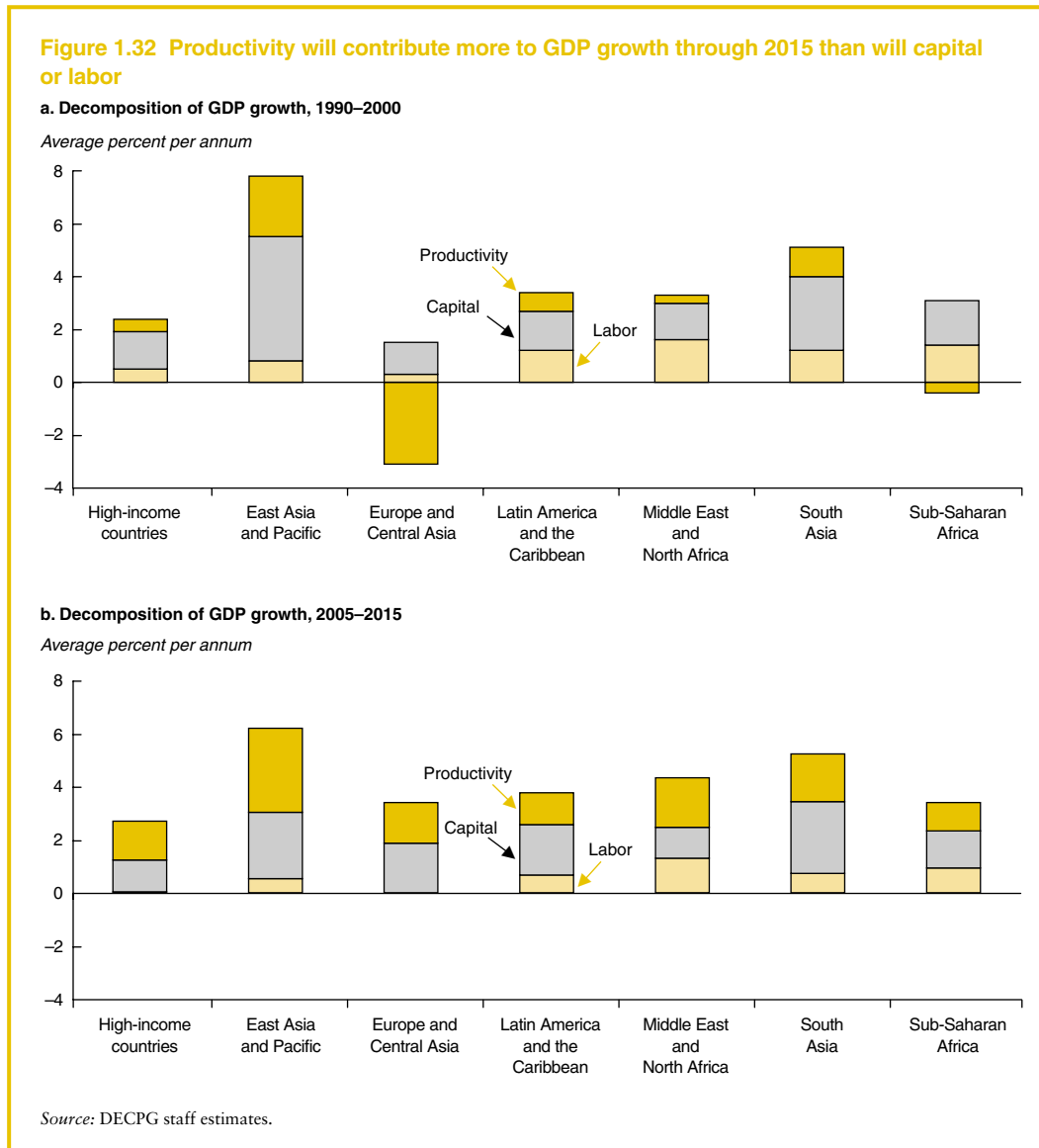
ity to swings in international interest rates and exchange rates and provided governments with some room to manage economic downturns. And macroeconomic conditions have improved—for example, lower inflation and interest rates are providing an improved environment for long-term investment by both domestic and foreign entities.

Apart from acceleration in growth, the relative importance of growth-supporting factors is likely to change. Productivity will likely increase in importance relative to population growth and capital accumulation (figure 1.32). This is especially true for countries in Latin America, where population growth during the coming 10 years is expected to be 0.5 percentage points lower than during the 1990s, capital accumulation will slow, and countries will be less able to rely on continued large current-account deficits. Reforms will have created the right environment to absorb technological innovations.

For the high-income countries, the scenario suggests per capita growth of around 2.5 percent over 2006–15, an acceleration of 0.7 percentage points from the average growth rate

of the 1990s. Acceleration in the developing countries will be more dramatic, with a projection of per capita growth of 3.4 percent for 2006–15, driven partly by a turnaround in Europe and Central Asia—an improvement already under way in the late 1990s. With accession to the European Union only months away, the accession countries can anticipate the type of growth experienced by Portugal and Spain upon their accession—built on solid investment flows, improved market access, and financial assistance from Brussels. The other countries in the region will benefit through trade linkages; they, too, will continue to consolidate the benefits from reforms initiated during their transition from planned economies.

Somewhat more tentatively, the scenario also presumes improved economic performance in Sub-Saharan Africa, which has witnessed two decades of negative per capita income growth. Despite the nearly 2 percentage point turnaround in per capita growth, a rate of 1.6 percent per capita if achieved, would still leave Sub-Saharan Africa at the low end of the developing-country growth spectrum, inadequate to make much of a dent



in poverty and other MDGs. Nonetheless there are positive signs emerging from parts of Sub-Saharan Africa, with per capita income growth positive for the fourth consecutive year, and a dozen countries achieving growth rates in excess of 4 percent per annum.

The main difference with the long-term scenarios contained in *Global Economic Prospects 2003* resides in the Middle East and

North Africa. Recent and prospective policy changes suggest that the region could attain a per capita growth rate of 2.5 percent over the next 10 years. Such an achievement would facilitate effort—particularly in private-sector development—to absorb the rapid increase in the labor force.

Growth rates in East Asia and Pacific are expected to remain strong through the long

term. At official exchange rates, incomes in rich countries remain more than 20 times higher than the average in East Asia and Pacific, and even at purchasing-power exchange rates, incomes are six times higher.

After the Middle East and North Africa, South Asia is the region least integrated into the global economy. Growth over the last decade can be attributed partly to trade policy reforms. Those reforms are expected to be pursued by local governments over the next decade, giving rise to sustained growth at rates approaching those of East Asia.

Latin America, like many of the other regions, has significantly diversified its exports over the last years and gained a strong foothold in global production networks. It is still, on average, relatively closed compared to some other developing regions and therefore will benefit from pursuing trade reforms within the hemisphere and beyond. Improved macroeconomic conditions—lower inflationary expectations and more flexible exchange rates—will provide better starting conditions to achieve higher potential growth of around 2.5 percent in per capita terms.

The risks to the long-term forecast are nevertheless not to be minimized. Many countries are still grappling with relatively low revenue-collection rates, which could become critical as countries attempt to make up for lost tariff revenues. The limits on government revenues are straining the capacity for required investment in public infrastructure—roads, ports, education, and other social services. The private sector can (and will) fill in some of the gaps, provided the right structures are in place. Conflict could affect growth prospects, particularly at the regional level, as we have seen in some parts of Sub-Saharan Africa in recent years or in the Middle East and Central Asia. Finally, a lack of progress in trade reforms or, worse yet, a return to protectionist tendencies could curb the expansion of trade and the ensuing benefits. The final section of this chapter assesses some of the economic benefits to be derived from further trade reform, above and beyond the baseline forecast presented here.

