A Global Growth Rebound: How Strong for How Long?

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After a disappointing first half of 2003, the world economy is poised to rebound in the second half and continue with above-potential growth during 2004. The United States and emerging Asia will lead the global rebound, with Japan pulled along in the upswing. Respectable growth rates will continue in Canada, Australia, and Central and Eastern Europe. Growth in Latin America should pick up as Argentina continues to bounce back from the catastrophe of 2001/02, Brazil begins to recover from its recent recession, Mexico benefits from strengthening growth in the United States, and Venezuela halts its headlong decline toward economic oblivion.

In contrast, near-term growth prospects for Western Europe remain somewhat of a mystery: the hard data point to continued stagnation, reinforced by the effects of an extremely hot summer; but several key sentiment indicators (including rising equity markets) point to a significant strengthening of growth before year-end. Despite a remarkably stubborn European Central Bank (ECB), I am with the optimists and expect that real GDP growth will strengthen to 2 percent during 2004.

For the world economy (on a WEO-weighted basis), global economic growth should rise from barely a 2 percent annual rate during the first half of 2003 to about a 4 percent annual rate during the second half and continue at that pace during 2004.

Indeed, a strengthening of growth is already apparent in the US economy, where second quarter performance surprised on the upside and where the third quarter real GDP now appears likely to record better than a 4 percent annual rate of advance. Emerging Asia will also show a sharp strengthening of growth as several countries snap back from SARS-related slowdowns and other temporary problems that retarded economic activity last winter and spring. Although not robust, Japan's positive growth performance during the first and second quarters surprised most analysts, and even justifies an upgrade in my (relatively) optimistic forecast from +1 percent to + 2 percent real GDP growth on a fourth-quarter-to-fourth-quarter basis. All of this implies that—provided that the economy of Western Europe does not defy all the normal patterns of cyclical behavior—global economic growth will strengthen significantly over the next few of quarters.

This presumption, and the assumption that global growth will continue at a respectable pace through most of next year, is reflected in the summary of the global growth forecast in the table below and in the more detailed table at the end of this policy brief.

Summary of world economic growth forecasts, real GDP growth rates (percent)

Region	Year over year			Q4 to Q4		
	2002	2003	2004	2002	2003	2004
Industrial countries	1¾	1½ (–¼)	3 (+½)	2½	2 (0)	3 (0)
Developing countries	4	3¾ (–¾)	5½ (+½)	4	4 (–½)	5½ (+¼)
World (WEO weights)	2¾	2½ (–½)	4¼ (+½)	3¼	3 (–¼)	4¼ (+¼)

Note: Changes from April 2003 forecasts in parentheses.
WEO = IMF's *World Economic Outlook*

As always, it should be noted that there are risks to this forecast—both on the upside and on the downside. On the upside, the key risk is that once an expansion begins to gain forward momentum in different regions of the world, the expansion tends to be mutually reinforcing to an extent that often exceeds expectations. [This is the reverse of what happened during the global economic slowdown of the past two and one-half years, when the general and mutually reinforcing factors tending to depress global economic growth were significantly and consistently underestimated.] On the downside, two potentially important global risks should be noted. First, global equity markets and business and consumer sentiment have recovered substantially from their lows of mid March. These are important positive factors tending to induce—as well as forecast—stronger global economic growth. But, these important improvements in sentiment are at risk if they are not soon validated by actual improvement in economic performance. Second, world oil prices remain at high levels (just above $30 per barrel) and the situation in world energy markets remains tight. Futures markets predict that world oil prices will decline over coming quarters as world supply constraints ease; and, if this happens, it will provide a further boost to global growth. However, a disturbance that produced a further upward spike in global energy prices would undermine prospects for strengthening global economic growth.

Beyond the next few quarters, two further questions cloud the medium-term outlook: (1) Will the inherent strength of the cyclical recovery in private demand be sufficient to compensate for the erosion of the near-term stimulus presently provided by expansionary macroeconomic policies in the United States and some emerging Asian economies? Will the US economy and global economy successfully adjust to the challenge of a declining US current account deficit and to the necessity of a further substantial depreciation of the US dollar against the currencies of all of its major trading partners?

