

# *The Economic Outlook for 2001: A Guide for California Exporters and Importers*

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Presented at The Bay Area World Trade Center's  
Political, Economic and Trade Services Outlook for 2001  
January 24, 2001

**Public  
Policy  
Institute of  
California**

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## **I. Introduction: Review of the World Economy in 2000 and Prospects in 2001**

This document draws on a number of analyses and forecasts to present a summary review of the world economy in 2000 and prospects in 2001. The consensus among the various sources is that the world economy performed extremely well in most of 2000. Although most forecasters expect a slowdown in 2001, no one believes there is a high probability of a recession.

This review and outlook should prove useful to importers and exporters planning their business activity for 2001. It may also prove useful to business people who rely on the strength of the domestic economy, because international events will surely affect the economic health of domestic suppliers and customers.

As a summary of the work of others, it presents thinking about the world economy *at a point in time*. The views presented here will change as the year advances. The references section at the end contains a number of useful internet links, so the interested reader may keep up with forecasts as they change.

The remainder of this section discusses the review and outlook for the world in general and describes how forecasts should be used. Section II reviews California trade in 2000 and contains a few comments on California trade in 2001. Section III discusses the North American Free Trade Agreement countries of Mexico and Canada; Section IV discusses Asia; Section V discusses Europe; Section VI discusses Latin America, Africa, and the Middle East; and Section VII presents a brief summary conclusion.<sup>1</sup>

### ***Overall Review and Outlook***

World gross domestic product (GDP) is expected to have grown a little more than 4 percent in 2000, about the same as it did in 1996 and 1997, the best years of the decade. The volume of world trade is expected to have grown about 10 percent, with the nominal value of exports growing by about 9 percent. Tables 1.1 and 1.2 show projections from a number of different organizations, with the date of the projection included.

While GDP growth in 2000 was strong, most forecasters are expecting a slowdown in both growth and trade for 2001, mostly because of an expected U.S. slowdown. Third-quarter U.S. GDP growth was 2.2 percent, the smallest increase in four years and well off the 3.7 percent average annual rate since Q2 1991 (U.S. Department of Commerce, Bureau of Economic Analysis 2001a).<sup>2</sup>

Despite this slowdown, almost no one is forecasting a recession, either for the United States or the world. In fact, most forecasts are calling for world GDP growth in the upper twos or lower threes, (above the growth rate of 1992, 1993, and 1998 and possibly on par with the growth rate of 1999).

All of California's top trade partners had good years in 2000. Mexico's projected growth of 7.1 percent was the highest in a decade, while Japan's growth of about 1.8 to

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<sup>1</sup> This is a March 9, 2001, revised version of a talk given on January 24, 2001. Except for the section on California trade, the figures in this paper have not been updated since its original presentation.

<sup>2</sup> Fourth quarter GDP growth was estimated at an even lower 1.4 percent, but the estimate is subject to two more rounds of revisions (U.S. Department of Commerce, Bureau of Economic Analysis 2001b).

2.0 percent represented a reversal of a dip in 1998 and near-zero growth in 1999. Canada's output growth of about 5 percent was its best in 10 years; Korea and Taiwan maintained a growth rate on par with their growth in the early 1990s; and the European Union's growth of about 3.2 percent was also the best in a decade.

Growth rates in all of the above countries and regions are expected to slow a bit in 2001, but to remain within the bounds of the rates achieved throughout the 1990s.

One key factor that should influence the world economy is an expected weakening of the dollar. A strong dollar has been one of the features of global economic performance in the second half of the 1990s. However, other currencies (most importantly the euro) are expected to strengthen. Interest rate cuts by the Federal Reserve Board should also help lower the relative value of the dollar as a byproduct of other policy goals. This expected depreciation should help economies with currencies linked to the dollar, such as Argentina, China, and Hong Kong, and should boost U.S. exports and slow U.S. imports.

In trade, as shown in Table 1.2, export growth and import growth are expected to slow throughout the world in 2001. Two patterns are apparent from the table. One is that trade growth rates will remain well above GDP growth rates. The other is that the changes in trade growth rates from 2000 to 2001 are much larger than changes in GDP growth rates.