And growth will greatly reduce poverty

Strong economic growth—particularly in China and India, with yet-high concentrations of poor—will lead to substantial reductions in the incidence of poverty through 2015, with the MDG of halving extreme poverty being achieved on a global level—if not in each country or region. Sub-Saharan Africa—unless dramatic changes occur—almost surely will not reach the goal. Even under a somewhat optimistic economic forecast, the percentage of the African population living on \$1/day or less will remain above 42 percent through 2015, far from the goal of 23.7 percent. Sub-Saharan Africa will have nearly three times the incidence of poverty as the next poorest region (table 1.6).

South Asia, having approximately the same initial level of poverty as Sub-Saharan Africa in 1990, had already achieved impressive gains by 2000 (from 42 percent to 32 percent according to the latest figures) and will likely almost halve that level by 2015.³

According to current projections, Latin America will reach 2015 some 38 percent above the target, and Europe and Central Asia, 90 percent above—the latter after recovering sharply from the large rise in poverty during the transitional 1990s.

This year's poverty forecast contains some noteworthy changes from last year. The changes can be attributed to four factors—changes in the initial estimation of the number of poor,⁴ changes in the macroeconomic relation between per capita consumption growth and poverty reduction, changes in the economic forecast, and changes in the population forecast. The first two factors are derived from updated surveys and National Account data. The third factor—changes to the economic forecast—are mainly attributable to changes in the short- and medium-term forecast with little or no change to the long-term forecast (with one exception, noted below). The poverty forecast also incorporates the World Bank's most recent population projections. Growth in population has been revised downward in many regions. If per capita consumption

Table 1.6 Global poverty will decrease significantly, but not uniformly across regions
Regional breakdown of poverty estimates in developing countries, various measures

Region	GEP 2003			GEP 2004		
	1990	1999	2015	1990	2000	2015
Number of people living on less than \$1 per day (millions)						
East Asia and Pacific	486	279	80	470	261	44
China	377	223	73	361	204	41
Rest of East Asia and Pacific	110	57	7	110	57	3
Europe and Central Asia	6	24	7	6	20	6
Latin America and the Caribbean	48	57	47	48	56	46
Middle East and North Africa	5	6	8	5	8	4
South Asia	506	487	264	466	432	268
Sub-Saharan Africa	241	315	404	241	323	366
Total	1,293	1,168	809	1,237	1,100	734
Excluding China	917	945	735	877	896	692
\$1 per day headcount index (percent)						
East Asia and Pacific	30.5	15.6	3.9	29.4	14.5	2.3
China	32.9	17.8	5.3	31.5	16.1	3.0
Rest of East Asia and Pacific	24.2	10.6	1.1	24.1	10.6	0.5
Europe and Central Asia	1.4	5.1	1.4	1.4	4.2	1.3
Latin America and the Caribbean	11.0	11.1	7.5	11.0	10.8	7.6
Middle East and North Africa	2.1	2.2	2.1	2.1	2.8	1.2
South Asia	45.0	36.6	15.7	41.5	31.9	16.4
Sub-Saharan Africa	47.4	49.0	46.0	47.4	49.0	42.3
Total	29.6	23.2	13.3	28.3	21.6	12.5
Excluding China	28.5	25.0	15.7	27.2	23.3	15.4
Number of people living on less than \$2 per day (millions)						
East Asia and Pacific	1,114	897	339	1,094	873	354
China	819	627	219	800	599	256
Rest of East Asia and Pacific	295	269	120	295	273	98
Europe and Central Asia	31	96	45	31	101	48
Latin America and the Caribbean	121	132	117	121	136	124
Middle East and North Africa	50	68	62	50	72	38
South Asia	1,010	1,128	1,139	971	1,052	968
Sub-Saharan Africa	386	480	618	386	504	612
Total	2,711	2,801	2,320	2,653	2,737	2,144
Excluding China	1,892	2,173	2,101	1,854	2,138	1,888
\$2 per day head count index (percent)						
East Asia and Pacific	69.7	50.1	16.6	68.5	48.3	18.2
China	71.6	50.1	15.7	69.9	47.3	18.4
Rest of East Asia and Pacific	64.9	50.2	18.4	64.9	50.8	17.6
Europe and Central Asia	6.8	20.3	9.3	6.8	21.3	10.3
Latin America and the Caribbean	27.6	26.0	18.9	27.6	26.3	20.5
Middle East and North Africa	21.0	23.3	16.0	21.0	24.4	10.2
South Asia	89.8	84.8	68.0	86.3	77.7	59.2
Sub-Saharan Africa	76.0	74.7	70.4	76.0	76.5	70.7
Total	62.1	55.6	38.1	60.8	53.6	36.4
Excluding China	58.7	57.5	44.7	57.5	55.7	42.0

Source: World Bank staff estimates.

growth rates remain unchanged, the revised rates of population growth will have no effect on the poverty headcount index (all else equal), but it would lower the absolute number of poor.

One of the changes in table 1.6 is the use of the year 2000, rather than 1999, as the base year for the forecast. Because developing countries were booming in 2000, the headcount index—assuming distribution neutrality—would have declined substantially.⁵ Most regions indeed witnessed a decline in the headcount index in 2000, compared with the 1999 headcount index reported last year, except for the Middle East and North Africa, and Sub-Saharan Africa.⁶ At the global level, the estimate of the headcount index in 2000 is 21.6 percent, compared with the 23.2 percent estimate for 1999 in last year's report—representing a decline of 6.9 percent.

However, not all of the changes can be attributed to the change in the base year. This year's estimates are also based on new surveys and methodology affecting, among others, the two largest developing countries—China and India. The estimate of the number of poor in China has been revised downward for two reasons. The first is that, for the first time, consumption-based data—deemed more appropriate for poverty analysis—are available on a time-series basis. The second is that rural/urban population shares have been revised, with the urban share higher than previously estimated. The lower incidence of poverty in urban areas accounts for the downward revision in the overall poverty level for China. The new survey used in India has also led to a downward revision in the estimate of the poverty level. A new household survey provided the basis for our revision of Pakistan's poverty profile. The Middle East and North Africa regime benefits from new surveys in Morocco and Tunisia. The estimated level of initial poverty in Yemen has raised the regional level of poverty, but from a very low base.⁷ There are eleven new surveys for Latin American countries, including Brazil and Mexico.

Looking forward to 2015, there are some rather sharp changes in the poverty forecast, focusing on the \$1/day indicator. At a global level, the new forecast for 2015 for the headcount index drops to 12.5 percent, compared with 13.3 percent in last year's report—a 5.9 percent decline. The projected number of poor in 2015 declines to 734 million, from 809 million last year. Part of the decline in the number of poor can be attributed to a decline in the population growth rate through 2015.

Compared with last year's forecast, the headcount index for East Asia declines by 44 percent, from 3.9 percent to 2.3 percent. By and large, the decline is the result of a new estimate of the headcount elasticity, since the long-term GDP growth rates remain largely unchanged. The other key difference is for the Middle East and North Africa region. The incidence of poverty starts from a low level (between 2 and 3 percent). With growth prospects revised upward, the headcount index is expected to drop to 1.2 percent, compared with last year's 2.1 percent, despite the upward revision in the base number of poor. In South Asia, the headcount index in 2015 has been revised upward from 15.7 percent to 16.4 percent, despite the decrease in the initial level. The new survey information suggests that the estimate of the headcount elasticity has declined, as the shape of the income distribution curve has shifted the poor toward the left end of the distribution tail, away from the poverty line. For Sub-Saharan Africa, the 2015 headcount index is forecast at 42.3 percent, a drop from last year's 46 percent. This improvement incorporates some new survey information, but positive trends in the short- and medium-term forecast, particularly for the oil exporters, account for most of the change.

