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International Economics Policy Briefs

Global Economic Prospects

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Overview

The global economic recovery is continuing but at a somewhat slower pace than was anticipated six months ago. Specifically, using the country weights from the IMF's World Economic Outlook, the forecast for real GDP growth in the world economy during 2002 (i.e., on a fourth-quarter-to-fourth-quarter basis) is cut by about half a percentage point to 3 percent—a pace that is slightly below my estimate of the potential growth rate for world GDP.[1] This downward revision reflects primarily slower growth than earlier expected during the first half of 2002 in most industrial countries and the expectation that growth will remain somewhat more sluggish than earlier expected at least through year-end. For 2003, the forecast for global economic growth is also cut by about half a percentage point—to 4 percent—reflecting both general factors suggesting slightly weaker performance in many industrial and developing countries and the particular economic risks arising from possible military action against Iraq and from potential credit events affecting key developing countries. Despite these downward revisions, however, there is little doubt that the world economy will see significant improvement this year from the 1 percent growth recorded in 2001, and it is still reasonable to expect further improvement to a growth rate modestly above global potential during 2003.[2] (See table 1.)

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1. Forecasts reported are rounded off to the nearest quarter percentage point. The forecast for Q4/Q4 world GDP growth for 2002 reported in early April was rounded up slightly to 3¾ percent (see table 3), while the present reported forecast is rounded down slightly to 3 percent (see table 2). The difference in the unrounded forecasts is closer to ½ percent than to ¾ percent.

2. The year-over-year results show only a one-half percent increase in global growth, 2 to 2½ percent between 2001 and 2002. The fourth-quarter-to-fourth quarter figures reveal a substantial acceleration from 1 percent to 3 percent global growth.

Table 1 Summary of global growth prospects (percent changes in real GDP)

	2001 year/year	2002 year/year	2003 year/year	2001 Q4/Q4	2002 Q4/Q4	2003 Q4/Q4
Industrial countries	¾	1½	2¾	0	2½	2¾
United States	¼	2½	3¼	0	3	3¼
Western Europe	1½	1	2½	¾	2¼	2½
Japan	-½	-½	1½	-2	1½	1½
Developing countries	3¼	3¾	5½	2¼	4	5½
World (WEO weights)	2	2½	4	1	3	4

cially the three largest industrial countries; and the main issue for global growth prospects is whether this performance will improve going forward. For the United States, the key questions are (1) how well will the growth of consumption spending be sustained in the face of relatively weak employment gains and falling equity prices, but rising real estate values and very low interest rates? (2) when and to what extent will gains in business fixed investment take over from recovery of inventory investment as a principal driver of domestic demand? and (3) in the face of a somewhat weaker dollar, how much will further deterioration of US net exports weigh on US GDP growth? For Western Europe, the main question is what will stimulate a somewhat more rapid pace of domestic demand growth, especially in view of the apparent unwillingness of the key monetary authority to supply further stimulus and the constraint on fiscal expansion implied by the Growth and Stability Pact and by longer-run concerns about the fiscal situations of most Western European governments? For Japan, the main question is much the same as for Western Europe—only much more pressing because of the very limited room for stimulative policy and because of the concerns about the fragilities of the financial sector and the urgent need to pursue critical structural reforms to lay a foundation for sustained growth? For those industrial countries that have performed somewhat better than expected, notably Australia and Canada, the question is how long this superior performance can be sustained if there is no strengthening of growth in the largest industrial countries?

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As a group, the developing countries appear to have performed slightly better than expected during the first half of 2002. However, this is almost entirely due to the somewhat better than expected performances of China (which accounts for one-fourth of the GDP weight of all developing countries) and some other Asian emerging-market countries (notably Korea, Singapore, and Thailand) and to a strong performance by India (which accounts for one-tenth of the GDP weight of all developing countries) that at least matched earlier expectations. Other developing countries, on average, have performed less well than expected, particularly so for some Latin American countries (including Argentina, Brazil, Uruguay, and Venezuela) that have faced both internal and external difficulties. Looking ahead, the key issues appear to be (1) how well will the recovery in Asian emerging markets be sustained, depending on performance in the industrial countries? (2) how well will Latin America fare next year, depending on whether Brazil is or is not successful in avoiding a major financial crisis? and (3) how might Turkey and the countries of the Middle East be affected by the evolving political and military situation with Iraq?