Both patterns are long-term trends. According to data from the World Bank (1998) and from the bank's web site (<http://www.worldbank.org>), nominal world GDP grew at an average annual rate of 8.5 percent from 1960 to 1997, while nominal world exports grew at an average annual rate of 10.3 percent. Furthermore, although the two tracked each other, export volatility was somewhat higher.<sup>3</sup>

In fact, more than three-quarters of the time during that long period, when the growth rate of GDP rose, the growth rate of exports rose more; and when the growth rate of GDP fell, the growth rate of exports fell more.

This provides some context for such large expected changes as the decreases in Taiwanese and Korean export and import growth rates shown in the table.

Subsequent sections in this document will discuss the trade outlook for various regions of the world.

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<sup>3</sup> More specifically, the coefficient of variation for world exports was 0.92 while the coefficient of variation for world GDP was 0.84. The coefficient of variation is one measure of volatility and is the standard deviation of a time series divided by the mean of the time series.

**Table 1.1**  
**GDP Growth Forecasts in 2000 and 2001 (percentage annual change)**

	IMF (October 2000)		PEO (November 2000)		WB (December 2000)	
	2000	2001	2000	2001	2000	2001
<b>World</b>	4.7	4.2			4.1	3.4
<b>U.S.</b>	5.2	3.2	5.1	2.9	5.1	3.2
<b>Mexico</b>			7.1	5.3		
<b>Japan</b>	1.4	1.8	2.1	1.3	2.0	2.1
<b>Canada</b>	4.7	2.8	4.8	3.8		
<b>Korea</b>	8.8	6.5	8.9	5.4		
<b>Taiwan</b>	6.5	6.0	6.4	6.0		
<b>U.K.</b>	3.1	2.8				
<b>E.U.</b>	3.4	3.3				
<b>PEO Area</b>			5.6	4.2		
	ML (January 2001)		Consensus (January 2001)			
	2000	2001	2000	2001		
<b>World</b>	4.1	2.8	4.0	2.9		
<b>U.S.</b>	5.1	2.5	5.1	2.6		
<b>Mexico</b>	7.3	3.7	7.1	4.5		
<b>Japan</b>	1.8	1.4	1.9	1.8		
<b>Canada</b>	5.0	3.0	5.0	3.3		
<b>Korea</b>	6.2	3.8	9.2	4.7		
<b>Taiwan</b>	6.2	4.3	6.3	5.0		
<b>U.K.</b>	3.0	2.5	3.0	2.6		
<b>E.U.</b>	3.2	2.8	3.2	2.9		

*Notes:* Figures represent percentage annual growth. IMF is the International Monetary Fund. PEO is the Pacific Economic Outlook. WB is the World Bank. ML is Merrill Lynch & Co., and Consensus is a consensus forecast as reported by Merrill Lynch. Countries shown are California's top export destinations. PEO Area includes most of the Western and Eastern Hemisphere Pacific Rim economies.

*Sources:* IMF (2000), Pacific Economic Cooperation Council and Australian Pacific Economic Cooperation Committee (2000), World Bank (2000), and Merrill Lynch & Co. (2001).

**Table 1.2**  
**Trade Growth Forecasts in 2000 and 2001 (percentage annual change)**

	IMF (October 2000)					
	1999		2000		2001	
<b>World Trade Volume Growth</b>	5.1		10.0		7.8	
<b>World Export Value Growth</b>			8.8		7.8	
	PEO (November 2000)				ML (January 2001)	
	Export Growth		Import Growth		Current Account (Percent of GDP)	
	2000	2001	2000	2001	2000	2001
<b>World</b>						
<b>U.S.</b>	9.4	9.1	13.5	10.3	-4.3	-4.2
<b>Mexico</b>	15.9	11.8	22.6	12.9	-3.0	-4.2
<b>Japan</b>	11.6	2.3	8.5	3.3	2.6	2.5
<b>Canada</b>	1.4	8.8	13.0	8.3	1.4	1.1
<b>Korea</b>	22.7	11.6	22.7	14.3	1.3	0.6
<b>Taiwan</b>	23.2	7.6	29.9	6.6	2.8	2.3
<b>U.K.</b>					-1.6	-1.8
<b>E.U.</b>					0.0	0.2
<b>PEO Area</b>	12.8	7.4	14.8	9.4		

*Notes:* Figures represent percentage annual growth. IMF is the International Monetary Fund. PEO is the Pacific Economic Outlook. ML is Merrill Lynch & Co. Countries shown are California's top export destinations. PEO Area includes most of the Western and Eastern Hemisphere Pacific Rim economies.

