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III. DEVELOPMENTS IN SELECTED NON-MEMBER ECONOMIES

Economic activity continued to recover in the non-member Asian region throughout most of 2002, led by double-digit growth in exports. The expansion gained further momentum during the second half in China, but decelerated in Dynamic Asia in response to the renewed weakness in the United States and other OECD countries. Growth in Dynamic Asia should rebound in 2003 if OECD markets recover, but is subject to significant risks from geopolitical tensions, along with structural problems and the potential fallout from the outbreak of disease in several economies. China is less exposed to external risks, but further progress on structural reforms to achieve more balanced growth in the domestic economy are likely to be needed to sustain rapid growth in real GDP beyond the near-term.

Economic growth in Russia and other Newly Independent and South-East European States slowed to below 5 per cent in 2002. In a weak global environment, growth was mainly driven by strongly expanding internal demand, boosted in many countries by sizeable increases in wages and social benefits. Growth is expected to remain robust in 2003 at around 4 to 5 per cent, both for Russia and the region, but may slow further in 2004. In some countries, including Russia, higher growth in commodities and basic manufactures, compared to more complex manufactured goods, may increase the future vulnerability of these economies to external shocks.

South-America is slowly recovering from the regional recession of 2002. The new administration in Brazil has reassured markets in pursuing prudent macroeconomic policies and starting to undertake further structural reforms. In Argentina, the real economy is showing signs of recovery, despite the political uncertainty. Other countries in the region display mixed performances, with growth picking up in Chile whereas Venezuela is facing a severe recession. In addition to the restoration of confidence in the region, a demand push from abroad, notably from OECD countries, would be important to strengthen the incipient economic recovery.

Economic activity in the Asian region recovered in 2002

Real GDP, domestic demand, and exports in the Asian region recovered strongly during 2002, but performances diverged during the second half as demand from OECD countries faltered and world Information and Communications Technology (ICT) markets turned down. In contrast to China, export and import growth in the Dynamic Asian Economies (DAE) came to a virtual halt by end of the second half and economic activity decelerated. Economies most dependent on ICT production were hardest hit, notably Singapore, where real GDP was virtually flat in the second half compared to the first half, as well as the Philippines and Chinese Taipei. Nevertheless, real GDP growth of the DAE averaged 3 per cent for 2002 as a whole, compared to nearly zero growth in 2001, and the regional current account surplus continued to increase.

Growth should pick up further in the Dynamic Asian Economies in 2003

Provided OECD, and particularly ICT, markets recover, real GDP growth in DAE should pick up further in 2003. With core inflation low except in Indonesia, monetary policy is likely to remain supportive of real growth. However geopolitical tensions surrounding Iraq, whose adverse effects on regional tourism, stock prices, foreign direct investment (FDI), and confidence could persist beyond the near-term, along with the outbreak of severe acute respiratory syndrome (SARS) pose greater than normal downside risks to the DAE outlook. In addition to its direct impact, a prolonged slump in external demand could aggravate internal structural problems and thereby further depress economic performance in some economies, notably in Thailand and Indonesia, where private sector debt strains remain serious, and in Chinese Taipei and Hong Kong, China, which have been experiencing deflation.

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Activity slowed in the Newly Independent States and in South-East Europe

Russia and other Newly Independent States and South-East Europe experienced a slowdown of economic activity from almost 6 per cent in 2001 to somewhat below 5 per cent in 2002. The slowdown was partly due to weak external demand, and partly to continued structural problems. Growth performances converged, as most countries expanded between 4 and 6 per cent. Notable exceptions were Kazakhstan and Azerbaijan, where expansion in the oil sector fuelled economic growth rates of roughly twice the average for the zone. In most countries gradual disinflation continued, generally helped by the relative strengthening of the local currency with respect to the dollar.