Before turning to the discussion of these issues for the industrial and developing countries, it is relevant to reflect briefly on the possible broader economic implications of potential military action against Iraq, with the notion that such action might be initiated within the next six months. When Iraq invaded and occupied Kuwait in October 1990, the immediate effect was an upward spike in world oil prices to over $40 per barrel. This spike in oil prices and the negative impact on consumer and business confidence helped to push an already sluggish US economy into recession and the world economy into

Table 2 Global growth prospects, 2002-03: Assessment as of September 15, 2002
(annualized percentage real GDP growth rates, year over year and fourth quarter to fourth quarter)

Country/region	2001 year/year	2002 year/year	2003 year/year	2002 Q4/Q4	2003 Q4/Q4
Industrial countries	¾	1½	2¾	2½	2¾
United States	¼	2½	3¼	3	3¼
Japan	-½	-½	1½	1½	1½
Western Europe	1½	1	2½	2¼	2½
United Kingdom	2	1¾	2½	2¼	2½
Euro area	1½	1	2¼	2¼	2½
Germany	½	½	2	2	2¼
France	1¾	1¼	2½	2½	2½
Italy	1¾	¾	2¼	2¼	2½
Developing countries	3¼	3¾	5½	4	5½
Asia	4¾	6	7		
China	7¼	7¾	7¾		
India	4½	5½	6¼		
Other	1¼	4¼	6		
Latin America	0	-2	2		
Argentina	-4½	-15	3		
Brazil	1½	1	0		
Mexico	-¼	1¾	4		
Central and Eastern Europe	2½	3¼	4½		
Middle East	2½	2½	3		
Africa	3	3	4		
World (WEO weights)	2	2½	4	3	4

Note: The WEO basis world GDP growth rates aggregate the real GDP growth of countries and regions using weights based on purchasing power parity adjusted measures of exchange rates, which are slightly modified from those published in the International Monetary Fund's World Economic Outlook. The modifications involve the following differences with the standard WEO presentation: (1) Three Asian newly industrialized economies (Hong Kong, Korea, and Singapore) plus Taiwan are included in the developing countries; (2) Russia and most of the former Soviet Union and Turkey are included in Central and Eastern Europe; (3) Israel (and Egypt) are included in the Middle East.

the slowdown of 1990-91. After the rapid and successful conclusion of the Gulf War in February 1991, however, oil prices plummeted back to around $20 per barrel; and, unlike situations following the more durable oil price rises of the mid- and late 1970s, there was no sustained effect on either world economic activity or inflation.

In the present situation, world oil prices have already risen moderately on worries of possible military action against Iraq. A decision to proceed with military action would almost surely push world oil prices significantly higher, even if other OPEC members replace lost Iraqi output. Indeed, experience in both late 1990/early 1991 and in the autumn of 2000 suggests that when private inventories of oil are low, panic buying can induce disproportionately large upward price spikes. In these two episodes (despite their other differences) commitments to release moderate amounts of oil from official inventories appeared to have substantial effects in calming market panic. With official inventories of oil now quite large, sensible policy management should be able to offset short-term restrictions of supply and surges of demand and contain oil price increases to well below the peaks reached a decade ago.

Moreover, assuming that military operations (but not necessarily their political aftermath) are relatively quick and successful, the impact on world oil markets and on the world economy should be comparatively modest—probably even less than was the case in 1990-91. Nevertheless, in view of what now seems like a high likelihood of military action, some allowance should be made for the likely negative economic side-effects. Somewhat arbitrarily, I have cut my global growth forecasts for 2003 by one-fourth of a percentage point to make this allowance.

Table 3 Global growth prospects, 2002-03: Assessment as of March 29, 2002
(annualized percentage real GDP growth rates, year over year and fourth quarter to fourth quarter)

Country/region	2001 year/year	2002 year/year	2003 year/year	2002 Q4/Q4	2003 Q4/Q4
Industrial countries	1	1½	3¼	3¼	3¼
United States	1¼	2 ½	4	4	4
Japan	-½	-½	2	1¾	2
Western Europe	1½	1½	2¾	2½	3
United Kingdom	2½	2¼	2½	2½	2½
Euro area	1½	1½	2¾	2¾	3
Germany	½	1	2½	2½	3
France	2	1¾	2¾	2½	2¾
Italy	1¾	1½	3	2¾	3
Developing countries	3½	3¾	6	4¼	6
Asia	4½	5½	7¼		
China	7¼	7	8		
India	4½	5½	6		
Other	1	4	7		
Latin America	¼	-¾	4		
Argentina	-4½	-10 to -15	3		
Brazil	1½	1½	4		
Mexico	-¼	2	5		
Central and Eastern Europe	2½	3½	5		
Middle East	2½	3	3½		
Africa	3	3½	4½		
World (WEO weights)	2¼	2¾	4½	3¾	4½

Note: The WEO basis world GDP growth rates aggregate the real GDP growth of countries and regions using weights based on purchasing power parity adjusted measures of exchange rates, which are slightly modified from those published in the International Monetary Fund's World Economic Outlook. The modifications involve the following differences with the standard WEO presentation: (1) Three Asian newly industrialized economies (Hong Kong, Korea, and Singapore) plus Taiwan are included in the Asian developing countries; (2) Russia and most of the former Soviet Union and Turkey are included in Central and Eastern Europe; (3) Israel (and Egypt) are included in the Middle East.