*Sources:* IMF (2000), Pacific Economic Cooperation Council and Australian Pacific Economic Cooperation Committee (2000), and Merrill Lynch & Co. (2001).

### ***Forecasts, Guesses, and Reality***

What do the forecasts in this section and the rest of this presentation really mean? Economic forecasters derive their numbers in several different ways. Some have elaborate mathematical models of the world economy or national economies that take account of the historic and theoretical relationships of different variables and compute new values for these variables over different time periods. Others take account of statistical relationships to compute future values based on current and past behavior of these variables.

No matter how good the model, however, all such predictions are subject to errors. These errors come from two sources. The first is that the global economy is far too complex to be captured exactly in a mathematical or statistical model. The second is that

unexpected events happen. As a result, many forecasters in their more detailed reports include different scenarios or some range of forecasts.

Despite the problems, these forecasts are often better than simple guesses because they take account of previous knowledge in a formal way and can therefore be adjusted and improved upon.

Note, for example, in Table 1.1 how the forecasts for world GDP by different groups differ by the time the forecasts were made. In October 2000, the IMF projected 4.2 percent world growth in 2001. In early December 2000, the World Bank projected 3.4 percent growth. And in January 2001, a consensus forecast projected growth of 2.9 percent. These projections vary not necessarily because the models used are vastly different (although they may be) but more likely because the later forecasters were able to incorporate more information relevant to the forecast.

For the exporter or importer, the best use of forecasts is to consider them as one input in business planning rather than as a certain prediction about the future. Forecasts can point out factors to be aware of – exchange rates, oil prices, regional differences. They can also point out general trends (despite their differences, all the forecasts in Table 1.1 project a slowdown in the U.S. and world economies).

Many of the sources used for the forecasts reported in this paper are listed in the reference section at the end of the paper. Exporters and importers should check these sources as the year progresses in order to see how and why expectations regarding the world economy change.

## **II. Review of California Trade in 2000**

### ***Summary***

California exports showed strong growth in 2000 and became more concentrated in terms of both destination countries and industries. Mexico retained its title as leading California export destination. Asia remained the most important region.<sup>4</sup>

### ***Review and Outlook***

Along with the world economy, California exports grew strongly during 2000. Figure 2.1 and Tables 2.1 through 2.5 give an overview of this performance. Figure 2-1 shows quarterly exports in millions of dollars. The dip during the Asian financial crisis is readily apparent (from a peak in Q3 1997 to a trough in Q1 1999). California exports expanded rapidly from that trough, from \$24.8 billion in Q1 1999 to \$35.2 billion in Q4 2000.<sup>5</sup>

Table 2.1 shows how these exports have grown between 1999 and 2000 for all California trade partners and for selected country groups among those trade partners.

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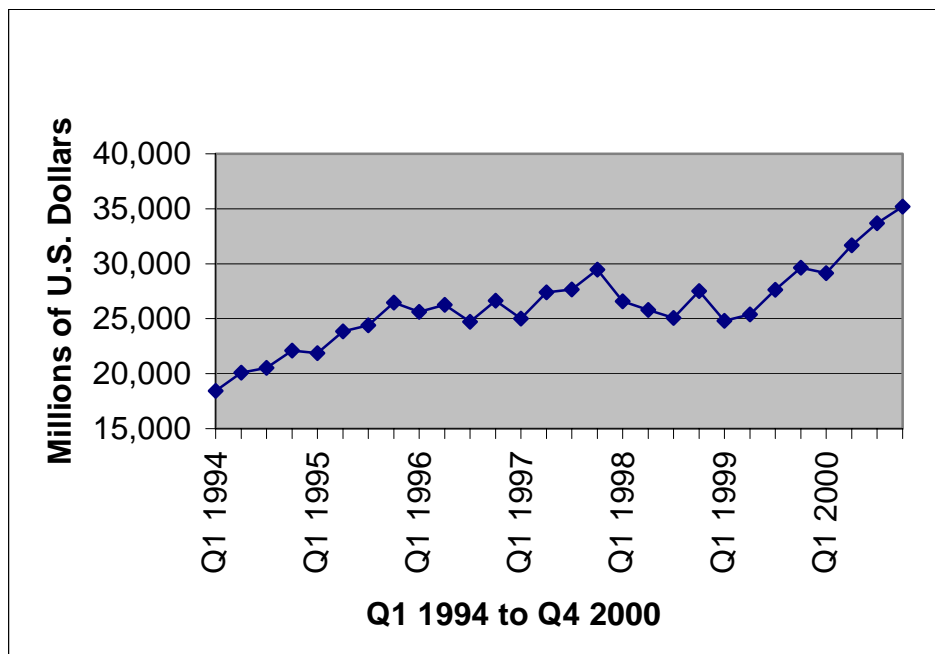
<sup>4</sup> When originally presented on January 24, 2001, this review and outlook contained California export data through only the third quarter of 2000, the latest available figures. This paper now includes year-end data.