Activity in South America is slowly picking up from the 2002 downturn

After a sharp economic downturn in the first half of 2002, South America experienced a trend reversal in the second half of the year, with the exception of Venezuela. This incipient recovery was mainly driven by strong improvements in the trade account, linked to the strong and persistent depreciation of exchange rates in various countries. Nevertheless, the GDP of the region still contracted by about 1 per cent in 2002, due in part to a 40 per cent drop of foreign direct investment (FDI) inflows to the region. For 2003, growth could increase somewhat, but there are major downside risks. In Argentina, while the severe recession is bottoming out, the recovery has not been supported by major policy actions awaiting the new government. Venezuela's economy may contract sharply in 2003 due to the temporary interruption of oil production and other economic activity and the associated drop in consumption. In Brazil, the smooth government transition in January and the orthodox policies put in place by the new administration have somewhat lessened the pressure on the exchange rate. Despite this development, inflationary pressures have persisted, requiring several increases in the base interest rate, and this in turn is limiting domestic demand growth. The outlook for Chile seems more favourable as exports are expected to grow, under the influence of the free trade agreements with the European Union and the United States, while consumer demand is recovering. Overall, depressed domestic demand and little room for manoeuvre for expansionary policies imply that an increase in foreign demand, mostly from OECD countries, as well as a recovery in foreign investment, will be decisive for the pick-up of growth in South America.

China

Real GDP growth accelerated further in the second half of 2002

China's real GDP growth accelerated further in the second half of 2002 to reach 8 per cent for the year as a whole, compared with the 7.3 per cent increase in 2001. GDP growth accelerated further in the first quarter of 2003, to its fastest pace since 1997. The unexpectedly strong growth performance has been driven by domestic demand, while the contribution of net exports was smaller than in 2001.

Domestic demand growth has been driven by government investment

Government fixed investment spending continues to be the largest contributor to growth. Real estate investment surged by 22 per cent year-on-year in 2002, but with vacancy rates over 10 per cent in major cities, concerns are rising that a new bubble may be in the making. Despite a rise in enterprise profits as a result of accelerating sales, business capital spending has remained relatively weak, due to limited access to credit by non-state enterprises and to continued excess capacity.

Private consumption growth has picked up

The slowdown of household spending in the first half of 2002 was followed by a sharp rebound in the second half. Personal consumption spending has been concentrated on durables, led by passenger cars, and has been especially strong in coastal cities. Growth in rural incomes and consumption continue to be weak, however. The

Table III.1. **Projections for China**[a]

	2001	2002	2003	2004
Real GDP growth	7.3	8.0	7.7	7.1
Inflation	0.7	-0.8	-0.2	0.0
Fiscal balance (% of GDP)	-2.6	-3.0	-3.0	-3.2
Current account balance ($ billion)	17.4	18.5	17.6	15.1
Current account balance (% of GDP)	1.5	1.5	1.3	1.1

a) The figures given for GDP and inflation are percentage changes from the previous year. Inflation refers to the consumer price index.

Source: Figures for 2001 and most of 2002 are from national sources. Figures for 2003-04 are OECD estimates and projections.

spending on consumer durables in part reflects a stock adjustment to the rise in individual home ownership sparked by housing reforms and to the fall in automobile prices in 2002 in the wake of tariff cuts.

Exports have been spurred by further market share gains

China's exports registered exceptionally strong growth in 2002, reaching 22 per cent, year-on-year. Export growth has been concentrated on Asia and Europe (21 and 20 per cent, respectively) reflecting a strong rebound of imports in the former and increasing market share in both regions. Imports also surged in 2002, reaching a growth rate of 21 per cent (year-on-year), driven by strong exports and domestic infrastructure spending, and further boosted by recovering domestic consumption and by tariff and quota reductions related to entry into the World Trade Organisation (WTO). FDI inflows rose by 13 per cent in 2002 compared to 2001, reaching $53 billion.

Deflation has eased but the underlying sources remain

Deflation has eased somewhat as a result of strong consumption spending, higher oil prices and a rise in food prices due to severe weather conditions. However, there has been little change in the underlying conditions behind the deflation, notably excess supplies in much of industry.

Domestic demand growth is likely to slow in 2003-04

Despite the rapid growth in 2002, domestic demand growth is likely to slow during 2003-04 as the real estate investment boom cools and as the stock adjustment in autos and other consumer durables now underway eases. The outbreak of severe acute respiratory syndrome could further depress growth, particularly if it is not quickly contained. The external contribution to GDP may also decline somewhat as gains in export market shares slow. The incoming government thus faces the challenge of achieving more balanced growth while boosting job creation to contain rising unemployment. The scope for macroeconomic stimulus is limited by the already low level of interest rates, the rising budget deficit and the prospectively large future increases in government debt likely to be needed to recapitalise the banking system and carry out other reforms.

