VII. INTERNATIONAL ECONOMIC DEVELOPMENTS

Output Growth

World output, which grew by 3.0 per cent in 2002 according to the World Economic Outlook of the International Monetary Fund, is expected to continue to recover in 2003 albeit at a relatively subdued growth rate of 3.2 per cent. The slowdown in world economic growth noted in the closing months of 2002 persisted during most of the first half of 2003. Geopolitical tensions over the Iraq war in early 2003, which threatened to stall world economic growth by undermining business and consumer confidence as well as pushing up oil prices, turned out to be short-lived although lingering security worries still remain. The pace of world growth is likely to strengthen in the second half of 2003 given that both the Federal Reserve in the United States and the European Central Bank (ECB) in the euro zone still have room for manoeuvre on interest rates should their respective economies show signs of fatigue. The United States, in addition, has some flexibility on the fiscal side relative to euro zone national governments, which are constrained by the EU Stability and Growth Pact.

Output growth in the advanced economies, on average, recovered from 1.0 per cent in 2001 to 1.8 per cent in 2002 and is expected to post the same growth rate in 2003. In 2002, the United States, the world's largest economy, expanded at a rate of 2.4 per cent after a near-zero growth rate of 0.3 per cent in 2001. Consumer and, to a lesser extent, business spending, the key drivers of the US economy, which recovered strongly in the first half of 2002 relatively to 2001, slowed down significantly in the fourth quarter of 2002. A combination of factors, namely, falling consumer sentiment, lower equity prices, rising unemployment, and ample excess capacity adversely affected consumer and business spending. Hit by geopolitical tensions over the impending Iraq conflict and harsh winter conditions, output growth in the United States remained quite weak in early 2003, with GDP growing by 1.4 per cent in the first quarter of 2003, falling short of market expectations. Looking ahead to the second half of 2003, a number of favourable factors, namely, strong productivity growth, accommodative interest rates and US tax cuts are likely to gradually improve consumer and business spending and enable the United States to grow by an expected 2.6 per cent in 2003. However, lingering downside risks to the growth picture still remain with the current account deficit and the fiscal deficit projected, respectively, at 5.1 per cent of GDP and 6.0 per cent of GDP in 2003.

The slowdown in the euro area was deeper and more prolonged than earlier expected, although recent indicators, notably the increase in equity prices and in business confidence, may indicate an improvement in economic prospects. Growth in the euro area declined from 1.5 per cent in 2001 to 0.9 per cent in 2002 and is projected to fall further to 0.5 per cent in 2003, down from a previous forecast of 1.1 per cent. Within this overall picture, growth prospects in Germany and France, the two largest economies of the euro zone, are expected to remain lacklustre. Germany, once seen as the locomotive of European growth, has been the key underperformer, posting an anaemic growth of 0.2 per cent in 2002, its slowest growth rate in nine years. Germany's stagnation still remains a concern, as there is no evidence to suggest that a turnaround is near. While industrial production and retail sales continue to slump, the jobless rate is at a 3-year high and the financial sector under increasing strains. Against this background, Germany is expected to stagnate in 2003. Weak consumer confidence and soft labour market conditions continue to plague the French economy, which is expected to grow at a rate of 0.5 per cent in 2003 compared to 1.2 per cent recorded in 2002. In Italy, economic activity is expected to expand by 0.4 per cent in 2003. Spain, Belgium and Luxembourg are likely to post stronger growth rates while Austria and Finland are expected to register a lower growth rate in 2003 than a year ago. Portugal and Netherlands are expected to contract in 2003. Ireland, which posted a growth rate of 6.9 per cent in 2002, is projected to grow at a mere 1.0 per cent in 2003. On a more positive note, Greece is projected to perform better than its bigger counterparts with a growth rate of 4.0 per cent in 2003. Structural reforms remain key to improving the euro area's economic performance, including meeting the challenges that an ageing population will imply for longer-term fiscal positions, labour supply and economic growth.

In the United Kingdom, the economy is expected to grow at a rate of 1.7 per cent in 2003, down from 1.9 per cent in 2002. Growth in the

United Kingdom weakened in the first half of 2003, reflecting a slowdown in investment and, to a lesser extent, private consumption as well as a deterioration of external demand. Soaring house price inflation, which was a concern in 2002, seemed to have abated and that enabled the Bank of England to ease its monetary policy stance in February 2003 to stimulate external and domestic demand. Recent data have indicated that the British economy remains in good shape and growth is on an uptrend. Public sector demand should remain strong with the massive government expenditure on public services, while the labour market has been resilient with continuing low unemployment and relatively stable growth in earnings.