(See the appendix for discussion of this allowance.) Looking beyond next year, a successful outcome in Iraq would probably help to stabilize world oil markets and contribute to improved economic performance in the region and worldwide.

The Americas

Following the terrorist attack of September 11, the US economy bounced back surprisingly in the final quarter of last year, with real GDP growth of 2.7 percent. It then surged forward at a 5 percent annual rate in the first quarter of 2002, led by a recovery (to less negative levels) of inventory investment. In the second quarter, however, growth fell back to barely 1 percent as gains in inventory investment and consumption and government spending all moderated, and net exports made a large negative contribution to GDP growth. The surprisingly weak GDP results for the second quarter, the large (more than 20 percent) drop in equity prices between early April and late July, and some weak economic data for June and July suggested that the US recovery might stall out and raised worries about a "double dip" recession. How serious are these concerns?

The only occasion when the US economy had a true "double dip" recession—two recessions within about a year—was in 1980-81. On that occasion, sharp fluctuations in economic policy, especially monetary policy, were undoubtedly the key driving factor. Specifically, in connection with efforts both to bring down rampant inflation and stabilize the real economy, the federal funds rate shot up from 9 percent to 22 percent between October 1979 and February 1980; then collapsed to below 9 percent by July 1980; and was pushed up again to over 20 percent by year-end. No such extreme fluctuations in economic policy will occur in present circumstances. Indeed, both monetary and fiscal policies have consistently operated to cushion the recession and boost recovery; and both monetary and fiscal policies will add impetus to recovery at least over the next year. And, if there did appear to be a significant risk that the US economy might fall back into recession, there is no doubt that the Federal Reserve would act aggressively to avert such an outcome.

A decision to proceed with military action would almost surely push world oil prices significantly higher, even if other OPEC members replace lost Iraqi output.

While true "double dips" have been rare historically and another one now is unlikely, a period of sluggishness during the initial stages of an economic recovery is not so unusual. This happened, for example, during the so-called "jobless recovery" in 1991-92. Now, with productivity growth apparently remaining relatively high, real GDP growth a little above 3 percent appears necessary to keep actual output rising in line with potential (assuming that capital is also being accumulated at an appropriate rate) and to keep labor demand expanding along with the increase in the labor force. This is consistent with the fact that since the recovery began in the final quarter of 2001, with real GDP rising at just under a 3 percent annual rate, employment has shown very little growth, and the unemployment rate has effectively stabilized at about 6 percent of the labor force.

In early April, my forecast of 4 percent real GDP growth for the US economy during both 2002 and 2003 implied growth above potential and a gradually declining unemployment rate. I now forecast that real GDP growth during the second half of this year and next year will proceed at a 3¼ percent annual rate—in line with the potential growth rate of the US economy. In addition to the allowance for the economic side-effects of possible military action against Iraq, the downward revision to the projected growth rate of real GDP reflects lower presumed growth rates for consumption and for business fixed investment. The significant decline in equity values since early April is the principal reason to anticipate somewhat less buoyant consumption and investment spending.

This effect, however, should not be overestimated. The negative effect on consumption from lower equity wealth will be importantly offset by the effect of higher residential real estate values—something that is likely to be reasonably well sustained in the face of a highly accommodative monetary policy. For business fixed investment, low rates of capacity utilization in many industries and higher costs of financing through equity and higher interest rate spreads for corporate debt are deterrents. But, net fixed investment for the entire US economy is estimated (based on estimates of capital depreciation of the US Department of Commerce) to have fallen from $500 billion per year at the peak in mid-2000 to $210 billion per year in mid-2002. Leaving aside net investment in the residential and government sectors, real net investment by private business is now very low and in some industries is surely negative. Thus, even relatively modest prospects for growth of final demand could have a significant effect in motivating some recovery in business fixed investment.

In business cycle recoveries, real GDP normally rises more rapidly than potential. Thus, a forecast that real GDP will grow only in line with potential through the end of 2003 surely leaves room for upside surprises. Indeed, growth at a 4 percent annual rate or even somewhat higher is certainly feasible, particularly in view of the accommodative stances of both monetary and fiscal policies. On the other hand, there are clearly risks on the downside. Beyond the uncertainties associated with Iraq, a drop in equity values back to or below the July lows would likely deter both consumption and investment spending both directly and through its effects on consumer and business confidence. Also, as the second quarter GDP results demonstrated, further significant deterioration of US net exports reflect-

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ing weak demand growth in the rest of the world can be an important break on US economic recovery. Indeed, sustained recovery of the US economy at rates matching or exceeding its potential will likely prove very difficult unless the rest of the world achieves somewhat stronger growth than that reached in recent quarters.