Further structural reforms are needed

Accordingly, sustaining real GDP growth is likely to depend increasingly on structural reforms. Key in this regard are financial sector reforms to end the present virtual credit crunch in lending to non-state and other small and medium sized enterprises (including rural enterprises). Equally important are measures to transform state-owned enterprises into profit-oriented commercial firms with the technology and other capabilities to enable them to be competitive. Public finances also need to be extensively reformed to provide better support to rural areas and a social safety net for those displaced by reforms. Reforms already taken represent important steps toward these goals but are unlikely to be sufficient. There has been much discussion over the past year of new major policy initiatives, particularly in the financial sector, but as yet no official decisions have been taken.

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The Russian Federation

Russian GDP continues to expand, but growth is increasingly uneven

Russia's GDP growth slowed to 4.3 per cent in 2002. While the service sector boomed, fuelled by real wage increases of above 15 per cent, growth in investment and industrial production continued to slow. Industrial growth was concentrated in the oil, metal and food processing sectors, with the rest of industry by and large stagnating. Exports rose in value terms, driven by higher export volumes. With import growth moderating, the current account surplus remained above 9 per cent of GDP, though decreasing somewhat.

Macroeconomic policies remain sound…

Inflation continued to decline gradually, supported by the continuing real appreciation of the rouble against the dollar. The central bank's recent move to inflation targeting also points to enhanced determination to stem inflation. Overall, external competitiveness was little affected in 2002, as the effective real exchange rate remained almost unchanged due to the rouble's depreciation against the euro. The recent introduction of more efficient monetary policy instruments – as repo and reverse repo operations – will facilitate liquidity management and sterilisation. In turn, this should reduce to some extent the trade-off between accepting higher inflation or allowing faster appreciation of the real exchange rate that characterised the previous monetary regime. Given underlying inflationary pressures and high oil-driven capital inflows, achieving the 2003 inflation target of 10 to 12 per cent without damaging the competitiveness of the Russian economy will be challenging. On the fiscal side a substantial part of increased revenues from higher oil prices in 2002 were channeled into a reserve fund (set up originally to provide for high debt repayments in 2003), as have been recent privatisation revenues. The transformation of this reserve fund into a stabilisation fund against government revenue shortfalls during periods of low oil prices is currently under discussion. The 2003 budget, while expansionary, plans for a small surplus, and in addition has a substantial built-in buffer as it is based on oil prices of around $20 per barrel.

… and there has been some progress on structural reform

Electricity reform made substantial progress as the Duma approved the plan to split up the monopoly electricity company along functional lines and to introduce competition in the sector. While the situation for small and medium sized enterprises remains difficult, deregulation policies recently approved have led to some improvement in the business climate. The current revision of the bankruptcy law should help

Table III.2. **Projections for the Russian Federation**[a]

	2001	2002	2003	2004
Real GDP growth	5.0	4.3	5.0	3.5
Inflation	18.6	15.1	14.0	11.0
Fiscal balance (% of GDP)[b]	2.9	1.0	0.1	1.0
Primary fiscal balance (% of GDP)[c]	5.6	3.4	2.7	3.0
Current account balance ($ billion)	35.0	32.2	34.0	25.0
Current account balance (% of GDP)	11.3	9.3	8.5	5.5

a) The figures given for GDP are percentage changes from previous year. Inflation refers to the end-of-year consumer price index.
b) Consolidated budget (including federal, regional and municipal budgets, excluding off-budget funds).
c) Federal Budget.
Source: Figures for 2001 and most of 2002 are figures from national sources. Figures for 2003-04 are OECD projections.

to make property rights more secure. There has also been some recent progress on railway and pension reform and the government has started to tackle regulatory, administrative, and military reforms. While the reform process is taking time, the recent large investment of British Petroleum (BP) in the Russian oil sector suggests improving confidence among the international business community in the capacity of the current government to deliver on reforms.

Growth is likely to continue in 2003…

Continuing strong domestic demand will sustain robust real GDP growth in 2003. Investment, mainly in oil and utilities, has recently picked up, and private consumption will continue to be strong due to a further rise in disposable income. The latter is, however, likely to abate after parliamentary elections take place in late 2003.