The Japanese economy is expected to expand at a higher rate of 2.0 per cent in 2003, up from 0.2 per cent in the preceding year. Real GDP slowed in the fourth quarter of 2002 to 0.5 per cent quarter-on-quarter, down from 0.7 per cent in the third quarter of 2002, reflecting a sharp drop-off in consumption growth and a draw-down in inventories. The rise in the Japanese yen during the second half of 2002 slowed exports, causing a lot of concern for the Japanese authorities as consumer and business spending were not picking up. An improved external environment and the pickup in stock prices together with an upward revision to the first quarter 2003 GDP led to sizeable increases in growth projections. Although risks have become more balanced, the outlook remains clouded by entrenched deflation and by persistent weaknesses in corporate, financial and public sector balance sheets. Other risks include the impact of a sustained appreciation of the Japanese yen on corporate profits, investment, deflation and net exports.

Growth in developing countries, as a group, is expected to pick up from 4.6 per cent in 2002 to 5.0 per cent in 2003. Different regions and countries, however, would be characterised by different growth patterns. The Latin American region, which experienced a contraction of 0.1 per cent in economic activity in 2002, is expected to rebound and post a growth rate of 1.1 per cent in 2003. This is due to recent signs of a pickup in activity in much of Latin America and the improvement in market sentiment although the situation in some countries of the region still remains somewhat difficult. Brazil, the region's largest economy, witnessed sluggish growth in 2002 owing to weak internal demand and output growth is expected to remain unchanged at 1.5 per cent in 2003. However, the newly elected government has pledged to maintain macroeconomic stability and fiscal discipline. In Argentina, where output has fallen almost 20 per cent below the 1998 levels, growth contracted by 10.9 per cent in 2002 but is expected to recover to a rate of 5.5 per cent in 2003. In Venezuela, the ongoing political crisis disrupted oil production and increased uncertainties in the non-oil sector. Real GDP fell sharply in the second half of 2002, resulting in growth contracting by 8.9 per cent for the year 2002 as a whole. Despite the recent resolution regarding oil issues, real GDP is expected to shrink by a further 16.7 per cent in 2003. Relatively strong economic performances are, however, expected in Mexico and Chile in 2003, underpinned by generally sound policies and a high degree of integration with the world economy.

Prospects for emerging Asia, which includes developing Asia, the newly industrialised Asian economies and Mongolia, remain favourable in 2003, with aggregate growth projected at 5.9 per cent compared to last year's 6.2 per cent. However, the 2003 growth outlook in the region was clouded by the adverse impact of the Severe Acute Respiratory Syndrome (SARS) outbreak on Mainland China and newly industrialised Asian countries. The SARS outbreak severely disrupted the transportation and tourism sectors and its impact was felt mostly on those economies for which tourism constitutes an important sector of activity. In 2002, the solid growth experienced by emerging Asia was mainly driven by China's membership of the World Trade Organisation (WTO), which contributed in boosting up intraregional and interregional trade. Moreover, the transfer of foreign production facilities to China stimulated investment spending. With a growth rate of 8.0 per cent in 2002, China's demand for imports from other economies in the region has been consistently strong. In the first quarter of 2003, China's economy grew at a staggering 9.9 per cent, its fastest pace in six years. However, in the second quarter of 2003, growth decelerated to 6.7 per cent, hitting a 12-year low, mainly on account of the SARS epidemic. Additionally, downside risks posed by falling prices, with an inflation rate of -0.8 per cent in 2002, seem to have abated and an inflation rate of 0.3 per cent was recorded in June 2003. For 2003, the Chinese economy is expected to grow by an overall 7.5 per cent.

Growth in Africa is expected to pick up from 3.1 per cent in 2002 to 3.7 per cent in 2003.

Although prospects vary across individual countries, continued macroeconomic policy strengthening, global recovery and higher nonfuel commodity prices are likely to support the economic outlook for 2003 in the region. Yet, some downside risks to the growth picture, namely, adverse climatic conditions and the security situation in West Africa, could still derail Africa's economic recovery. Within the Sub-Saharan African region, which is projected to post a higher growth rate of 3.6 per cent in 2003 from 3.1 per cent in 2002, all countries, with the exception of Ethiopia, Ivory Coast, and Zimbabwe, are expected to register positive growth rates.