The answers to these questions, which will be critical to global economic performance beyond 2004, are not yet clear. A resurgence of private investment demand does appear to be beginning in the United States, and there are more tentative signs of a pick up in business investment in Japan and in Europe. With the waning of the effects of tax cuts and mortgage refinancing, continued strong growth of private consumption in the

United States is contingent on an upturn in employment growth—which should materialize if output growth remains near 4 percent. At this stage the basis for a resurgence of private consumption in Europe and Japan seems less secure—although stronger economic growth (and its likely positive effects on consumer confidence) should help. For emerging market economies, both business and consumer spending should pick up with the upturn in global growth, although prospects for some countries are still limited by the relatively low level (and high cost) of foreign financing.

With respect to the necessary correction of the US current account deficit, acceleration of growth in the rest of the world and the depreciation of the US dollar since 2001 should help to bring an end to further increases in the US imbalance. However, the factors necessary to bring about a substantial reduction in the US current account deficit—especially the factors necessary to accomplish this in a manner consistent with growth at least in line with global potential—are not yet in place.

The Americas

The US economy has been and remains the lynchpin of global growth—accounting for 22 percent of world GDP on a WEO (PPP exchange rate) weighted basis and for nearly 30 percent of world GDP aggregated at market exchange rates. Moreover, both during the past five years (of global expansion, recession and recovery) and since the present recovery began in late 2001, the US economy has out-punched even its own weight on the demand side—accounting for about half of total world demand growth. Thus, it is particularly reassuring that after a sluggish first half of 2003 (with annualized real GDP growth of just over 2 percent), the pace of US economic advance is clearly picking up momentum.

Incoming data suggest that third quarter real GDP growth will easily exceed 4 percent (at an annual rate). The likelihood that total employment will soon start to rise (at a modest pace), together with continuing gains in wages should help to keep consumer spending growing, despite a fall-off in household gains from mortgage re-financing. Rising equity values and corporate profits, along with the needs of businesses to replace depreciating equipment, should stimulate further gains in investment in equipment and software.

Meanwhile, the sharp decline of investment in (non-residential) structures appears to be ending, and a continued environment of very low (short-term) interest rates should help to fuel a rebound. Inventory investment should record at least modest gains as it rises back to levels needed to at least sustain inventory/sales ratios. And, although the strong second-quarter gains in real federal purchases are unlikely to be repeated and state and local governments remain under considerable budget pressures, the overall impact of fiscal policy (including the recently-enacted tax cuts) should continue to support recovery for another couple of quarters.

This leaves net exports as the main uncertainty for US real GDP growth. Except for the recession year of 2001, since 1996 progressive and cumulatively massive deterioration of US real net exports has subtracted about ¾ of 1 percent each year from the US real GDP growth rate.

Looking ahead, it is reasonable to expect that net exports will cease to make significant negative contributions to US economic growth and should start to make at least modest positive contributions. Some reversal of the random events that produced an unusually large negative contribution of net exports to second quarter GDP is likely in the third or fourth quarters. Strengthening of output and demand growth in key US trading partners will also help in both the near and medium term. And, the depreciation of the US dollar that has occurred since 2001 (mainly against the euro, the Canadian dollar, and the Australian dollar), together with substantial further downward correction of the value of the dollar against most other currencies going forward, should prove to be a durable force tending to improve US net exports.

For 2003, I now forecast that US real GDP will rise at better than a 4 percent annual rate during the second half. Given the results for the first half, this implies that for the year as a whole, that real GDP growth will be 2½ percent on a year-over-year basis (up ¼ of 1 percent from my early April forecast) and will be 3½ percent on a fourth-quarter-to-fourth quarter basis (up ¾ of one percent from the April forecast).

For 2004, I hold to my April forecast of 3¾ real GDP growth on a Q4/Q4 basis but raise my year-over-year forecast by ¼ of one percent to 4 percent. This reflects the evidence that we are getting stronger growth in the second half of this year (which affects year-over-year growth for 2004), but there remains some doubt about how well this will be sustained next year. The reasons for this slight caution about next year are the following: Continued high world oil prices will likely have some retarding effect on US and global growth. The recent upsurge in longer-term US interest rates probably portends some slowdown in residential construction, as well a dampening effect on consumer spending growth related to mortgage re-financings. The effects of fiscal and monetary stimulus may begin to wear thin by the second half of 2004. And, the strength and durability of the upturn of growth in the rest of the world (which is expected to help US net exports) remains uncertain.