Looking ahead to the Doha Round

A successful outcome of the multilateral trade negotiations known as the Doha Development Agenda, or the Doha Round, would

greatly improve the growth and poverty outcomes discussed above. This section analyzes an illustrative pro-poor scenario of multilateral trade reform, using the World Bank’s global trade model.

An illustrative pro-poor scenario

Several proposals to improve market access for merchandise trade have been tabled in advance of the upcoming WTO ministerial meetings in Cancun in September 2003 (see chapter 2). Most observers concur that any agreement reached in Cancun should meet at least three criteria—it should be simple, it should address tariff peaks, and it should be development-friendly. An illustrative pro-poor scenario and its potential impact on incomes, trade, and poverty are discussed below.

Rich countries would be subject to a maximum tariff in agriculture of 10 percent—that is, all peaks would be cut back to a maximum of 10 percent (table 1.7). The average tariff target would be 5 percent. On the manufacturing side, tariff peaks would be scaled back to 5 percent, with a 1 percent target on the average manufacturing tariff rate, which is already low. Developing countries would be subject to a maximum agricultural tariff of 15 percent, with a targeted average of 10 percent (double the rich-country average). In manufacturing, the peak would be capped at 10 percent; the targeted average would be 5 percent.

The pro-poor scenario includes elimination of export subsidies, decoupling of all domestic

subsidies, and the elimination of the use of specific tariffs, tariff rate quotas (TRQs), and antidumping duties and sanctions. Specific tariffs and TRQs have unpredictable and perhaps unintended consequences for exporters⁸ and consumers, and—in the case of TRQs—have proven difficult to administer. Antidumping measures, in increasing use since 1995, have a chilling effect on many exporters by presenting them with the possibility of losing market access on short notice.

Analyzing the impact of the pro-poor scenario is not a trivial exercise, partly because of data issues—the difficulty in quantifying specific tariffs and TRQs—and partly because of methodological issues—modeling TRQs and the impact of antidumping measures raises a number of thorny problems. Nonetheless, drawing on the work published in *Global Economic Prospects 2002*, the next section describes the impact of the foregoing scenario, using the World Bank’s trade model (with modifications).

Assessing the impact of the pro-poor scenario is complex

The starting point is the GTAP database—used by trade analysts worldwide for trade assessments. The base year is 1997, with more recent agricultural protection data, but excluding other developments—such as recently signed regional trade agreements, China’s WTO accession offer, and future changes to farm programs (such as the recently agreed reform of the EU’s Common Agricultural Program). Taking these points into consideration, together with other features of the GTAP dataset, the impact assessment likely will overstate some of the benefits of the pro-poor scenario. It is also possible, however, that other factors, such as the pro-competitive and dynamic effects of trade reform, could prove our impact assessment to be an underestimate.

Summary indications of the scenario’s impact on *tariffs* using the GTAP level of protection are presented in table 1.8. The table is divided into two broad sectors—agriculture (in-

Table 1.7 Tariffs could be cut clearly and simply
Pro-poor tariff targets by type of country and sector (percent)

	Industrial	Developing
Agriculture		
Average	5	10
Maximum	10	15
Manufacturing		
Average	1	5
Maximum	5	10

Source: World Bank.

Table 1.8 The pro-poor tariff scenario would significantly lower protection

Analysis of initial and final average tariffs in agriculture and manufacturing under the World Bank's tariff scenario, using World Bank trade model (percent)

	Agriculture			Manufacturing		
	Average tariff		Percent reduction in non-peak tariffs	Average tariff		Percent reduction in non-peak tariffs
	Initial	Final		Initial	Final	
OECD Cairns countries	15.9	6.0	100.0	2.2	1.0	56.3
European Union with EFTA	22.4	7.4	100.0	4.2	1.2	100.0
United States	10.8	5.0	60.6	2.4	1.0	57.7
Japan	50.3	10.0	100.0	1.6	0.9	0.0
Korea, Rep. of, and Taiwan (China)	49.4	8.2	100.0	5.7	3.1	100.0
Hong Kong (China) and Singapore	1.6	1.6	0.0	0.0	0.0	0.0
Brazil	12.0	10.0	21.3	14.6	6.9	100.0
China	38.8	11.0	100.0	13.8	8.6	100.0
India	25.9	13.2	100.0	21.7	8.8	100.0
Indonesia	9.0	7.4	0.0	8.6	5.0	29.0
Russian Federation	11.8	10.0	12.3	12.3	5.6	100.0
Mexico	23.6	10.0	61.5	2.7	2.3	0.0
Southern African Customs Union	45.7	12.2	100.0	9.4	5.0	32.4
Vietnam	32.5	11.4	100.0	16.9	5.2	100.0
Rest of South Asia	23.6	10.3	100.0	31.3	9.9	100.0
Rest of East Asia	22.9	11.9	100.0	7.9	5.0	29.6
Rest of Latin America and Caribbean	14.5	10.0	77.9	12.0	6.3	100.0
EU accession countries	24.9	12.8	100.0	7.5	5.0	35.5
Rest of Europe and Central Asia	22.4	10.0	92.5	5.0	4.7	0.0
Middle East	76.4	12.8	100.0	8.4	5.0	49.4
North Africa	35.5	10.2	100.0	18.6	9.1	100.0
Rest of Sub-Saharan Africa	20.6	10.5	100.0	16.0	8.8	100.0
Rest of WORLD	8.1	6.0	0.0	7.5	5.0	15.6

Note: Agricultural tariff peaks are cut to 10 and 15 percent respectively in high-income and developing countries. Manufacturing tariff peaks are cut to 5 and 10 percent respectively in high-income and developing countries. The targets for average agricultural tariffs are respectively 5 and 10 percent, respectively, for high-income and developing countries. Targets for the average manufacturing tariff are 1 and 5 percent, respectively, for high-income and developing countries.

Sources: GTAP release 5.3 and World Bank staff calculations.

cluding processed foods) and manufacturing. The first column in each sector provides the (import weighted) average tariff.⁹ Thus for Japan, the average tariff is 50 percent in agriculture but less than 2 percent in manufacturing.

The second column shows the targeted average tariff rate. The rich-country agricultural target of 5 percent is achieved in the United States, for example. In Japan and some regions, it is not achieved. In Japan, for example, the scenario would lead to an average rate of 10 percent, twice the target rate, because Japan's peaks are high and cover a wide percentage of agricultural trade. Initial tariffs below the peaks would have to become negative for the target to be achieved.¹⁰ In some

cases cutting the peaks is sufficient to achieve or surpass the targeted tariff level. This is the case, for example, for Indonesian agriculture, where the average tariff is already below the target and reducing the peaks simply drops the average.

The third column provides the level of reduction in non-peak tariffs. In the United States, for example, non-peak agricultural tariffs would be reduced by an average of 60 percent to achieve the 5 percent average target.

Rich countries would see a significant drop in the average agricultural tariff. In the advanced countries of Asia, in particular, average agricultural tariffs would fall from near 50 percent to somewhere around 10 percent—still

above the target level. The United States would achieve the target, but from a more modest 11 percent initial level, whereas the European Union would see a drop in the average (extra-EU) tariff from 22 percent to just above 7 percent. Developing countries would also see significant reductions, higher on average than in rich countries. Many regions would not meet the 10 percent target because of the many tariffs higher than the 15 percent cutoff point.