<sup>5</sup> It is not clear that the state's exporters have fully recovered. Fitting a trend line to trade from Q1 1994 to Q4 1997 using a simple linear regression shows that if that trend had continued uninterrupted, California exports in Q4 2000 would have been about \$36.1 billion.

Note, for example, how the share of California exports to the top five trade partners has risen from 51.2 percent to 52.8 percent of the state's total exports, and the share of exports to the top 10 partners has risen from 72.7 percent to 73.4 percent. Clearly, California businesses are concentrating their exports more than previously.

This is happening for NAFTA countries (Canada and Mexico) and for Asian countries within the top 25 export destinations, but not for European countries within the top 25 destinations. In the past year, California trade has shifted toward Mexico and Asia.

**Figure 2.1**  
**Quarterly California Exports (Millions of U.S. Dollars)**



Source: MISER AXESWeb (<http://www.misertrade.org>) and California Technology, Trade, and Commerce Agency (<http://commerce.ca.gov>).



**Table 2.1.**  
**California Exports By Country Group (Millions of U.S. Dollars and Percentages)**

Country Group	1999	2000	Percent Change	Share 1999 (%)	Share 2000 (%)
<b>Total</b>	107,449	129,721	20.7	100.0	100.0
<b>Top 5 Destinations</b>	55,051	68,457	24.4	51.2	52.8
<b>Top 10 Destinations</b>	78,144	95,219	21.9	72.7	73.4
<b>Top 25 Destinations</b>	99,483	122,052	22.7	92.6	94.1
<b>NAFTA</b>	28,153	34,091	21.1	26.2	26.3
<b>Asian Countries Within Top 25 Destinations</b>	46,330	58,525	26.3	43.1	45.1
<b>European Countries within Top 25 Destinations</b>	22,660	26,851	18.5	21.1	20.7

Source: MISER AXESWeb (<http://www.misertrade.org>)

Table 2.2 shows the same data for the top 25 export partners. Mexico's share of California's exports has risen substantially. In fact, in 1999, Mexico surpassed Japan as California's top trade partner, and this lead widened during 2000. Growth of exports to Canada also rose, but more slowly than exports overall, so Canada's share of California exports fell from 12.3 percent in 1999 to 11.6 percent in 2000.

Other big gainers in both overall growth and share growth included Thailand, China, Malaysia, India, Korea, France, Philippines, and Taiwan. Korea, Malaysia, and Thailand were all Asian financial crisis countries. Growth of exports to those markets may reflect both a rebound effect and a response to reforms undertaken since 1998. India presents an interesting case. On the one hand it receives a very low level of exports from California, so a modest increase in the level of exports to that country will result in a large proportional increase. On the other hand, the large proportional change of export growth over this period may reflect future long-term trends as California's Indian technology workers spur further trade with their native land and as India continues to reform its relations with the world economy.