Turning to Canada, economic recovery has been moderately stronger and better sustained than south of the border. Both buoyant growth of domestic demand and a relatively strong trade situation (in comparison with the United States) contributed to this outcome. Although inflationary pressures are not an immediately pressing concern, with the economy performing well, the Bank of Canada has taken back 75 basis points of its earlier easing. Monetary policy nevertheless remains reasonably accommodative, particularly in view of the still highly competitive value of the Canadian dollar.

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Looking ahead through 2003, the Canadian economy should grow about in line with, or perhaps slightly more rapidly, than the United States, thanks partly to its continuing cost competitiveness advantage relative to its southern neighbor. However, the potential growth rate of the Canadian economy appears to be somewhat below that of the United States, and the remaining margin of slack in the Canadian economy may not be that large. (The unemployment rate is now running about 7½ percent, but this is less than a percentage point above the minimum achieved in several decades.) This suggests that Canadian economic growth at an annual rate of 4 percent or higher would probably occasion significant further monetary tightening that would bring growth down to a more sustainable pace. On the other side, if the US economy were to slow significantly below 3 percent annual growth, there probably would be meaningful negative spillovers to growth in Canada.

As expected, the Mexican economy is recovering in the wake of US economic recovery, with second quarter real GDP showing a 2 percent year-on-year gain. Turmoil in much of the rest of Latin America has had little negative spillover for Mexico, with interest rate spreads rising only modestly and capital inflows remaining relatively buoyant. The downward correction of the Mexican peso against the US dollar has been moderate and generally desirable, despite putting some upward pressure on inflation. Looking ahead, prospects for the Mexican economy are also likely to be closely tied to US economic performance and not to developments elsewhere in Latin America. If the US economy grows at about its potential, growth in Mexico should probably slightly exceed 4 percent; and deviations of US growth above or below potential could well have magnified implications for Mexico—as was the case the past two years. As a net oil exporter, however, Mexico should be somewhat less adversely affected from any short-term negative economic spillovers from military action against Iraq.

In South America, economic conditions generally remain difficult and prospects uncertain. The economic and financial catastrophe in Argentina now appears likely to push real GDP down this year to the bottom end of the range of a 10 to 15 percent drop suggested in April—or possibly below it. However, with Argentine real GDP now about 25 percent below its 1998 peak, and with Argentines relearning the skills of operating in an economy with unstable money and without a functioning financial system, the bottom has probably been reached. A sharp recovery of perhaps half of the real GDP losses of the past year by end 2003 is not an unreasonable prospect. This would be consistent with the pattern seen in virtually all emerging-market economies that have suffered severe financial crises since the mid-1990s. But recovery in Argentina over the next year or two is unlikely to look like the recoveries of Mexico following the tequila crisis or Korea following the Asian crisis. Much fundamental damage has been done to the Argentine economy and to its basic institutions, which will take a long time to fix. Even with the most constructive efforts—well beyond what the present Argentine government has been able to achieve—it will likely take a number of years for Argentina to regain the level of prosperity achieved in 1998.

Brazil now is the major question mark for Latin America. With rising concerns about a possible sovereign default and/or debt restructuring, interest rate spreads on Brazilian bonds rose from around 700 basis points in early April to about 2,500 basis points at their peak this summer. Subsequently, with the announcement of a new IMF support package and reassuring pledges of fiscal responsibility by the leading candidates in Brazil's upcoming presidential elections, spreads have fallen back somewhat. Nevertheless, high interest rates and tight credit conditions weakened economic activity, and

Brazil's growth this year appears likely to reach barely 1 percent.

For next year, the critical question is whether or not the new Brazilian government, to be elected in late October and take office at the start of 2003, will be able rapidly to reassure financial markets that policies will be consistent with fiscal sustainability. If so, then interest rate spreads can

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probably recede to levels meaningfully below 1,000 basis points, and there is a reasonable prospect that economic recovery can push Brazil's growth during 2003 to 4 percent or better. If not, then interest rate spreads will remain high, sovereign debt default and/or restructuring will become a self-fulfilling prophecy, and financial turmoil will grip Brazil's economy next year. In this latter scenario, the outcome need not be, and probably would not be, nearly as catastrophic as we have seen during the past year in Argentina. Brazil does not face the difficult problem of backing away from a very rigid exchange rate peg, and there in no necessary reason why sovereign debt restructuring would imply a complete collapse of the financial system and of much of the institutional underpinnings of a modern market-oriented economy. Undoubtedly, however, sovereign debt restructuring would be a messy affair; and under this scenario, it would be reasonable to expect a significant economic contraction in Brazil next year—say, on the order of a 5 percent drop of real GDP.