Across the Middle East region, real GDP growth is projected at 5.1 per cent in 2003 compared to 3.9 per cent in 2002. Oil exporting countries, supported by higher oil prices and production combined with the continued global recovery, are expected to grow at a faster rate of 6.0 per cent in 2003 from 4.5 per cent in 2002. However, lingering geopolitical tensions and security concerns in the area have seriously constrained the growth in the tourism sector in many oil-importing countries, since it constitutes an important source of revenue. If these tensions were to persist for the rest of 2003, GDP growth could be adversely affected.

GDP growth in the transition economies remains solid and is projected at 4.9 per cent in 2003 compared to 4.2 per cent in 2002, though delays in implementing reforms in Russia have weakened investment prospects. In Central and Eastern Europe, GDP growth continues to be underpinned by strong foreign direct investment inflows as European Union accession nears, offsetting the impact of weaker euro area demand.

Inflation

With global inflation currently at low levels and considerable excess capacity in both the United States and the euro area, the inflation outlook is expected to remain benign. Consumer price inflation in the advanced economies declined to 1.5 per cent in 2002 from 2.2 per cent in 2001 and is expected to remain tame in 2003 although increasing to 1.8 per cent. Inflation in the United States is projected to rise to 2.1 per cent in 2003. But, as oil prices declined from peaks attained during the Iraq war, inflation pressures in the US abated and reached 2.1 per cent, the lowest level in nine months, in June 2003, thereby raising concerns that the United States might be at risk of deflation.

In the euro zone, inflation, measured using the harmonised index of consumer prices (HICP), is expected to decline to 2.0 per cent in 2003, helped partly by a stronger euro. In June 2003, euro zone year-on-year inflation rate hit the target of 2.0 per cent set by the ECB. However, within the euro zone, inflation rates continued to vary widely across individual countries. Germany, already stuck with stagnation, runs a high risk of being caught in a deflationary trap. In a bid to guard against the risk of deflation, the ECB reviewed its monetary policy strategy in the second quarter of 2003 by formally stating that in its pursuit of price stability, it would aim to maintain inflation close to 2.0 per cent instead of a range between zero and 2.0 per cent.

In the United Kingdom, RPIX inflation, that is, inflation measured from retail price index excluding mortgage interest, is expected to rise above the government-set target of 2.5 per cent to reach 2.8 per cent in 2003. The Bank of England had already anticipated that RPIX inflation would overshoot its target in the near term before dropping down to around target over the policy horizon. Temporary factors, such as higher council taxes, not warranting any drastic policy change were the key drivers to RPIX inflation overshooting its target.

Among the major industrial nations, Japan has been experiencing sustained deflation for the past four years. Low prices in China and other Asian emerging markets have given rise to concerns that deflationary pressures could be transmitted across countries through trade, corporate and financial linkages.

Interest Rates

With subdued inflationary pressures, monetary policy in the major industrial countries has remained to a large extent accommodative in 2002 since the substantial general policy easing of 2001. For most of 2002, the US Federal Reserve left its key interest rate unchanged at its lowest level in four decades at 1.75 per cent. On 6 November 2002, against the backdrop of weaker-than-expected growth in part attributable to heightened geopolitical tensions, the US Federal Reserve, while adopting a neutral bias, reduced the federal funds rate by 50 basis points to 1.25 per cent. However, at its Federal Open Market Committee (FOMC) meeting of 6 May 2003, US policymakers cited a possible "unwelcome substantial fall in inflation" and indicated that it was prepared to cut rates again to ward off further economic weakness. As widely expected, on 25 June 2003, the Fed concluded its two-day FOMC meeting by cutting its federal funds rate by 25 basis points to a 45-year low of 1.00 per cent.