The Canadian economy, which has outpaced its southern neighbor since 1998, slowed substantially during the first half of 2003 and appears to have remained relatively weak into the summer. The slowdown in the United States, the appreciation of the Canadian dollar, and some SARS-related problems (mainly in the Toronto area) clearly contributed to the Canadian slowdown. In retrospect, some of the modest tightening by the Bank of Canada during 2002 appears to have been premature; and in mid July, the Bank of Canada cut money market rates by 25 basis points.

For 2003, it now appears that the Canadian economy will record only about 2¼ per cent growth (both year-over-year and Q4/Q4), with growth picking up in the final quarter—aided by the rebound south of the border. For 2004, the forecast of 3¼ percent growth is modestly above the estimated potential growth rate for the Canadian economy. This reflects an expected bounce-back from the short-term difficulties of 2003 and the influence of the continuing US economic rebound. On the other hand, the stronger Canadian dollar and the relatively limited margin of slack in the Canadian economy are reasons to expect that the growth rebound will be less vigorous than in the United States. Also, Canadian monetary and fiscal policy are—appropriately—much less stimulative than in the United States. While this contributes to a somewhat less buoyant growth forecast for 2004, it also means that there is a good deal of room for policy to respond if the economy fails to perform adequately.

Forecasts and (forecast changes) for Latin America

	2003 (year over year)	2004 (year over year)
All Latin America	1 (–1¼)	4½ (+¾)
Argentina	5 (0)	5 (+1)
Brazil	1 (–1¼)	4 (+1)
Mexico	1¼ (–1¾)	4½ (0)

Growth in the Mexican economy was also somewhat disappointing during the first half of 2003, partly reflecting the sluggishness in the US economy. Even with a projected acceleration of growth during the second half (aided by a stronger US economy), my April forecast of 3 percent real GDP growth (year-over-year) for Mexico looks too high; and that forecast is now cut to 1¼ percent.

Nevertheless, the Mexican economy looks well-positioned for a substantial rebound in 2004, with year-over-year growth forecast to be 4½ percent. The Mexican economy has close links to the US economy where growth is already accelerating. Unlike the Canadian dollar, there has been no sharp appreciation against the US currency. Margins of slack are ample. And, global financial markets remain very friendly to Mexico in terms of the availability and cost of credit and the volume of direct investment. While lack of progress on key elements of President Fox's reform agenda raises some concerns for the longer term, a sharp shift away from sensible economic policies is not a near-term threat.

Brazil is another country where my April forecast for 2003 growth now looks too optimistic. This is not primarily because external conditions have been particularly unfavorable for Brazil. Indeed, the mood in international financial markets has shifted dramatically in Brazil's favor. For example, Brazil's 11 percent Eurobond that was selling at less than 60 cents on the dollar a year ago has recently appreciated back to par. Correspondingly, yield spreads on Brazil's external debt have dropped from over 1500 basis points to about 700 basis points. Nor has Brazil's tight fiscal policy (with a primary surplus of nearly 5 percent of GDP in the first half of 2003) been the primary cause of economic sluggishness.

Rather, the main culprit has been the continued high level of domestic nominal and real interest rates. Domestic interest rates have remained high because the central bank had to contend with the upsurge of inflation and of inflationary expectations induced both by last year's large depreciation of the Brazilian real and by the large injections of liquidity that the central bank undertook a year ago to keep domestic short-term interest rates at unsustainably low levels.

Last April, my expectation was that determined action by Brazil's central bank to tighten monetary conditions (raising the SELIC rate from 18 percent to 28 percent) would rapidly bring progress in reducing inflation and inflationary expectations, and this in turn would allow the central bank to ease back on monetary conditions relatively rapidly. In fact, the process has taken longer than I had expected, although the central bank has recently been able to cut the SELIC rate back down to 22 percent.

With more progress in reducing domestic interest rates and a better global growth environment, the Brazilian economy should begin to bounce back fairly vigorously beginning in the second half. Accordingly, while I have cut my year-over-year forecast for 2003 from 2¼ percent to 1 percent real GDP growth, I have upgraded my forecast for 2004 from 3 percent to 4 percent.

For 2003, Venezuela looks certain to win the prize as Latin America's worst performing economy—with an economic collapse perhaps even surpassing that of Argentina in 2001/02. The disruption from the strike against the state oil company and other disturbances related to President Chavez and opposition to his rule (including many policies of the Chavez administration) are primarily responsible for Venezuela's economic plight. A possible referendum on President Chavez's continuation in office (allowed for under the Venezuelan constitution) may help to resolve the political basis for these economic difficulties. Even at the worst, it seems unlikely that the Venezuelan economy will continue to deteriorate as rapidly as during the past year. At best, the Venezuelan economy might stage a quite spectacular recovery—from very low levels.