In manufacturing, the average tariff rate in rich countries would decline slightly following the removal of peaks. In developing countries, the 5 percent target could be met in many regions, with Mexico and the EU-accession countries already below the target with their prevailing initial tariff rates.¹¹

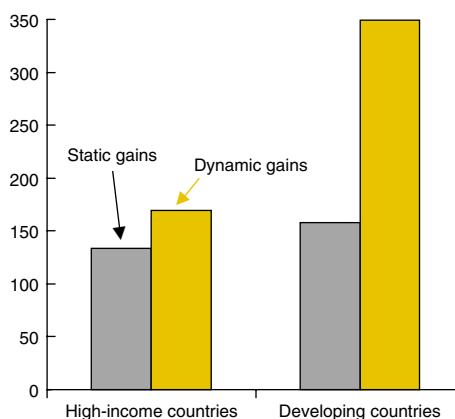
The “decoupling” part of the scenario is achieved by removing all domestic support in agriculture—input and output subsidies and payments to land and capital. These would be replaced by direct payments to farm households. Such lump-sum transfers, not modeled explicitly, are important in determining income distribution within each region, but they have no direct effects on the distribution of production, on income across regions, or on the results described below. Export subsidies, which have played a relatively small role recently, are also removed. The impacts of specific tariffs and TRQs in agriculture are captured in the base protection data and are modeled as part of the ad valorem equivalent tariff. The full ad valorem tariff is subject to the reductions described in table 1.8.

The scenario would yield significant gains

The scenario described and analyzed above would generate \$291 billion in global economic gains—nearly 75 percent of the total potential gains from full merchandise trade reform.¹² Measured in static terms, some \$159 billion¹³ in additional income would be reaped by developing countries in 2015 (compared to the baseline); rich countries would gain around \$132 billion (figure 1.33). The gains, which would raise income levels by 1.5 and 0.5 percent, respectively, for developing

Figure 1.33 The pro-poor reform scenario promises substantial income gains

Change in real income in 2015 relative to baseline (\$1997 billion)



Source: World Bank staff simulations.

and rich countries, could be much higher if dynamic effects—such as increases in productivity¹⁴ and increasing FDI—are taken into consideration. Varying the trade model to link sectoral productivity to the export/output ratio shows that dynamic effects can indeed be substantial. In developing countries, the dynamic gains from the trade reform scenario are some 120 percent higher than the static gains. The dynamic gain for rich countries is less dramatic, because of the low GDP weight of agriculture, for which protection is strongest.

The reduction of trade barriers in agriculture and food yield \$193 billion (in 2015), two-thirds of the total static gains from merchandise trade reform of \$291 billion (table 1.9). More than 50 percent of these gains in agriculture and food, \$101 billion, are reaped by developing countries, of which 80 percent is the result of own-reform in these two sectors. In other words, reform of agriculture and food in rich countries would lead to a gain of some \$20 billion for developing countries as a whole. Manufacturing liberalization by rich countries would lead to gains of \$25 billion to developing countries and could potentially even lead to a (small) loss to rich countries as increased mar-

Table 1.9 A large share of real income gains comes from lowering of barriers in agriculture and food*(real income gains in 2015 relative to the baseline in \$1997 billion)*

	Liberalizing region		
	Low- and middle-income countries	High-income countries	All countries
	Decomposition of static impacts		
Gains to low- and middle-income countries			
Agriculture and food	80	20	101
Manufacturing	33	25	58
All merchandise trade	114	44	159
Gains to high-income countries			
Agriculture and food	23	64	91
Manufacturing	44	-3	41
All merchandise trade	67	63	132
Global gains			
Agriculture and food	103	84	193
Manufacturing	77	22	98
All merchandise trade	181	107	291
	Decomposition of dynamic impacts		
Gains to low- and middle-income countries			
Agriculture and food	167	75	240
Manufacturing	95	9	108
All merchandise trade	265	85	349
Gains to high-income countries			
Agriculture and food	19	100	117
Manufacturing	36	13	48
All merchandise trade	55	115	169
Global gains			
Agriculture and food	185	174	358
Manufacturing	131	22	156
All merchandise trade	321	199	518

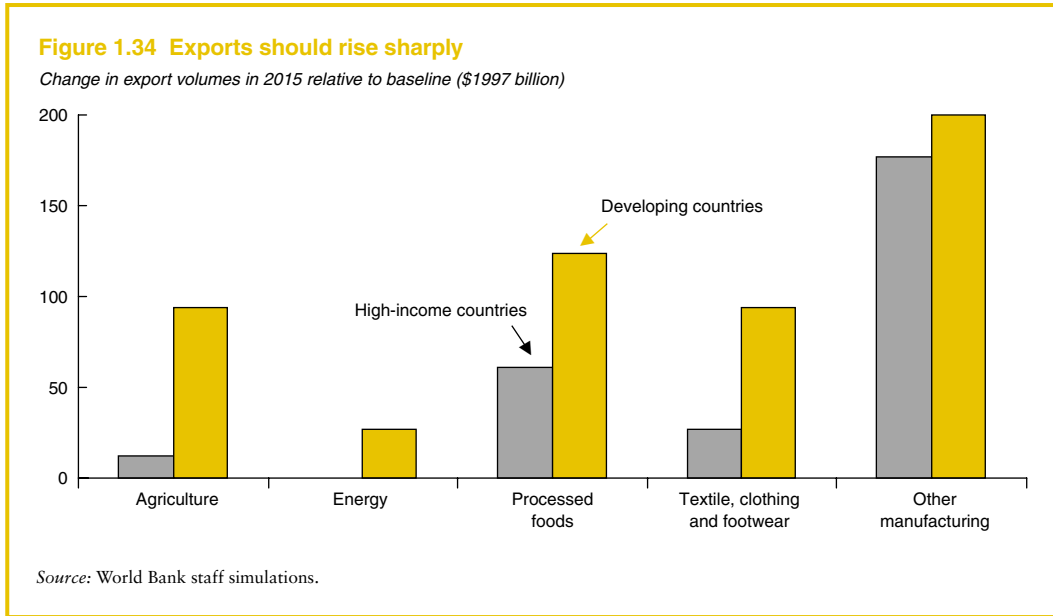
Source: World Bank staff simulations.

ket access by developing countries generates terms-of-trade losses for rich countries—losses not fully compensated by the gains in allocative efficiency. There is a degree of asymmetry in the impacts of the reforms on rich and on developing countries. The former gain significantly more from their own reforms (\$114 billion of the \$159 billion total), whereas the impacts for rich countries are more or less evenly spread between own-reform and developing-country reforms.

Trade would increase sharply under the scenario—particularly in the most severely protected sectors: agriculture and food (figure

1.34). Globally, merchandise trade would increase by about 10 percent (more than \$800 billion), but exports from developing countries would rise by 20 percent (nearly \$540 billion). The largest percentage increase in trade (nearly 50 percent) would occur in processed foods. Agricultural trade would rise by 32 percent. Developing countries should see an increase in their exports of textiles, clothing, and footwear, although its magnitude would depend on the final implementation of the Uruguay Round.