At present, financial markets appear to assess the probabilities of these two scenarios for Brazil as about even—up from about a 25 percent risk of restructuring suggested in my early April forecast. Using this market rating of the relative probabilities indicates a central forecast for Brazil's real GDP growth next year of about zero—with a starkly bimodal distribution around this central forecast.

In the rest of South America, the Chilean economy has escaped most of the negative spillover from problems elsewhere on the continent. Nevertheless, growth this year, at about 2½ percent, will be well below the trend of the past 15 years. Growth next year should improve somewhat; but a negative outcome in Brazil would limit prospects for this improvement. In Venezuela, political turmoil is contributing to a sharp fall of about 5 percent in this year's real GDP. Next year, the recession may not get much worse, but there seems little reason to expect that either the political situation or economic conditions will get much better. In Colombia, the guerilla war has been a major negative for growth this year, and it remains to be seen whether economic performance will improve much next year. In Peru, domestic political problems are less dire, and economic growth still seems likely to run about 3 percent this year and next—a pace that remains well below the best of recent years.

Europe

As forecast in early April, recovery in Western Europe has lagged behind and proceeded at a more sluggish pace than in North America. Indeed, growth in Germany (including revisions to 2001 results) has been significantly more sluggish than expected six months ago, while growth in the rest of the Western Europe has been somewhat below that forecast. As things now stand, it appears that a moderate downward revision, to 2¼ percent from 2¾ percent is appropriate for the forecast of Western European (and,

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specifically, for the euro area) economic growth during 2002.

The main concern, however, is not this downward revision, but rather that there now appears little reason to expect the acceleration to 3 percent real growth in Western Europe during 2003, which was forecast in April. Potential adverse economic spillovers from military action against Iraq are part of the reason for these new doubts. But, beyond this, there does not seem to be any compelling reason to expect greater dynamism from Western European economies. In addition, sharp declines in equity prices—while not as important for the United

States—are clearly a negative influence on consumption and investment spending. Moreover, consumer and business confidence have weakened in response to weaker equity prices as well as other economic developments. And, while the strengthening of the euro in foreign exchange markets implies a move toward a more balanced pattern of global growth, it does not have positive implications for growth in the euro area.

On the policy front, the French and Italian governments have indicated that they will back away from earlier commitments to near-term reductions in their fiscal deficits, but additional fiscal stimulus from these sources (relative to Western Europe as a whole) will be quite modest. Germany (as well as Portugal) will be under pressure for fiscal contraction to avoid violating the 3 percent upper limit on the fiscal deficit in the Growth and Stability Pact. The budget for the United Kingdom does suggest some modest additional stimulus; but this is not the case (and desirably so) for most other Western European countries.

More generally, despite declarations of its continuing validity and necessity by many euro area officials, it is now clear that the Growth and Stability Pact is seriously flawed. Undoubtedly, most European governments need to move their medium-term fiscal positions toward balance or (preferably) moderate surplus, particularly in view of mounting pension and healthcare expenses as populations age. But, the existing pact, as formulated and implemented, is ineffective and potentially counterproductive in achieving this desirable objective. Fiscal policy needs to be more restrained when European economies are performing well; but the budget discipline imposed by a pact that focuses on actual budget deficits inevitably tends to become more lax precisely when economies are performing well. On the other side, when economies are performing poorly, adherence to the constraints of the pact (or to budget targets agreed under its general auspices) are generally contrary to sound cyclical policy management. The time has come for European officials to stop worshipping the Growth and Stability Pact as a divine object and to focus on a reformulated mechanism that would make better economic sense.

With respect to monetary policy, the European Central Bank (ECB) has wisely kept its short-term policy interest rate at 3¼ percent, despite earlier indications of an intention to tighten policy. However, with inflation still running near the top of the ECB's tolerance range, monetary easing is not something that the ECB appears willing to contemplate unless data indicate that the euro area is faltering toward recession. With real short-term interest rates in the euro area well above those in the United States, with a significantly flatter yield curve in the euro area than in the United States, and taking account of the appreciation of the euro and the depreciation of the dollar since early April, it is clear that euro area monetary policy is not providing the degree of stimulus to economic recovery that the Federal Reserve is supplying on the other side of the Atlantic.

If demand growth in the euro area were sufficient and likely to remain sufficient to reduce existing margins of slack (or if other policies, particularly fiscal policies, were available for the task), then the ECB's apparent unwillingness to contemplate further easing would not be a problem. But, despite moderate economic recovery, margins of slack have recently been rising in the euro area, and there is no assurance that they will not rise further, without any serious threat of an outright recession.