… but its unbalanced nature may pose threats in the medium-long term

Further expansion in oil production and planned investments in utilities are likely to sustain moderate growth beyond 2003. Growth in the oil sector, and a further shift away from more complex and less competitive manufactured goods into commodities and basic manufactures should contribute to increase overall productivity levels. These developments may, however, increase the vulnerability of the Russian economy to external shocks, while rising wages and real exchange rate appreciation risk undermining growth in other industrial sectors. To stem these developments, further structural reforms, particularly in the area of taxation and banking, will be needed to facilitate the reallocation of resources to potentially more dynamic sectors.

Brazil

The Brazilian economy is recovering from the confidence shock…

The Brazilian economy performed somewhat better in the second half of 2002 compared to the first half. Several factors explain this trend. The adjustment of the trade imbalance accelerated due to the major exchange rate depreciation. After the elections, confidence improved, leading to a modest recovery in investment. Finally, the economic spurt in the second half (year-on-year) partly reflects a depressed base of comparison in the second half of 2001, when economic activity was low due to the energy crisis. Noteworthy, in parallel to these developments, Brazil faced a large shortfall of private capital inflows, including commercial credit lines and FDI. In this context, the financial package of the International Monetary Fund was critical in lessening the pressures on the balance of payments.

… but the large exchange rate depreciation generated inflationary pressures

Responding to the inflationary effects of the exchange rate depreciation, the monetary authorities raised the base interest rate during the second half of 2002. Nevertheless, inflation came in above the end-2002 target and inflationary pressures persisted in the first months of 2003. This led the central bank to tighten monetary policy further. The exchange rate shock and increases in the base interest rate raised the public debt, which is largely indexed to these two variables. The public finances remained on track but, to provide for the increased cost of servicing the debt, the government has had to increase the primary surplus to almost 4 per cent of GDP in 2002.

Presently there is no room for expansionary macroeconomic policies…

The remarkably smooth government transition in January and the commitment of the new administration to pursue a prudent monetary stance and fiscal austerity have re-established confidence. Accordingly, exchange rate pressures diminished and the public debt to GDP ratio has improved since the elections. However, slow

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Table III.3. **Projections for Brazil**[a]

	2001	2002	2003	2004
Real GDP growth	1.4	1.5	2.0	3.0
Inflation	7.7	12.5	14.0	9.0
Fiscal balance (% of GDP)[b]	-3.6	-4.6	-4.5	-3.0
Primary fiscal balance (% of GDP)	3.8	3.9	4.3	4.0
Current account balance ($ billion)	-23.2	-8.6	-5.0	-6.0
Current account balance (% of GDP)	-4.6	-1.8	-1.1	-1.1

a) The figures given for GDP and inflation are average percentage changes from the previous period. Inflation refers to the end-year consumer price index (IPCA).
b) Harmonised concept excluding revaluations of public debt due to changes in the exchange rate.
Source: Figures for 2001 and 2002 are from national sources. Figures for 2003-04 are OECD estimates and projections

economic growth is putting the finances of the states and municipalities under pressure. Fiscal policy is due to be further tightened during 2003, with a foreseen increase in the primary surplus achieved in large part by severe public expenditure cuts. These restrictive macroeconomic policies will continue to restrain domestic demand. An increase in net exports will not be easy, given the already high degree of capacity utilisation and weak demand of Brazil's trading partners. Moreover, increasing productive capacity by investment is constrained by high real domestic interest rates and limited international credit.

… but the outlook may improve with increased confidence

In this context, implementation of structural reforms is a key element in the confidence-building process. The government has submitted proposals in the areas of tax and pension reform to the congress. Sticking to the reform agenda is a necessary condition to strengthen confidence, which would allow the exchange rate to stabilise, reduce inflationary pressures, and decrease domestic interest rates. In principle, these trends should be accompanied by renewed international credit lines. Under this favourable scenario, the debt burden would be alleviated and investment and consumption boosted. An improved international environment would also increase exports by the end of 2003 and in 2004, fostering economic growth. Under a more pessimistic scenario, government efforts to pursue reforms would either not materialise, or not be rewarded by increased capital inflows and economic growth. The political and social difficulties associated with such a scenario create uncertainties to the outlook.