The number of poor would decline substantially under the partial reform scenario de-



scribed here. At the world level, the number of persons living on \$1/day or less would decline by 61 million, or 8 percent of the current forecast for 2015 of 734 million (figure 1.35).¹⁵ The number living on \$2/day or less would decline by 144 million. The greatest reduction

in absolute terms would come in Sub-Saharan Africa. The region's unskilled workers would see the largest percentage increase in nominal wages and decreases in the cost of living. The largest percentage fall would occur in the Middle East. This region has the highest over-

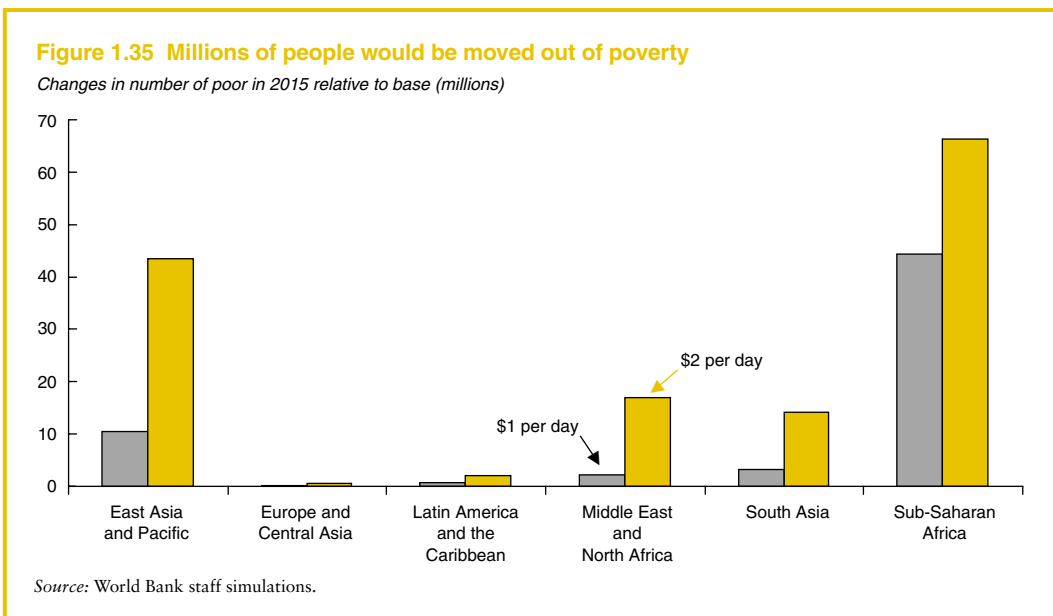
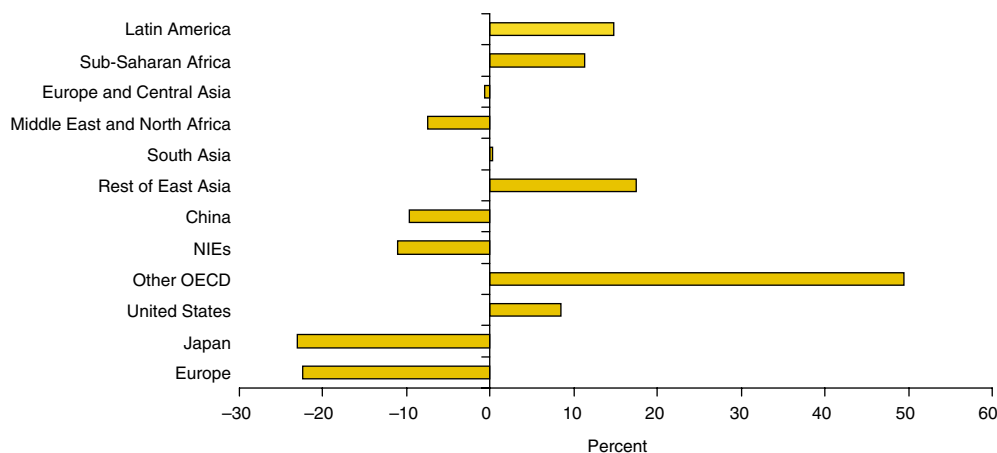


Figure 1.36 Gains for most, but adjustment costs for some*Percent change in rural value added in 2015 relative to the baseline*

Note: The negative impacts on Chinese farmers could be overstated since the baseline simulation does not incorporate the impacts of WTO accession.

Source: World Bank staff simulations.

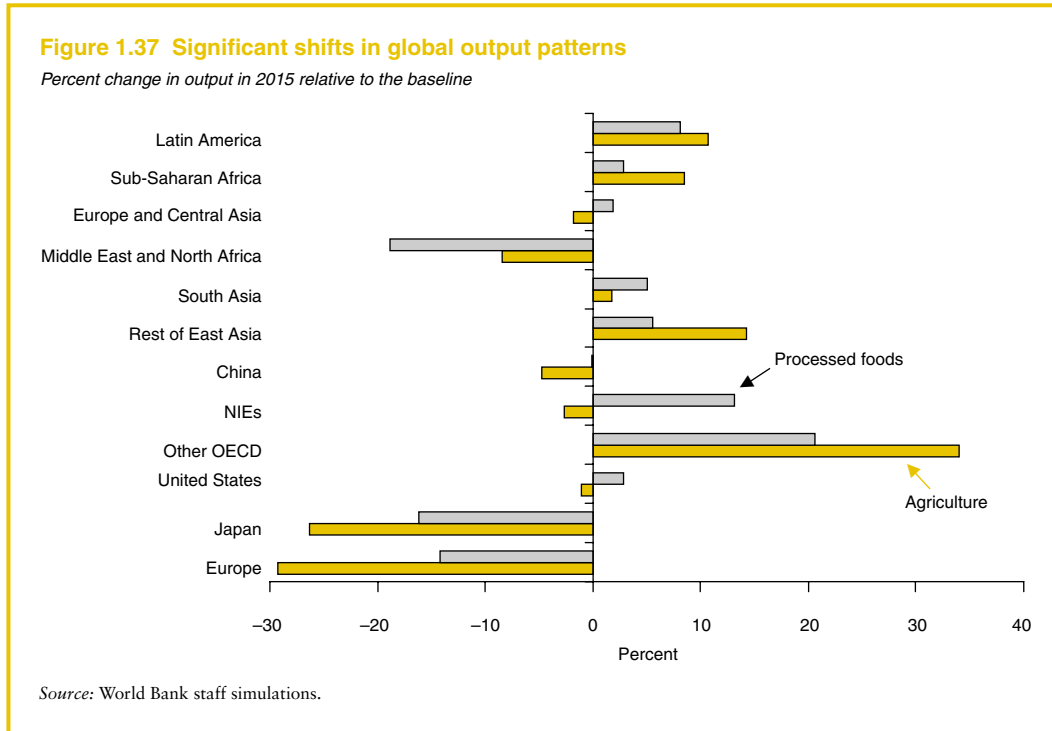
all barriers to imports and a substantial tax on consumers. However, the region has a relatively low level of poverty, particularly compared to Sub-Saharan Africa and South Asia.

The positive impact on overall growth, accompanied by a sharp boost in trade and a poverty outlook improvement leaving all regions better off in aggregate, does not signify that the reforms are without adjustment costs, even over the long term.¹⁶ For example, given the levels of protection in the agricultural sectors, particularly in the OECD countries, farmers stand to lose the most from reductions in protection. The change in agricultural incomes needs to be put in context. First, the adjustment will occur over a 10-year period, allowing for a gradual adjustment. Second, the adjustment in most countries will be limited to a small share of GDP. In high-income countries, agricultural output is less than 3 percent of total output on average. For developing regions, agricultural output varies from a low of 7 percent for upper middle-income countries to 24 percent for low-income countries. Additionally, manufacturing will expand, and the

transitional impacts will be mitigated to the extent that rural economies are diversified.

As can be seen in Figure 1.36, rural value added in Europe and in Japan could decline by more than 20 percent over the long term. And within agriculture, the distribution of the impacts is likely to be highly differentiated—across sectors within agriculture, as well as by factor ownership. For example, tenant farmers could be better off than landowners because the price of land is expected to fall in most OECD regions with the removal of protection. Farmers in some developing regions could also witness a decline in overall agricultural income—particularly in China and the Middle East and North Africa. On the other hand, farmers in Canada, Australia, and New Zealand will reap significant rewards from this reform, as will farmers in the rest of East Asia (for example in new market access for rice and vegetable oils), Latin America (grains, livestock, and sugar), and in Sub-Saharan Africa (sugar).