In this regard, it is clearly unfortunate that the ECB did not take advantage of the opportunity to cut its policy interest rate more aggressively in 2001 when the accumulating signs of economic weakening and the concerns arising from the terrorist attack of September 11 provided a plausible rationale for greater easing. Not acting more aggressively then, makes it difficult for the ECB to rationalize acting more aggressively now—especially in view of the ECB rhetorical adherence to price stability as the fundamental and virtually exclusive goal of monetary policy.

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The fact is that, like all sensible central banks, the ECB does adjust its monetary policy (as did the Bundesbank before it) to help stabilize the real economy, subject to the constraint that reasonable price stability is not put at significant risk. Consistent with this general policy orientation, another 75 basis points of monetary easing during 2001, taking the short-term policy interest rate down to 2½ percent, might reasonably have been justified. The effects of such additional easing would not have been large, suggesting that (like the easing actually undertaken by the ECB and the larger easing undertaken by the Federal Reserve) there would have been no need to reverse it during 2002. Output would have been boosted by such an easier monetary policy, but probably by not more than about half of a percentage point of euro area GDP by end 2002 and (assuming that the additional easing was gradually withdrawn) by not more than about a percentage point on the level of GDP by end 2003.

While these output effects would not have been huge, they certainly would have been worthwhile, particularly for a euro area and a world economy operating with significant margins of slack—especially recognizing that there was little risk of generating undesirable inflationary pressures. Moreover, the budget deficits in the euro area generally decline by about 60 to 70 percent on a cyclical improvement in GDP, implying that stronger output growth induced by a prudently easier monetary policy would bring, other things equal, smaller budget deficits. Again, the effect would not be large; but budget deficits that are perhaps six-tenths of 1 percent of GDP smaller (than they otherwise would be) by end 2003 would have been worthwhile. This suggests that European central bankers should expend a little less energy decrying the evils of budget deficits and praising the virtues of the flawed Growth and Stability Pact and, instead, should devote a little more attention to how monetary policy affects budget outcomes in ways that are beyond the control of the fiscal authorities.

It is still reasonable to expect that, despite its many important internal problems, the Japanese economy will achieve modest real growth as part of a general global economic recovery.

With an appropriately modified Growth and Stability Pact (focusing on cyclically adjusted budget positions), fiscal policy in the euro area would be able to make at least a modest contribution of offsetting the risk of continued sluggishness. More importantly, further easing of monetary policy could certainly help to forestall some of this risk, even if it could not (because of lags) fully recover the favorable effects of more aggressive easing during 2001.

The forecast of what is most likely to happen going forward, however, must take account of what policy is likely to do, not necessarily what it should do. And, it does not appear that either fiscal or monetary policy in the euro area is likely to do much more either to catch up for past sluggishness or to accelerate future recovery. This, together with the other negative information since early April, suggests a downward revision of projected growth for Western Europe going forward from a 3 percent annual rate to a 2½ percent annual rate, with a standard error of perhaps ¾ of a percentage point around this central forecast.

In Central and Eastern Europe, events are proceeding about in line with the forecast of early April. With world oil prices remaining firm, the Russian economy appears likely to achieve 4 percent growth this year; and an upward spike in world oil prices associated with military action against Iraq would have short-term economic benefits for Russia. Economic conditions have been improving in Turkey; and positive growth this year in the range of 3 percent or so seems likely. Turkey's large (and probably still growing) public debt remains a significant worry. But, with the imminent possibility of military action against Iraq, it seems likely that Turkey will receive whatever additional official assistance it needs to avoid debt servicing difficulties in the next year—leaving to the future the question of where Turkey will find the resources to repay its rapidly expanding official debts. Moreover, while military action against Iraq would pose important political problems for Turkey and might have negative longer-run economic implications, the short-term economic effects seem unlikely to be negative.

Both China and India are relatively insensitive to both a potential spike in world oil prices and to modestly slower growth in the rest of the world.

In Central Europe, the recent floods have done considerable damage, especially in the Czech Republic (and eastern Germany). On balance, this will be a short-term economic negative, although clean-up and rebuilding will have some positive effects on measured GDP. In Poland, the policies of the new finance minister will likely provide near-term stimulus to a relatively weak economy, but the sustainability of these policies beyond the next year or so is questionable. Elsewhere in Central Europe, performance is perhaps marginally weaker than earlier expected, reflecting in part the somewhat weaker than expected performance in Western Europe; and this suggests a modest scaling back of the forecast for future growth.