After collapsing by about 25 percent from the peak in mid 1998 to the low point in the middle of 2002, the Argentine economy has bounced off the bottom, and my optimistic forecast of 5 percent real GDP growth (year-over-year) for 2003 now appears to be on track. With a more favorable global and regional economic climate, another 5 percent real GDP gain is a reasonable prospect for 2004—even if progress in addressing key problems of structural reform (particularly in the banking system) remains sluggish.

At this point, negotiations with the IMF that would unlock a roll-over of Argentina's credits from the international financial institutions remain unresolved. A break-down that leads to Argentina's default to these official creditors would clearly not be a positive development for Argentina or the international financial system. But the incentives for both sides to reach a reasonable agreement are great.

Last year, the IMF held out for too long before recognizing that, despite serious deficiencies, the Argentine government's policies were succeeding in at least stabilizing a desperate situation. Ultimately, some of the IMF's major shareholders had to insist that an IMF program allowing for a rollover of IFI credits and endorsing Argentina's decision not to make payments to private external creditors was appropriate in view of the exceptionally difficult conditions of 2002. A year later, the Argentine economy has improved but is still not in good shape. Another year of roll-overs of IFI credits and deferrals of payments on private external credits is appropriate.

The key issues in a multi-year IMF program for Argentina do not concern 2003, but rather 2004 and, especially, the years beyond—and the likelihood is that Argentina will be engaged in negotiations for rollovers of its IMF and other IFI credits for a number of years to come. In particular, Argentina faces enormous problems in resurrecting a normally functioning financial system; and serious efforts to address these problems are rightly a subject for IMF conditionality. But, experience in many countries, both developing and industrial, shows that these types of financial sector problems usually take many years to resolve. Agreement to an IMF program for 2003/04 should not be held hostage to unrealistic expectations about how rapidly the Argentine government can address problems in the financial sector.

Similarly, the size of the Argentine government's primary budget surplus (the budget position excluding interest payments of government debt) is and should be a key issue in negotiations with the IMF. A primary surplus of 2½ to 3 percent of GDP is a respectable objective for 2003/04, when the Argentine economy remains quite depressed. But, a primary surplus that is limited to 2½ to 3 percent of GDP in later years, as the Argentine economy continues to recover toward normal levels of activity, is not respectable and should not be acceptable.

The Argentine government owes substantial debt service on its domestic debt (which continues to increase) and on its debt to the IFIs. Subtracting these payments from a primary budget surplus limited indefinitely to no more than 3 percent of GDP implies that payments on Argentina's large private external debt (now in default) would never be more than very modest—in comparison with the size of these obligations. The Argentine government would effectively proclaim not only the right, in dire economic circumstances, to defer payments to external private creditors in dire circumstances and to call of these creditors for a reasonable longer-term write-down it their claims. It would also assert the right to walk away from the bulk of these claims even when the ability to pay debt service substantially improves; and it would ask the IMF and the official international community to endorse this outrageous mistreatment of its external private creditors.

So far, however, the Argentine government has not taken such an objectionable position; and there is no good reason why it should. Presumably, Argentina and the IMF (and the IMF's main shareholders) should be able to agree on the sound principle that funds to meet Argentina's obligations to external creditors should expand more than proportionately with GDP as the Argentine economy recovers—just as they have effectively agreed that funds for this purpose needed to shrink dramatically when Argentina fell into a catastrophic recession.

Asia

Last year and this year, my economic forecast for Japan has been at the top of the range of widely reported private forecasts (i.e. those reported in the Economist and in Consensus Forecasts). Last year, Japan's real GDP growth of 2½ percent (Q4/Q4) somewhat exceeded my relatively optimistic forecast; and this year's performance now seems likely to exceed my April forecast of 1 percent growth (Q4/Q4). Indeed, if one fully believes the preliminary real GDP report for the second quarter, the Japanese economy has already achieved nearly 1 percent growth for the year.

Recent surveys of Japanese business and consumer sentiment point to rising optimism. Recent data on consumer purchases and on wages suggest increasing buoyancy in household spending. Investment by both large and small firms also shows some signs of recovery. In the trade sector, exports were hurt somewhat by SARS-related problems in Asian trading partners. However, the rebounds in both the United States and emerging Asia, together with Japanese efforts to preserve a reasonably competitive yen, point to important positive contributions from net exports to Japanese economic growth in the second half of 2003 and in 2004. The upsurge in Japanese equity values so far this year indicates that both domestic and international investors are beginning to take seriously the prospect of a sustained recovery in the Japanese economy.