These adjustments will be accompanied by structural shifts in world agricultural and food output, following closely the patterns of changes



in rural value added (figure 1.37). The changes in agricultural output tend to dominate those in processed foods, despite relatively similar levels of protection, in part because of the lower costs of inputs—that is, raw agricultural commodities—for the processing sectors. The main reductions in output occur in Europe, Japan, and the Middle East and North Africa

for both agriculture and processed foods. The beneficiaries include Canada, Australia, and New Zealand among rich countries; Asia outside of China; Sub-Saharan Africa; and Latin America. The NIEs—particularly Korea and Taiwan (China)—show that they could be competitive in processed foods were they to remove agricultural protection.

Annex 1 Historical trade dynamics for developing countries

Table 1.A1 Sectoral export decomposition for developing countries^a

Percent

	Share (percent)			Average growth (percent per annum)		Contribution to growth (percent)	
	1977	1987	1997	1977-87	1987-97	1977-87	1987-97
High income Asia excluding Japan^b							
Agriculture	5.1	1.8	0.3	4.6	-5.9	0.9	-0.4
Oil and gas	0.6	0.1	0.1	-6.5	12.6	-0.1	0.1
Other natural resources	0.9	0.4	0.2	5.6	5.5	0.2	0.1
Processed foods	8.7	5.1	2.3	9.7	3.1	4.0	0.9
Textiles, apparel, and leather goods	30.0	25.1	13.5	13.8	4.9	23.7	7.7
Motor vehicles and parts	0.4	1.8	3.4	33.6	19.0	2.2	4.2
Electronic equipment	10.9	17.1	31.7	21.2	18.7	19.0	39.0
Other machinery	12.6	17.3	22.4	19.6	14.5	18.7	24.9
Other manufacturing	30.9	31.4	26.1	16.0	9.6	31.5	23.4
Total	100.0	100.0	100.0	15.9	11.6	100.0	100.0
East Asia and Pacific							
Agriculture	19.1	13.1	2.2	7.0	-1.8	9.9	-0.6
Oil and gas	25.3	20.7	3.6	8.9	-1.4	18.3	-0.7
Other natural resources	11.3	5.5	2.1	3.5	6.3	2.4	1.2
Processed foods	20.3	15.2	6.9	8.0	8.5	12.5	4.8
Textiles, apparel, and leather goods	5.1	14.0	22.4	23.0	23.0	18.8	24.5
Motor vehicles and parts	0.1	0.7	0.7	36.9	17.3	1.0	0.7
Electronic equipment	1.8	7.2	20.9	27.7	30.7	10.0	24.4
Other machinery	2.8	4.4	13.8	16.2	31.5	5.3	16.1
Other manufacturing	14.3	19.1	27.4	14.4	21.7	21.7	29.5
Total	100.0	100.0	100.0	11.1	17.4	100.0	100.0
South Asia							
Agriculture	27.8	22.1	5.9	5.3	-1.1	16.9	-1.0
Oil and gas	0.3	1.7	0.1	29.4	-15.9	2.9	-0.6
Other natural resources	13.4	16.9	5.2	10.3	0.4	20.1	0.3
Processed foods	19.8	12.8	10.3	3.2	10.5	6.5	9.3
Textiles, apparel, and leather goods	14.0	27.9	46.5	15.4	18.8	40.2	54.4
Motor vehicles and parts	0.9	0.6	1.2	3.9	20.6	0.4	1.4
Electronic equipment	0.3	0.4	1.2	10.5	25.0	0.5	1.6
Other machinery	5.3	4.7	4.5	6.4	12.5	4.1	4.5
Other manufacturing	18.2	13.0	25.0	4.2	20.5	8.4	30.1
Total	100.0	100.0	100.0	7.8	12.8	100.0	100.0
Latin America and the Caribbean							
Agriculture	26.0	17.8	10.0	4.3	2.8	11.1	4.1
Oil and gas	14.2	16.3	6.9	9.7	0.0	17.9	0.0
Other natural resources	7.1	5.8	4.4	6.0	6.0	4.7	3.4
Processed foods	20.1	14.1	12.0	4.5	7.1	9.1	10.4
Textiles, apparel, and leather goods	2.7	3.8	8.5	12.2	18.1	4.7	12.0
Motor vehicles and parts	1.5	3.6	8.4	18.5	18.6	5.3	12.0
Electronic equipment	1.7	3.1	5.9	14.9	16.2	4.2	7.9
Other machinery	3.6	7.6	13.3	16.7	15.1	11.0	17.5
Other manufacturing	23.1	27.9	30.6	10.4	9.9	31.9	32.6
Total	100.0	100.0	100.0	8.3	8.9	100.0	100.0

(Table continues on next page)

Table 1.A1 (continued)

Percent

	Share (percent)			Average growth (percent per annum)		Contribution to growth (percent)	
	1977	1987	1997	1977–87	1987–97	1977–87	1987–97
Europe and Central Asia							
Agriculture	22.8	14.7	5.2	5.2	10.6	9.6	3.8
Oil and gas	0.2	2.6	11.0	45.1	41.7	4.2	12.2
Other natural resources	18.6	9.7	4.7	3.1	14.1	4.2	3.9
Processed foods	15.0	13.4	6.3	8.7	13.8	12.4	5.2
Textiles, apparel, and leather goods	9.9	18.0	12.6	16.8	18.4	23.2	11.8
Motor vehicles and parts	1.3	1.5	3.0	11.7	31.4	1.7	3.2
Electronic equipment	0.6	0.6	2.1	10.3	38.8	0.6	2.3
Other machinery	10.1	8.5	9.3	8.1	24.0	7.5	9.5
Other manufacturing	21.6	30.9	45.9	14.0	27.7	36.8	48.1
Total	100.0	100.0	100.0	9.9	22.8	100.0	100.0
Middle East and North Africa							
Agriculture	1.8	2.4	1.9	2.5	2.1	-15.9	1.0
Oil and gas	86.2	69.4	42.4	-2.5	-0.4	586.9	-5.0
Other natural resources	1.0	2.3	2.0	8.1	3.0	-37.8	1.4
Processed foods	0.9	1.5	1.4	4.7	4.6	-16.0	1.4
Textiles, apparel, and leather goods	1.0	2.1	5.8	7.1	15.6	-31.6	12.2
Motor vehicles and parts	0.5	0.3	0.5	-5.9	11.2	6.6	0.9
Electronic equipment	0.2	0.6	2.0	13.6	18.0	-12.6	4.4
Other machinery	0.8	2.4	4.1	11.4	10.1	-47.7	6.9
Other manufacturing	7.6	19.0	39.9	9.3	12.7	-332.0	76.7
Total	100.0	100.0	100.0	-0.3	4.6	100.0	100.0
Sub-Saharan Africa							
Agriculture	23.9	20.4	13.2	1.1	0.9	8.8	2.8
Oil and gas	37.9	38.2	18.3	2.8	-2.1	39.2	-10.8
Other natural resources	13.3	12.7	12.2	2.2	4.9	10.6	11.4
Processed foods	8.9	7.0	6.5	0.3	4.5	0.9	5.6
Textiles, apparel, and leather goods	0.3	1.2	4.7	16.5	20.8	4.0	9.7
Motor vehicles and parts	0.1	0.2	0.9	9.2	25.2	0.4	2.0
Electronic equipment	0.1	0.2	0.4	12.7	13.1	0.6	0.7
Other machinery	1.0	1.7	4.1	8.6	15.1	4.0	7.6
Other manufacturing	14.4	18.4	39.8	5.3	13.8	31.5	70.9
Total	100.0	100.0	100.0	2.7	5.4	100.0	100.0
Low- and middle-income countries							
Agriculture	13.4	12.6	5.2	4.1	1.9	11.2	1.4
Oil and gas	51.6	33.5	12.0	0.4	0.5	3.3	0.8
Other natural resources	6.3	6.3	3.8	4.8	5.9	6.3	2.5
Processed foods	9.5	10.0	7.4	5.4	8.0	10.9	6.0
Textiles, apparel, and leather goods	2.6	7.1	15.5	16.1	20.3	14.8	19.8
Motor vehicles and parts	0.6	1.4	2.8	13.6	19.4	2.6	3.5
Electronic equipment	0.7	2.7	9.8	20.4	26.6	6.1	13.5
Other machinery	2.1	4.7	10.6	13.8	20.8	9.1	13.6
Other manufacturing	13.4	21.7	33.0	10.0	16.1	35.7	38.9
Total	100.0	100.0	100.0	4.8	11.3	100.0	100.0

a. The years represent three-year averages to remove some of the volatility from the data. Thus 1977 represents the average of 1975–77, 1987 is the average of 1985–87, and 1997 is the average of 1995–97. Relative caution is advised regarding Europe and Central Asia, where data prior to 1990 are not always reliable. This would have only a small impact on the total because of the region's relatively small weight.

b. High-income Asia is excluded from the low- and middle-income region in the totals. It is provided for information and includes Hong Kong (China), Republic of Korea, Singapore, and Taiwan (China).