In the euro zone, the ECB, amid deteriorating growth prospects and concerns about inflationary pressures, maintained its key refinancing rate unchanged at 3.25 per cent until its interest rate setting meeting of 6 December 2002. Against the backdrop of an easing of price pressures partly helped by the appreciation of the single currency, the ECB surprised markets with a hefty 50 basis points rate cut. Another subsequent reduction of 25 basis points in the key refinancing rate to 2.50 per cent came in early March 2003 as the impact of the global slowdown, amid deepening geopolitical tensions, became more pronounced. Despite the weak economic recovery in the euro zone, the ECB resisted calls to cut interest rates further, arguing that factors other than interest rates, namely, lack of confidence and structural rigidities were mostly to blame for the gloomy outlook. On 5 June 2003, however, amid signs of economic stagnation in the region, falling inflation and a soaring euro, the ECB cut its key refinancing rate by 50 basis points to 2.0 per cent. In the United Kingdom, even though inflation was above its target, the Bank of England, on 6 February 2003 eased, for the first time since November 2001, its key repo rate by 25 basis points to 3.75 per cent, its lowest level since 1955, stating that signs of economic weakening were present.

In Japan, monetary policy continued to remain accommodative with interest rates at near-zero levels. The Bank of Japan opted for quantitative easing, including increasing the bank reserves targets in late 2002 and outright purchases of government bonds. However, despite these efforts, prices continued to decline and the Bank of Japan has since been considering alternative policy routes. On present trends, the easing of the monetary policy stance in Japan is likely to continue although the Bank of Japan's policy options seem limited.

Exchange Rates

Against the backdrop of the uncertain growth outlook amid increasing geopolitical tensions, the US dollar, on average, weakened against major currencies in 2002-03 as investors reassessed the downside risks to the US economy on concerns over the emergence of a fiscal deficit and the ballooning current account deficit. Despite uninspiring economic data for the euro zone, the single currency rose strongly against the US dollar and, on average, managed throughout fiscal year 2002-03, to break key support levels. During May and June 2003, the euro breached its January 1999 launch level of US$1.1747, even reaching a record high of US$1.1935 on 27 May 2003, in New York trade. Much of the euro's strength has been attributed to its safe haven status comforted by the external balance surplus of the euro zone and to the interest differential in favour of the single currency. Despite weak prospects for the Japanese economic recovery in early 2003, the fragile state of the financial sector and aggressive yen-selling intervention by the Bank of Japan, the yen on average strengthened against the generally weak US dollar. On average, the Pound sterling trended upward against the US dollar between July 2002 and January 2003. Following the Bank of England surprise rate cut in early February 2003 compounded by gloomy UK economic data, it weakened until April 2003 when it resumed its uptrend to close the fiscal year strongly against the US dollar.

Balance of Payments

The US current account deficit widened further from 3.9 per cent of GDP in 2001 to 4.6 per cent of GDP in 2002 and is projected to worsen to 5.1 per cent of GDP in 2003 despite the decline in the external value of the US dollar. With US interest rates already low and equity markets weak in early 2003, investors have fretted over whether the rest of the world would still be willing to finance the gap. Reflecting the growing US current account deficit, there has been a correction in the foreign exchange markets with the depreciation of the US dollar. Although US officials have indicated that at current levels the US dollar was helping US exports, it is not clear whether a US dollar correction on its own would be sufficient to reverse the trend given the scale and nature of the US current account deficit. In the United Kingdom, the current account deficit fell from 1.3 per cent of GDP in 2001 to 0.9 per cent of GDP in 2002 and is expected to widen slightly to 1.0 per cent in 2003 as divergence remained between the domestically-oriented and the externally-exposed sectors. The recent realignment of the Pound in nominal effective terms is somewhat expected to boost export volume growth relative to imports. In contrast, Japan has experienced a relatively large and stable current account surplus over the past years. In 2003, Japan is expected to post a current account surplus of 2.9 per cent of GDP. In the euro area, the current account is expected to post a surplus of 0.8 per cent of GDP in 2003 compared to a surplus of 0.9 per cent of GDP in 2002.

Budget Deficit

The sluggish economic recovery in the major advanced economies coupled with historically low interest rates have prompted national governments to do more on the fiscal side to stimulate economic growth. In the United States, fiscal stimuli took the form of increased spending and tax reductions. From a surplus in 2000, the fiscal position in the United States deteriorated to a relatively sizeable deficit of 0.7 per cent of GDP in 2001 and 3.8 per cent of GDP in 2002. With the latest budget proposals, the United States is expected to incur a higher budget deficit of 6.0 per cent of GDP in 2003. The fiscal deficit of the euro area rose to 2.3 per cent of GDP in 2002, with Germany and France breaching the 3.0 per cent limit of the EU Stability and Growth Pact. In 2003, the euro area fiscal deficit is expected to reach 3.0 per cent of GDP with fiscal deficit in Germany and France projected at around 3.9 per cent and 4.0 per cent of their respective GDP. While fiscal stimulus helped to support growth in the United Kingdom, the budget deficit is expected to widen from 1.3 per cent of GDP in 2002 to 2.5 per cent of GDP in 2003. In Japan, the budget deficit is projected to decline modestly in 2003 to 7.4 per cent of GDP from 7.5 per cent in 2002, but mounting public debt remains a problem.