In light of these developments and prospects, I raise my forecast for Japanese real GDP growth this year from 1 percent to 2 percent (Q4/Q4). For now, I hold to my (still relatively optimistic) forecast of 2 percent real GDP growth for 2004, but note that there is considerable room for this forecast to be exceeded.

Japanese economic policy is contributing to the better than expected economic performance. Specifically, the combination of significant quantitative easing (liquidity injections) by the Bank of Japan and the large-scale sterilized intervention to resist yen appreciation practiced by the Ministry of Finance effectively amounts to a policy of partially non-sterilized intervention. By resisting what might otherwise have been a sharp appreciation of the yen, this policy has helped to forestall events that, three times in the past decade, have undermined incipient Japanese economic recoveries.

This policy of resisting sharp yen appreciation is not the same thing as the highly irresponsible policy suggested by some prominent economists that the Japanese government should peg the yen's exchange rate at 150 or 200 to the US dollar, as a means of leveraging a Japanese economic recovery. Such a policy would be an unambiguous violation of the IMF Articles of Agreement's prohibition of competitive devaluation, and it would rightly provoke a retaliatory response. In contrast, the policy of resisting sharp appreciation of the yen (i.e., limiting the yen's rise against the dollar over the past year to about 10 percent) is accepted as necessary and appropriate in Japan's present economic circumstances and in view of its limited policy options. Nevertheless, as the Japanese economy gathers somewhat more domestic momentum, it will be important to move away from a policy that, in the longer-term, would be inconsistent with achieving necessary adjustments in the global pattern of payments imbalances.

Forecasts and (forecast changes) for emerging Asia

	2003 (year over year)	2004 (year over year)
All emerging Asia	5½ (–½)	7 (+ ¾)
China	7¼ (–¼)	7¾ (+ ¾)
India	6 (+½)	6½ (+1)
Others	3 (–1½)	6 (+1½)

On the WEO weighting basis, China (not Japan) is the largest economy in Asia and the second largest economy in the world. For the first quarter of 2003, China reported real GDP growth of 9.9 percent versus the same quarter a year earlier. For the second quarter reported real GDP growth dropped to 6.7 percent versus a year earlier. This suggests that quarter on quarter real GDP was virtually flat, or even declined lightly, in the second quarter.

Because the economic effects of SARS in China were concentrated in the major commercial centers, especially Beijing, a modest negative impact for China as a whole is moderate in comparison with the sharp second-quarter declines of real GDP in Singapore and Hong Kong, where the effects of SARS were more heavily concentrated. For these economies, like China, there is increasing evidence of rapid rebounds of activity now that the SARS crisis has past. This suggests that the net effect of SARS on real GDP growth for 2003 will be moderately negative, relative to my April forecasts, with Singapore and Hong Kong showing larger net effects while the effects for China, Malaysia, Taiwan, and Thailand are more moderate.

For all of these economies, 2004 looks to be a better year (about in line with my April forecasts)—provided that SARS does not return this coming winter. If SARS does recur, the economic effect will undoubtedly be negative, although lessons learned from dealing with the first episode should help to reduce this negative impact.

The Korean economy also experienced a sharp slowdown in the first half of 2003, but more so in the first quarter than in the second quarter; and factors other than SARS appear to have contributed importantly to the slowdown. Specifically, Korea is particularly dependent on imported oil, and the rise in world oil prices (associated with the situations in Iraq and Venezuela) certainly hurt the Korean economy. Also, the boom in consumer spending fed by the spread of consumer credit ended in early 2003. And uncertainties associated with North Korea's nuclear program have not been a plus for the South Korean economy.

Meanwhile, India has been marching to the tune of a different drummer than most of the East Asian emerging market economies. Growth slowed somewhat in late 2002 and early 2003, mainly reflecting the effects of a severe drought; SARS was not a major factor. Activity appears to have picked up significantly in the second quarter; and a good monsoon this summer points to strong contributions from the important agricultural sector to overall GDP growth. In addition, falling agricultural prices are helping to provide room for the Reserve Bank to ease interest rates, which will be a positive factor for economic growth and will also aid the budget.