Source: GTAP release 5.0.

Table 1.A2 Regional export decomposition for developing countries^a

Percent

	Share (percent)			Average growth (percent per annum)		Contribution to growth (percent)	
	1977	1987	1997	1977-87	1987-97	1977-87	1987-97
High income Asia excluding Japan^b							
Quad countries	65.6	69.4	47.0	16.5	7.4	70.5	35.9
High income Asia excluding Japan	7.8	8.6	15.1	16.9	18.1	8.8	18.3
East Asia and Pacific	8.5	9.2	25.0	16.9	23.3	9.5	32.8
South Asia	0.7	2.1	1.6	28.7	8.5	2.5	1.3
Latin America and the Caribbean	1.3	1.1	2.8	13.5	22.6	1.0	3.6
Europe and Central Asia	0.2	0.2	1.6	13.2	39.3	0.2	2.3
Middle East and North Africa	7.1	3.9	2.1	9.1	5.2	2.9	1.3
Sub-Saharan Africa	2.6	1.2	1.2	7.1	11.8	0.8	1.2
Rest of the world	6.1	4.4	3.6	12.0	9.5	3.9	3.2
World total	100.0	100.0	100.0	15.9	11.6	100.0	100.0
East Asia and Pacific							
Quad countries	66.1	58.6	54.8	9.8	16.6	54.6	53.8
High income Asia excluding Japan	18.7	26.2	26.2	15.0	17.4	30.3	26.2
East Asia and Pacific	4.8	4.9	7.1	11.4	21.7	5.0	7.6
South Asia	1.3	2.1	1.5	16.4	13.2	2.6	1.3
Latin America and the Caribbean	2.4	1.3	2.0	4.8	22.2	0.7	2.1
Europe and Central Asia	0.3	0.7	1.4	21.3	26.6	0.9	1.6
Middle East and North Africa	2.9	2.6	2.6	10.1	17.5	2.5	2.7
Sub-Saharan Africa	1.4	0.7	1.0	3.6	21.5	0.3	1.1
Rest of the world	2.1	2.8	3.4	14.2	19.8	3.1	3.6
World total	100.0	100.0	100.0	11.1	17.4	100.0	100.0
South Asia							
Quad countries	52.7	64.8	62.3	10.0	12.4	75.6	61.2
High income Asia excluding Japan	4.4	7.3	9.5	13.4	16.0	9.8	10.5
East Asia and Pacific	4.6	2.8	7.3	2.7	24.0	1.3	9.1
South Asia	4.7	4.8	3.5	8.1	9.1	5.0	2.9
Latin America and the Caribbean	0.6	0.6	1.6	7.8	24.2	0.6	2.0
Europe and Central Asia	2.0	1.2	2.9	2.7	22.9	0.5	3.5
Middle East and North Africa	22.2	12.8	7.4	2.0	6.8	4.3	5.1
Sub-Saharan Africa	4.1	2.2	2.8	1.3	15.9	0.5	3.1
Rest of the world	4.7	3.5	2.8	4.5	10.5	2.4	2.5
World total	100.0	100.0	100.0	7.8	12.8	100.0	100.0
Latin America and the Caribbean							
Quad countries	75.0	77.2	68.9	8.6	7.7	79.1	62.8
High income Asia excluding Japan	0.7	1.9	2.9	20.1	13.6	2.9	3.7
East Asia and Pacific	1.0	1.6	2.8	13.6	15.0	2.1	3.7
South Asia	0.3	0.6	0.4	15.2	5.9	0.8	0.3
Latin America and the Caribbean	15.9	12.0	20.2	5.3	14.7	8.8	26.2
Europe and Central Asia	1.0	0.7	1.0	5.2	12.5	0.5	1.2
Middle East and North Africa	3.3	2.9	1.8	6.9	4.1	2.6	1.1
Sub-Saharan Africa	1.0	1.4	0.8	11.4	2.8	1.6	0.3
Rest of the world	1.8	1.6	1.1	7.1	4.6	1.5	0.7
World total	100.0	100.0	100.0	8.3	8.9	100.0	100.0

(Table continues on next page)

Table 1.A2 (continued)

Percent

	Share (percent)			Average growth (percent per annum)		Contribution to growth (percent)	
	1977	1987	1997	1977-87	1987-97	1977-87	1987-97
Europe and Central Asia							
Quad countries	75.7	68.3	57.9	8.8	20.8	63.6	56.4
High income Asia excluding Japan	0.9	0.5	3.2	4.1	46.2	0.3	3.5
East Asia and Pacific	0.6	2.3	5.5	26.0	33.7	3.4	5.9
South Asia	1.1	1.5	0.6	13.1	11.5	1.7	0.4
Latin America and the Caribbean	2.6	1.5	1.3	4.0	21.2	0.8	1.3
Europe and Central Asia	0.9	1.9	23.5	18.7	57.5	2.6	26.7
Middle East and North Africa	10.9	19.4	3.9	16.4	4.6	24.8	1.6
Sub-Saharan Africa	1.5	0.4	0.3	-4.2	20.7	-0.3	0.3
Rest of the world	5.7	4.2	3.9	6.4	22.0	3.1	3.9
World total	100.0	100.0	100.0	9.9	22.8	100.0	100.0
Middle East and North Africa							
Quad countries	77.3	74.6	66.6	-0.7	3.4	158.5	52.4
High income Asia excluding Japan	5.1	6.5	11.3	2.2	10.6	-37.8	19.8
East Asia and Pacific	1.9	2.1	6.3	0.5	16.7	-3.1	13.6
South Asia	1.0	3.5	3.6	13.3	4.6	-75.5	3.6
Latin America and the Caribbean	6.0	3.2	1.9	-6.4	-0.7	89.1	-0.4
Europe and Central Asia	1.1	2.7	2.8	9.1	5.2	-46.0	3.1
Middle East and North Africa	4.6	4.8	4.0	0.0	2.8	0.4	2.6
Sub-Saharan Africa	0.9	0.7	1.4	-2.7	11.6	6.8	2.5
Rest of the world	2.1	1.9	2.2	-1.2	6.1	7.6	2.8
World total	100.0	100.0	100.0	-0.3	4.6	100.0	100.0
Sub Saharan Africa							
Quad countries	83.7	84.4	70.8	2.8	3.5	86.6	50.9
High income Asia excluding Japan	1.1	2.3	6.5	10.6	16.6	6.3	12.5
East Asia and Pacific	0.6	0.8	4.8	4.6	26.5	1.2	10.6
South Asia	0.5	1.0	1.9	8.7	12.9	2.3	3.3
Latin America and the Caribbean	3.3	3.9	2.9	4.4	2.5	5.7	1.6
Europe and Central Asia	0.3	0.6	1.3	11.1	14.1	1.6	2.3
Middle East and North Africa	2.0	1.4	1.7	-0.7	7.4	-0.5	2.1
Sub-Saharan Africa	3.9	4.0	7.2	3.1	11.7	4.5	11.9
Rest of the world	4.6	1.7	2.9	-7.1	11.4	-7.8	4.7
World total	100.0	100.0	100.0	2.7	5.4	100.0	100.0
Low and middle income							
Quad countries	75.5	72.1	61.7	4.3	9.6	66.5	56.2
High income Asia excluding Japan	5.1	8.9	13.5	10.8	16.0	15.3	15.9
East Asia and Pacific	2.1	2.6	5.6	7.2	20.3	3.5	7.2
South Asia	1.0	2.0	1.5	12.8	8.5	3.8	1.3
Latin America and the Caribbean	6.9	5.1	6.1	1.8	13.2	2.2	6.6
Europe and Central Asia	0.9	1.3	4.4	9.3	25.7	2.1	6.0
Middle East and North Africa	4.5	4.4	2.9	4.5	7.0	4.2	2.2
Sub-Saharan Africa	1.5	1.3	1.4	3.0	12.2	0.9	1.4
Rest of the world	2.6	2.2	2.9	3.3	14.2	1.6	3.2
World total	100.0	100.0	100.0	4.8	11.3	100.0	100.0