Asia

The recently revised quarterly GDP data for Japan show that real growth was effectively nil in the first quarter of 2002 and accelerated moderately to about a 2 percent annual rate in the second quarter. This basically confirms the early April forecast that the Japanese economy would recover, with a lag, behind the recovery in the United States and other leading regions in the global economy. Also as expected, growth in Japan was heavily dependent on the export sector, with domestic demand remaining virtually stagnant.

Looking ahead, it is still reasonable to expect that, despite its many important internal problems, the Japanese economy will achieve modest real growth as part of a general global economic recovery. However, several factors point to a slightly more modest forecast than that I advanced in April; specifically, 1½ percent growth during both 2002 and 2003, rather than 1¾ percent and 2 percent respectively. Prospects for global recovery are modestly weaker now than in early April, and the foreign exchange value of the yen is moderately stronger. Japanese equity markets have sold off along with equity markets elsewhere; and this implies particular problems for Japanese banks in meeting their minimum capital requirements. As a major oil importer, Japan would certainly feel a negative impact from a spike in world oil prices associated with military action against Iraq.

On the other hand, there are reasons not to be too pessimistic about near-term economic prospects for Japan. Reflecting more positive developments than were earlier expected, a recovery of modest proportions does appear to have started in Japan; and most forecasts for Japan (excluding my own) have been upgraded since early April. Several important indicators of business activity and sentiment have either turned positive or become less negative. And, despite the lack of progress in fundamental and necessary restructuring, the meltdown of the Japanese financial sector that some had feared does not yet appear imminent.

For the developing countries of Asia, the situation is distinctly more positive. As noted earlier, China (which has by far the largest GDP weight of any developing country) has performed somewhat better than forecast; and India is also doing at least as well as was expected. Moreover, both China and India are relatively insensitive to both a potential spike in world oil prices and to modestly slower growth in the rest of the world; and, looking ahead, prospects for both of these countries continue to look quite buoyant.

For other Asian emerging-market economies, the picture is more mixed. Korea has done well, led by recovery of domestic demand. Malaysia, Singapore, and Thailand have also staged significant recoveries, aided by rising exports as well as domestic demand. Indonesia has sustained moderate growth. But, recovery in Taiwan has been more subdued, and Hong Kong's growth has remained disappointing. Moreover, looking ahead, these highly open emerging-market economies are significantly more vulnerable to slower growth in the rest of the world and (with the exception of Indonesia) to a spike in world oil prices than are China and India. Thus, a modest downward revision of the April growth forecasts for these countries, from 7 percent year-over-year for 2003 to 6 percent, generally seems warranted. Nevertheless, because of the stronger than expected performance and large weight of China, the forecast for all of emerging-market countries of Asia remains essentially unchanged from optimistic levels indicated in early April.

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The Middle East and Africa

Leaving aside Iraq itself, prospective military action and its effect on world oil prices probably has positive short-term economic implications for the oil-exporting countries of the Middle East (and elsewhere). Political turmoil that might be stimulated by military action against Iraq is a potential economic negative, but short-term economic risks in this regard seem relatively limited. On the other hand, the continuing Israeli/Palestinian conflict is clearly having substantial negative consequences for the (relatively large) Israeli economy and far more devastating consequences for the (much smaller) economy of the areas controlled by the Palestinian Authority. On balance, I see little reason to change the early April forecast of modest positive growth for the Middle East this year and next—but recognize that the range of uncertainty has expanded because of possible military action against Iraq.

For Africa, most commodity prices (aside from oil and cocoa) remain relatively weak, and this is an important negative factor for many nonoil, primary product-exporting countries. Moreover, growth in the two largest economies in sub-Saharan Africa—South Africa and Nigeria—does not appear particularly buoyant this year. On the other hand, the incidence of natural and man-made disasters in Africa this year is below that of many recent years. All things considered, with a slightly weaker forecast for growth in the rest of the world and worries about the effects of possible military action against Iraq, a slight downward revision of forecasts for Africa seems appropriate.

Conclusion

This forecast, like all economic forecasts, is subject to a considerable margin of error. But the risks to the forecast are on the upside as well as the downside and are about evenly distributed around the central forecast. A moderate allowance has been made for short-term negative economic side-effects from possible military action against Iraq—under the assumption that there is a relatively high likelihood of such action. If such action occurs, the economic side-effects could be more serious than has been assumed. On the other hand, at this stage, it is still possible that military action may be avoided; or, if action is undertaken, it might prove highly successful even in its relatively short-term economic effects.

More generally, forecasts for the industrial countries now generally envision growth that is in line with or modestly below potential, in contrast with the normal cyclical tendency for growth to exceed potential during the initial stages of an economic recovery. Clearly, there is upside room for performance to exceed forecast if normal cyclical tendencies assert themselves. On the other hand, growth in the industrial countries could fall further short of potential if, for example, equity markets sell off to or beyond the lows of this summer.