All things considered, my April forecast of 5½ percent growth for the Indian economy this year and next now looks too pessimistic. Growth of 6 percent this year and 6½ percent for 2004 is now a more reasonable projection.

Looking at emerging Asia as a whole (which has a WEO weight equal to that of the United States), the April forecast of 6 percent growth for 2003 (year-over-year) now appears about ½ percentage point too high—due to the unexpected, largely SARS-related slowdown during the first half. A growth rebound, making up for much of the first half short-fall, should occur in many countries in the second half. On a year-over-year basis, this second half rebound contributes to an upgrade of ¾ percent to the forecast for emerging Asia for 2004. Adding in a respectable performance from Japan and recoveries from the recent slowdowns in Australia and New Zealand, all of Asia should hold up its end in the global economic rebound.

Europe

Western Europe, particularly the euro area, is the region where recent economic performance has been most disappointing. This is both because real GDP growth (and growth of real domestic demand) has been very sluggish for the past 2½ years and because available and prudent policy actions to induce more satisfactory growth have not been fully utilized.

Specifically, after growing only 1½ percent (year-over-year) in 2001, the euro area managed only ¾ of a percent growth (year-over-year) in 2002, and now appears likely to record only ½ of 1 percent growth (year-over-year) for 2003. This implies a cumulative real GDP gain over three years of less than 3 percent, in comparison with an estimated cumulative gain in potential GDP of at least 7 percent. Even allowing for an excess of actual output above potential of 1 to 2 percent in 2000, it follows that there is now a negative output gap (actual GDP below potential) of 2 to 3 percent of GDP. Indeed, the three largest euro area economies, Germany, France and Italy, all recorded slightly negative real GDP growth during the first half of 2003. And, even with some economic acceleration, there is no reason to expect that the output gap will shrink significantly any time soon.

Moreover, macroeconomic policy in the euro area has not been aggressive in confronting the widening output gap. Fiscal policy has been constrained by the Stability and Growth pact—notwithstanding some violations. The ECB has cut policy interest rates far less and much more slowly than the Federal Reserve in the face of accumulating evidence of underlying economic sluggishness. Not surprisingly, growth of real domestic demand in the euro area, which is primarily effected by macroeconomic policies, has grown even more slowly than real GDP.

Comparison with the United States is highly relevant. The recession of 2001 left year-over-year growth barely positive and somewhat more than wiped out the positive output gap that existed in the US economy in 2000. Since the end of the recession in late 2001, US real GDP growth has proceeded at a 2¾ percent annual average rate—only about ½ percent below estimated potential growth rate. Thus, since the end of the recession, the US output gap has widened only modestly; and it now appears likely to contract.

Moreover, in contrast to the euro area, US macroeconomic policy has fought very hard to resist a widening output gap. The Federal Reserve has aggressively cut money market interest rates by a cumulative 550 basis points. The automatic stabilizers and discretionary fiscal actions have shifted the federal budget position by about 6 percent of GDP from surplus into deficit. The effect of these stimulative policies is seen in growth of real domestic demand that has kept pace with the growth of potential GDP. Thus, for the United States (in contrast to the euro area), widening margins of slack since late 2001 reflect weaknesses in demand growth abroad rather than inadequate support from domestic macroeconomic policies.

Looking ahead, what are the prospects that economic growth in the euro area will begin to accelerate? With its short-term interest rate at 2 percent, the ECB is surely correct in arguing that monetary policy is not a barrier to recovery. But, as I have argued previously, since early 2001 ECB policy has failed to provide as much stimulus as it could have and should have. Nevertheless, if the euro area now begins to show better signs of recovery, it seems unlikely that the ECB will ease further—whether or not a case could be made that further easing would be useful (although not essential) to spur a more rapid euro area recovery.

Similarly, euro area fiscal policy is not an impediment to more rapid economic growth. By and large, the automatic fiscal stabilizers have been allowed to operate fully, despite the strictures of the Stability and Growth pact. But, fiscal policy in the euro area (generally with good reason) has not provided, and is not providing, anything like the stimulus of US fiscal policy.

This suggests that stronger growth in the euro area will need to come primarily from the normal forces of cyclical recovery—without much additional policy support. Like most forecasters, I expect that after two and a half years of persistent economic sluggishness, these normal forces of cyclical recovery will begin to assert themselves by late this year—aided by generally stronger growth in the most of rest of the world economy. Recent improvements in measures of business consumer confidence suggest that this process is underway; and this is reinforced by upward movements in European equity prices. The investment excesses of 1999-2000 appear to have been worked off, and inventories are lean.