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Conventional signs

$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mbd	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

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Summary of projections[a]

	2002	2003	2004	2002 I	2002 II	2003 I	2003 II	2004 I	2004 II
	Percentage changes from previous period								
Real GDP									
United States	2.4	2.5	4.0	3.5	2.7	1.7	3.8	4.1	3.8
Japan	0.3	1.0	1.1	1.0	3.5	0.0	0.6	1.2	1.4
Euro area	0.9	1.0	2.4	1.1	1.1	0.9	1.4	2.6	2.9
European Union	1.0	1.2	2.4	1.2	1.4	1.0	1.5	2.6	2.8
Total OECD	1.8	1.9	3.0	2.5	2.4	1.4	2.4	3.2	3.2
Real total domestic demand									
United States	3.0	2.8	4.0	4.2	3.3	2.1	3.8	4.2	3.8
Japan	-0.3	0.5	0.4	-0.4	3.2	-0.6	-0.2	0.5	0.7
Euro area	0.3	1.1	2.4	0.4	1.0	1.0	1.5	2.6	2.9
European Union	0.7	1.3	2.5	0.7	1.5	1.1	1.6	2.8	3.0
Total OECD	1.9	2.0	2.9	2.4	2.8	1.4	2.4	3.1	3.1
	Per cent								
Inflation[b]									
United States	1.1	1.6	1.3	0.9	1.3	2.0	1.2	1.5	1.3
Japan	-1.7	-2.2	-1.8	-1.7	-2.6	-2.1	-1.8	-1.8	-1.8
Euro area	2.4	1.9	1.7	2.5	2.1	1.9	1.8	1.6	1.6
European Union	2.5	1.9	1.8	2.8	2.1	1.9	1.9	1.8	1.8
OECD *less* Turkey	1.4	1.3	1.2	1.5	1.2	1.5	1.2	1.2	1.2
Total OECD	2.1	1.7	1.4	2.0	1.7	1.9	1.5	1.4	1.3
	Per cent of labour force								
Unemployment									
United States	5.8	6.0	5.8	5.7	5.8	6.0	6.1	5.9	5.7
Japan	5.4	5.7	5.7	5.3	5.4	5.6	5.8	5.7	5.7
Euro area	8.2	8.8	8.7	8.1	8.3	8.7	8.8	8.8	8.6
European Union	7.6	8.0	7.9	7.5	7.7	8.0	8.1	8.0	7.9
Total OECD	6.9	7.2	7.0	6.8	7.0	7.1	7.2	7.1	6.9
	Per cent of GDP								
Current account balance									
United States	-4.8	-5.4	-5.5	-4.6	-5.0	-5.4	-5.4	-5.5	-5.5
Japan	2.8	3.1	3.9	3.0	2.6	2.9	3.4	3.8	4.1
Euro area	1.1	1.4	1.4	0.9	1.3	1.3	1.4	1.4	1.4
European Union	0.9	1.0	1.0	0.7	1.0	1.0	1.0	1.0	0.9
Total OECD	-1.1	-1.2	-1.2	-1.0	-1.1	-1.2	-1.1	-1.1	-1.1
	Per cent								
Short-term interest rate[c]									
United States	1.8	1.4	3.0	1.9	1.6	1.3	1.4	2.6	3.5
Japan	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Euro area	3.3	2.3	2.3	3.4	3.3	2.5	2.1	2.1	2.5
	Percentage changes from previous period								
World trade[d]	3.6	5.9	8.8	5.9	7.9	4.1	7.5	9.3	9.4

Note: Apart from unemployment rates and interest rates, half-yearly data are seasonally adjusted, annual rates.

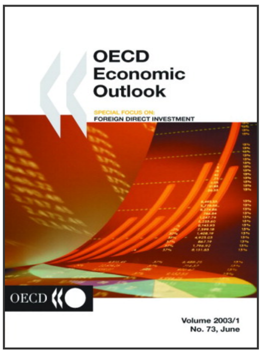
a) Assumptions underlying the projections include:
- no change in actual and announced fiscal policies;
- unchanged exchange rates as from 26 March 2003; in particular 1$ = 120.10 yen and 0.936 euros;
- the cut-off date for other information used in the compilation of the projections is 4 April 2003

b) GDP deflator.

c) United States: 3-month eurodollars; Japan: 3-month CDs; euro area: 3-month interbank rates. See box on policy and other assumptions underlying the projections.

d) Growth rate of the arithmetic average of world merchandise import and export volumes.

Source: OECD.



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