a. The years represent three-year averages to remove some of the volatility from the data. Thus 1977 represents the average of 1975-77, 1987 is the average of 1985-87, and 1997 is the average of 1995-97. Relative caution is advised regarding Europe and Central Asia, where data prior to 1990 are not always reliable. This would have only a small impact on the total because of the region's relatively small weight.

b. High-income Asia is excluded from the low- and middle-income region in the totals. It is provided for information and includes Hong Kong (China), Republic of Korea, Singapore, and Taiwan (China).

Source: GTAP release 5.0.

Notes

1. Technically, the non-economic component of confidence is modeled as an unobserved state variable and estimated using a Kalman filter/smoothing, with data pertaining to economic conditions as exogenous controls. The model was fitted on monthly data over the period 1984–2001 (September). Then the estimate was used together with actual, observed economic data to predict confidence out of sample over the period October 2001–April 2003.

2. It was decided at the December 2002 Copenhagen Summit to invite eight transition countries to join the EU in May 2004.

3. The differences between Sub-Saharan Africa and South Asia are not limited to the higher growth rate in the latter over the last decade. The poverty gap indicator—a measure of the average distance to the poverty line for the poor—has been much higher in Sub-Saharan Africa. This implies that even at identical growth rates, poverty would have decreased more rapidly in South Asia.

4. The initial poverty estimate will also be subject to revisions in the national income and product accounts because adjustments to the survey-based consumption levels will follow adjustments to consumption derived from the national accounts.

5. A numerical example may help clarify the procedure. Say population is 1,000 in 1999 and per capita consumption growth in 2000 is 5 percent and population growth is 1 percent. If the headcount index is 40 percent in 1999, then the number of poor is 400. With a headcount elasticity of 1.5, the headcount index would improve from 40 to 37 percent ($40 \cdot (1 - 1.5 \cdot 0.05)$), assuming there is no change in the distribution of income. Total population in 2000 reaches 1,010, thus the number of poor is 374, a decline of 6.5 percent, whereas the headcount index improves by 7.5 percent. The difference is the population growth rate.

6. These comparisons are not strictly exact because last year's 1999 levels do not incorporate the new survey information nor other adjustments to the historical data.

7. The survey coverage in the Middle East and North Africa region is particularly sparse compared to most other developing regions. Per capita GDP across the region tends to be relatively high and therefore poverty rates low, so small changes to poverty levels in one or two sizeable countries with a fair number of poor—for example Egypt or Yemen—can have a disproportionate impact on the regional poverty level.

8. For example specific tariffs penalize more competitive exporters with relatively lower prices.

9. In the case of the European Union, intra-EU trade is excluded from the average tariff calculation and the reduction.

10. The formula for cutting the non-peak tariffs is given by the following expression:

$$\tau_i^1 = \chi \cdot \tau_i^0 \quad \text{for } i \in \{Agric, Manu\} \text{ where}$$

$$\chi = \frac{\tau_a^1 \sum_i M_i - \sum_{i \in \{Peak\}} \tau_p^1 M_i}{\sum_{i \in \{Peak\}} \tau_i^0 M_i}$$

The target average is τ_a^1 . The import levels are given by M . All tariff peaks are reduced to τ_p^1 . All other tariffs are reduced by the factor χ , given by the formula above. There is nothing preventing the adjustment factor from being above 1 (that is, initial tariffs could increase to achieve the target reduction) or below 0 (that is, non-peak tariffs would have to become negative to achieve the target). In the illustrative pro-poor scenario, the reduction factor is capped above by 1—in which case the average will be below the target, and bound below by 0 in which case the average will be above the target. This is the case of Japan in agriculture. An alternative would be to further reduce the peaks so that the target is achieved.

11. Setting the level of the maximum tariff can have some unintended consequences. In the case of developing country manufacturing tariffs, for example, setting the maximum tariff to 20 percent instead of 15 percent could actually reduce the overall average. The reason is that all tariffs in the 15 to 20 percent band in the latter (15 percent) case are bound to below 15 percent. In the former (20 percent) case those tariffs would be reduced by a certain percentage amount—perhaps even 100 percent. The difference in the average tariff will depend on the number of tariffs within the 15 to 20 percent band and the relative import weights.

12. The model is similar to that used to produce the gains from trade reform in *Global Economic Prospects 2002*. More information regarding the nature of the simulations and a more detailed description of the results is given in that report. The model documentation is available at <http://www.worldbank.org/prospects/pubs/techref.pdf>. *Global Economic Prospects 2002* reported global merchandise trade reform gains of \$355 billion (in the static exercise). The gains have risen modestly in this report—essentially for two reasons. We have upgraded the database from release 5.0 of the GTAP data set to release 5.3, and we have a new baseline reflecting two years of observed changes in economic performance and a (minor) reevaluation of long-term growth prospects. The current model is also based on a different regional and sectoral aggregation, which can affect the impacts of trade reform. (There are more regions and sectors and, all else being equal, one would expect this to raise the real income gains by removing some of the aggregation bias of trade policy

instruments). There have also been a few minor changes to model specification and parameters.

13. All figures, unless otherwise stated, refer to changes in 2015 compared with the baseline level. Dollar amounts are measured in real terms and are based on 1997 dollars. Figures can be converted to 2003 terms by adjusting for economic growth and inflation. The former would involve dividing a figure by $(1.03)^{(2015-2003)}$, where it is assumed that the global economy grows at 3 percent per annum in real terms between 2003 and 2015. The inflation adjustment involves multiplying a figure by $(1.025)^{(2003-1997)}$ where it is assumed that the rate of inflation is 2.5 percent per annum between 1997 and 2003. (Both growth and inflation rates are approximations.) The total adjustment factor is 81 percent, so that the global gain of \$295 billion in 2015 is more or less equivalent to \$235 billion in 2003 global GDP and prices.

14. Few dispute that trade openness will improve productivity. There is nonetheless great uncertainty about the channels—greater domestic competitiveness, imports of technology-laden goods, FDI, export-driven competitiveness—and the magnitude. The results reported herein are intended to illustrate the potential magnitudes.

15. This compares with a reduction of 114 million persons in the case of full merchandise trade reform.

16. The positive income gains—identified in virtually all of the model's regions—imply that transitional mechanisms can be implemented, leaving everyone better off. Whether these mechanisms are designed and implemented is an important issue, but typically the decision of local governments.

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