Hard numbers on economic performance (such as industrial production), however, remained weak through the spring; and very hot weather probably does not bode well for much economic improvement during the summer. And, despite some recent weakening, the foreign exchange value of the euro is well above year-ago levels. Thus, the acceleration of growth in Western Europe will surely lag behind that in the United States and much of Asia. Nevertheless, all things considered, it seems reasonable to project that euro area growth next year will pick up to about 2¼ percent (Q4/Q4)—performance that will still leave an output gap of about 3 percent of GDP at the end of 2004.

After performing significantly better than both the US and major continental European economies in 2001 and 2002, real GDP growth in the United Kingdom slowed substantially in the first half of 2003. Manufacturing remained weak, and consumption spending, which had been well sustained through 2002, weakened considerably. Net exports also continued to deteriorate, despite significant weakening of sterling against the euro. Notwithstanding an inflation rate somewhat above the Bank of England's 2.5 percent target, official rates were cut 25 basis points to 3.5 percent.

It now appears that growth in the UK economy will remain tepid during the second half of 2003, with only modest gains in consumption and with continued weakness in business spending. Next year should see a pick up in the growth rate as the traded goods sector begins to benefit from the weakening of sterling and the resurgence of global demand growth. Economic policy, however, is not well-positioned to provide additional stimulus if the recovery should falter. Fiscal policy has already reached the prudent limits of expansion; and the inflation situation does not appear to leave a great deal of room for further easing by the Bank of England. Nevertheless, it may be judged that UK macroeconomic policy has done a quite good job in managing the recent period of global economic weakness.

Forecasts and (forecast changes) for Western Europe

	Year over year		Q4 to Q4	
	2003	2004	2003	2004
Western Europe	¾ (–½)	2 (–¼)	¾ (–½)	2¼ (0)
United Kingdom	1¾ (–¼)	2¼ (–¼)	1½ (–¾)	2½ (0)
Euro area	½ (–½)	1 ¾ (–¼)	¾ (–½)	2¼ (0)
Germany	0 (–¾)	1¼ (–½)	¼ (–¾)	1¾ (0)
France	¾ (–½)	1¾ (–½)	½ (–1)	2¼ (–¼)
Italy	½ (–¾)	1¾ (–½)	¾ (–¾)	2¼ (0)

In Central and Eastern Europe, strong contributions from Russia and Turkey (and the small Baltic states) have kept real GDP growth reasonably high through the first half of 2003, despite relatively weak performances by Poland, Hungary, and the Czech Republic. Looking forward, it appears that growth in Russia will be well sustained for at least the next year or so, helped by continued high energy export prices and (so far) not much hurt by the real appreciation of the ruble.

The situation in Turkey is of greater concern. After a very strong recovery from the deep difficulties of 2001, there will likely be at least a short-term slowdown in Turkey's economic growth. This may well be followed by another upsurge in growth next year—in line with the boom and bust pattern of Turkey's economy since 1999.

More worrying for the longer term is the now evident slowdown of economic reform in Turkey. Last year's fiscal deficit limits (agreed with the IMF) were significantly exceeded in the pressures of an election year. This year's targets may be met, but only with the aid of one-time fiscal gimmicks and accounting dodges. Also, the Turkish government seems to be getting back into the bad business of using banks (particularly state-owned banks) to extend credit to favored enterprises and sectors of the economy. In the past, this practice has led to large-scale losses in the banks that ultimately show up in public debt. Indeed, as much as a third of Turkey's present huge public debt is the result of the ultimate recognition of such losses.

At about 80 percent of GDP, Turkey's huge public debt is a continuing threat to economic and financial stability. The recent favorable change in market sentiment toward Turkey (and toward emerging market debt more generally) has tempered the immediate threat. The perception that Turkey continues to do reasonably well under its IMF-supported reform program—and is still likely to receive further financial support from the United States—has reinforced these gains in market sentiment. However, if market sentiment again turns negative in two or three years (perhaps because of belated recognition of limited progress in economic reform), Turkey's very large public debt and its already large outstanding obligations to the IMF will make the situation very difficult to manage.

The accession of ten Central and Eastern European countries to membership in the European Union in May 2004 will likely provide a boost to confidence and to economic activity. Although participation in the euro area will neither be immediate nor automatic, membership in the EU will probably provide some further stimulus to inward foreign investment flows on reasonably attractive terms—thereby boosting domestic investment and growth. Stronger economic growth in Western Europe will also provide a short-term boost. Thus, 2004 and 2005 promise to be pretty good years for most of the economies of Central and Eastern Europe.