Oil

Oil prices experienced a sustained upward pressure during fiscal year 2002-03, reflecting mainly the heightened geopolitical risk and uncertainty prevailing in the Middle East. The war prospects in Iraq implied a significant war premium in the crude oil price as market fears about severe disruptions in oil supply were factored into the crude oil futures market. Market apprehensions about distortions in the world crude oil supply balance arising out of the regional security tensions in the Gulf was exacerbated by a damaging strike in Venezuela, the world's fifth crude oil exporter. The strike, which stretched from December 2002 to January 2003, drastically reduced Venezuela's oil output from 3.1 million barrels per day to below 50,000 barrels per day at its lowest point in December 2002, and by May 2003, output was still 300,000 barrels below the optimum level, or 2.8 million barrels per day. Iraq's output, which was estimated at 2.8 million barrels per day before the war in March 2003, hardly exceeded 0.5 million barrels per day by June 2003. A climate of social unrest also prevailed in Nigeria (OPEC's fifth largest producer) for the first six months of 2003, and sporadic acts of terrorism in Saudi Arabia, OPEC'S top producer, injected nervousness into the world oil market. The trends in international oil prices in 2002-03 are further elaborated in Box 6.

Gold

The COMEX gold futures market reflected world economic and geopolitical developments, which influenced the oil markets. Gold, the so-called war commodity, tends to be scooped up by nervous investors ahead of armed conflicts to protect against a falling currency and weakening stock market indices. COMEX gold futures average registered a US$43.6/Oz. premium in fiscal year 2002-03 compared to 2001-02. As at July 2002, COMEX gold held a US$45/Oz. premium compared to July 2001. This premium widened in December 2002 to US$57/Oz., and peaked to US$75/Oz. in January 2003, as the war scenario gained credence. Gold moved along a positive correlation path with the risk and uncertainty overhanging the equity markets, which gained impetus during the first three quarters of fiscal year 2002-03. COMEX gold averaged US$332.9/Oz. for fiscal year 2002-03 compared to US$289.3/Oz. for 2001-02.

COMEX gold futures benefited significantly from the bullion's status as a safe-haven asset and war insurance during the Iraq War. Given the inflationary impact of higher oil prices, gold also capitalized on its status as an inflation-hedge instrument. Additionally, the weak dollar combined with sluggish equity market indices attracted investment funds into bullion investments. COMEX gold thus developed a positive correlation with the euro, as the European currency overtook the US dollar in the last quarter of 2002, and peaked in May 2003 and June 2003 to its highest level. The euro strength injected an added momentum to gold futures, but by the end of fiscal year 2002-03, gold detached slightly from its positive correlation with the euro and traded on its own fundamentals.

World Trade

World trade is likely to decline in real terms to 2.9 per cent in 2003 from 3.2 per cent in 2002, after registering a mere 0.1 per cent in 2001. World trade growth will continue to depend heavily on economic developments in the United States. With a turnaround in US consumer and business sentiment expected in the second half of 2003, merchandise imports by advanced economies are projected to grow by 2.9 per cent in 2003 from 2.4 per cent a year earlier. Merchandise exports from the advanced economies are projected to grow at a slower pace of 1.1 per cent in 2003 compared to 2.0 per cent in 2002. For developing countries, however, merchandise imports and exports are projected to grow at 5.3 per cent and 5.0 per cent, respectively, in 2003 from 6.2 per cent and 6.3 per cent, respectively, in 2002.

External Debt

Total external debt of developing countries increased from US$2,170.2 billion in 2001 to US$2,191.5 billion in 2002 and is expected to rise further to US$2,219.2 billion in 2003. The ratio of external debt to GDP, which stood at 40.1 per cent in 2001, rose to 40.9 in 2002 but is projected to fall to 37.7 per cent in 2003 owing to the prospective expansion in economic activity in developing countries as a whole with a pick up in the global economy.