For developing countries, the likely spillover from somewhat slower growth (than earlier forecast) in the industrial countries has been built into the central forecast. But, if the industrial countries were to perform below their revised forecast, this would likely imply negative side-effects for developing countries; and, conversely, if the industrial countries perform better than forecast. In addition to this external risk, several important developing countries have their own substantial internal risks. These risks appear to be particularly great in Latin America, especially for Brazil where the outcome for 2003 will probably be either well above or well below the central forecast of zero growth.

Appendix: Economic Effects of Military Action Against Iraq

Estimation of the likely economic effects of military action against Iraq obviously involves a good deal of speculation and uncertainty. For the purpose of this exercise, it is assumed that such action would take about three months, including the necessary build-up of forces, and would conclude successfully without massive devastation of Iraq's economy or long-term impairment of its petroleum production. Damage to the economies and oil production of Iraq's neighbors is assumed to be small and rapidly repaired.

The principal economic effects of military action against Iraq are presumed to come from the consequences of a significant but temporary increase in world oil prices, specifically, an increase of about $10 per barrel lasting for about three months. This compares with a price increase of about $20 per barrel (in current dollars) lasting about six months in the case of the Gulf War of 1990-91. The reason to expect a smaller and shorter-duration price increase on this occasion is that Kuwaiti oil output will likely remain available and the lag between clear manifestation of the intention of military action and its conclusion will be briefer than the nearly six-month interregnum between Iraq's invasion of Kuwait and the successful conclusion of Desert Storm. Moreover, other oil exporters have indicated that they would probably make up shortfalls of Iraqi oil exports, and appropriate use of official oil reserves should be able to limit oil prices to about $30 to $35 per barrel—or about $10 above their level in the absence of military action.

World oil production (and consumption) now run about 30 billion barrels per year. A price increase of $10 per barrel for three months would cost oil consumers about $75 billion, and would imply a corresponding revenue gain for oil producers. Prices of other forms of energy would probably also be affected, although significantly less than the price of oil. All told, under these assumptions, the transfer from energy consumers to energy producers might amount to $100 billion.

Because the short-run marginal propensity to spend out of increased revenue by energy producers appears to be significantly less than the short-run marginal propensity to (not) spend due to real income losses of energy consumers, the direct short-run impact on world aggregate demand of a $100 billion shift of income from energy consumers to energy producers is negative—probably on the order of about half of the transfer, or about $50 billion. The multiplier effect (including impacts on consumer and business confidence) of the negative direct effect is greater than unity—perhaps by as much as a factor of two. Thus, as a ballpark guess, the assumed temporary increase in world energy prices might be expected to cut world GDP by about $100 billion. This amounts to about one-fourth of 1 percent of the level of world GDP of about $40 trillion.

Of course, if the effect of military action on world oil prices was larger and longer-lived than what has been assumed, then the likely impact on global GDP would be correspondingly greater. In particular, the Gulf War of 1990-91 was associated with an increase in world oil prices roughly twice as large and for twice as long as has been assumed for the present estimate; and the impact was probably to reduce global GDP in 1999-91 by about 1 percent. [World GDP fell by about 4 percent relative to potential in 1990-91; but a normal cyclical slowdown following the long expansion of the 1980s, induced partly by significant tightening of monetary policies in a number of countries, was the predominant cause of this global slowdown.] Alternatively, the increase in world oil prices in 2000, which was somewhat larger (from the base of 1999 oil prices) and longer-lived than assumed in the present exercise was estimated by the IMF staff to have a negative impact of about one-fourth of 1 percent on world GDP; whereas my own estimate was a negative effect of about one-half of 1 percent.

Beyond its effect through world oil prices, military action against Iraq will affect world GDP through other channels. Iraq's GDP is likely to absorb a large, negative, short-term hit; but Iraq's GDP is only a tiny fraction of the world's total. For the rest of the region, the economic effects (aside from those coming through oil prices) are assumed to be small. For the United States, military action will mean increased government spending that will provide a direct boost to GDP. But, military action is likely to be carried out primarily with existing forces, using existing equipment and available inventories of ammunition and other supplies. No doubt, inventories are being built-up in anticipation of possible action and will need to be rebuilt if action occurs. But, under the assumption of a relatively brief and successful campaign, the increase in defense spending during the period of military action and the subsequent couple of quarters is likely to be comparatively modest—surely well below $100 billion. Thus, the positive effect of such increased spending on world GDP seems unlikely to overturn the ballpark estimate that military action against Iraq would have a negative effect of roughly one-fourth of 1 percent of world GDP.