Looking beyond that time-span, however, there is reason for some concern. Booms financed by inflows of foreign investment and encouraged by relatively low interest rates may prove unsustainable, especially if they are further encouraged by inadequately disciplined domestic policies. The history of recent emerging market financial crises provides several examples of this unfortunate phenomenon.

The Middle East and Africa

The war in Iraq ended swiftly with a minimum of casualties and little physical damage to essential economic infrastructure. Restoration of security, of public utilities, and of economic activity—including in the oil sector—however, has progressed more slowly than might have been hoped. For the Iraqi economy, therefore, the short-term effects of the war and the initial stages of reconstruction have surely meant a substantial fall in an already low level of activity. Iraq's immediate neighbors have also felt some negative economic impact from the war and its aftermath, but the effect has generally not been severe.

For world oil markets, the failure to bring Iraqi production and exports rapidly back on line has contributed to a continued high level of world oil prices—which have generally run about $30 per barrel since May. For major oil exporters, including Saudi Arabia, Kuwait, and the United Arab Emirates, these higher oil prices have contributed to somewhat stronger than expected general economic performance.

Meanwhile, the Israeli economy has continued to stagnate in the face of ongoing conflict with the Palestinians, and this situation appears unlikely to get much better any time soon. The Egyptian economy has been growing relatively slowly, partly reflecting economic and political difficulties elsewhere in the region.

All of this suggests that my April forecast of only ½ of 1 percent growth for the Middle East region in 2003 is about right. For 2004, a stronger global growth environment and progress in addressing key regional problems in Iraq and elsewhere still offers the hope that regional real GDP growth will strengthen meaningfully to about 3 percent.

In Africa, economic performance has been marginally weaker than earlier expected, partly because global growth in the first half of 2003 has been below expectations. In South Africa, by far the largest economy in Sub-Saharan Africa, growth slowed late last year and early this year under the impact of sharp increases in domestic interest rates. These interest rate increases, in turn, reflected necessary responses of the Reserve Bank to sharp downward pressures on the exchange rate of the rand and an upsurge of inflation (later partly attributed to measurement errors). With the resurgence of the rand and easing of inflation worries, the Reserve Bank has recently been able to cut policy interest rates considerably; and this should contribute more vigorous growth in the second half of 2003 and in 2004. Buoyant world gold prices and stronger global economic growth will also help.

Meanwhile, Nigeria's economy seems to be growing at only about a 3 percent annual rate, despite the benefits of high world oil prices. Elsewhere in sub Saharan Africa, economic disasters have accompanied political and social turmoil in Liberia and Zimbabwe; and this has not been offset by strong performances elsewhere in the region. Thus, on balance, it now appears that real GDP growth in Africa will fall a little short of my earlier 3 percent forecast for 2003. Better global growth prospects for 2004, and some recent strengthening in non-oil commodity prices, suggest that Africa should be expected to do somewhat better next year.

Global Growth Prospects: Assessment as of September 8, 2003 (annualized percentage real GDP growth rates)

Country or region	**Year over year**			**Q4 to Q4**		
	2002	**2003**	**2004**	**2002**	**2003**	**2004**
Industrial countries	1¾	1½	3	2½	2	3
United States	2½	2½	4	3	3½	3¾
Japan	¼	1½	2	2½	2	2
Western Europe	1	¾	2	1½	¾	2¼
United Kingdom	2	1¾	2¼	2¼	1½	2½
Euro area	¾	½	1¾	1¼	½	2¼
Germany	¼	0	1½	¾	¼	1¾
France	1¼	¾	1¾	1½	½	2¼
Italy	½	½	1¾	1	½	2¼
Developing and transition countries	4	3¾	5½	4	4	5½
Asia	6½	5½	7			
China	8	7¼	7¾			
India	5½	6	6½			
Others	4¾	3	6			
Latin America	–1½	1	4			
Argentina	–11	5	5			
Brazil	1½	1	4			
Mexico	1	1¼	4½			
Central and Eastern Europe	4¾	4¼	4½			
Middle East	1½	0	3			
Africa	3	2½	3½			
World (WEO weights)	2¾	2½	4¼	3¼	3	4¼

Q4 = Fourth quarter
WEO = IMF's *World Economic Outlook*