**Table 2.2.**  
**California Exports By Country (Millions of U.S. Dollars and Percentages; Top 25 Countries)**

Country	Region	1999	2000	Percent Change	Share 1999 (%)	Share 2000 (%)
<b>Mexico</b>	NAFTA	14,916	19,030	27.6	13.9	14.7
<b>Japan</b>	Asia	13,753	17,270	25.6	12.8	13.3
<b>Canada</b>	NAFTA	13,236	15,062	13.	12.3	11.6
<b>Korea</b>	Asia	6,676	9,077	36.0	6.2	7.0
<b>Taiwan</b>	Asia	6,469	8,018	23.9	6.0	6.2
<b>U.K.</b>	Europe	5,461	6,329	15.9	5.1	4.9
<b>Germany</b>	Europe	4,596	5,553	20.8	4.3	4.3
<b>Singapore</b>	Asia	4,875	5,264	8.0	4.5	4.1
<b>Netherlands</b>	Europe	4,212	5,132	21.8	3.9	4.0
<b>Hong Kong</b>	Asia	3,950	4,484	13.5	3.7	3.5
<b>China</b>	Asia	2,668	3,854	44.5	2.5	3.0
<b>France</b>	Europe	2,389	3,110	30.2	2.2	2.4
<b>Malaysia</b>	Asia	2,189	3,106	41.9	2.0	2.4
<b>Australia</b>	Asia	2,399	2,643	10.2	2.2	2.0
<b>Thailand</b>	Asia	1,319	2,141	62.3	1.2	1.7
<b>Philippines</b>	Asia	1,576	2,023	28.4	1.5	1.6
<b>Italy</b>	Europe	1,396	1,674	19.9	1.3	1.3
<b>Brazil</b>	Latin America	1,376	1,424	3.5	1.3	1.1
<b>Ireland</b>	Europe	1,188	1,283	8.0	1.1	1.0
<b>Israel</b>	Middle East	965	1,161	20.3	0.9	0.9
<b>Belgium</b>	Europe	1,087	1,128	3.8	1.0	0.9
<b>Switzerland</b>	Europe	929	1,034	11.3	0.9	0.8
<b>Spain</b>	Europe	765	877	14.7	0.7	0.7
<b>Sweden</b>	Europe	638	731	14.5	0.6	0.6
<b>India</b>	Asia	456	643	41.1	0.4	0.5

Source: MISER AXESWeb (<http://www.misertrade.org>)

Just as California's exports are becoming more concentrated by country, so they are becoming more concentrated by industry. Table 2.3 shows exports by industry for 1999 and 2000. While 54.5 percent of California exports were in only two industries in 1999, 58.2 percent were in the top two in the 2000 period. The share held by the top five and the top 10 also increased.

Table 2.4 shows the top 10 export industries. The top two – electronic and electric equipment, and industrial machinery and computers – each accounted for almost one-third of California exports. The number three industry – instruments – accounted for almost another one-tenth. Standard trade theory says that economies export goods that

use the factors they have in abundance, and this seems to describe California's experience. The state has a great deal of high-skill labor, and the top three export industries are among the highest-skill manufacturing industries.

**Table 2.3**  
**California Exports By Industry Group**  
**(Millions of U.S. Dollars and Percentages)**

<b>Industry Group</b>	<b>1999</b>	<b>2000</b>	<b>Percent Change</b>	<b>Share 1999 (%)</b>	<b>Share 2000 (%)</b>
<b>Total</b>	107,449	129,721	20.7	100.0	100.0
<b>Top 2 Industries</b>	58,578	75,459	28.8	54.5	58.2
<b>Top 5 Industries</b>	82,143	100,963	22.9	76.4	77.8
<b>Top 10 Industries</b>	96,203	116,326	20.9	89.5	89.7

Source: MISER AXESWeb (<http://www.misertrade.org>)

**Table 2.4**  
**California Exports By Industry**  
**(Millions of U.S. Dollars and Percentages; Top 10 Industries)**

<b>Industry</b>	<b>1999</b>	<b>2000</b>	<b>Percent Change</b>	<b>Share 1999 (%)</b>	<b>Share 2000 (%)</b>
<b>Electronic and Electric Equipment</b>	30,921	37,833	22.4	28.8	29.2
<b>Industrial Machinery and Computers</b>	27,657	37,625	36.0	25.7	29.0
<b>Instruments</b>	9,266	11,923	28.7	8.6	9.2
<b>Transportation Equipment</b>	10,043	8,575	-14.6	9.3	6.6
<b>Chemicals</b>	4,256	5,007	17.6	4.0	3.9
<b>Food and Kindred Products</b>	4,371	4,473	2.3	4.1	3.4
<b>Agricultural Crops</b>	3,137	3,933	25.4	2.9	3.0
<b>Misc. Manufacturing</b>	2,085	2,339	12.1	1.9	1.8
<b>Special Classification</b>	2,294	2,325	1.3	2.1	1.8
<b>Fabricated Metal Products</b>	2,172	2,293	5.6	2.0	1.8

Source: MISER AXESWeb (<http://www.misertrade.org>)

The top three not only are the largest, but they also show extremely rapid growth. However, except for industrial machinery and computers, they are not among California's top 10 export-growth industries. In this area the top industry is bituminous coal and lignite mining, up 135 percent from 1999 to 2000, rising from \$3.2 million to \$7.6 million. As in the case of exports to India, the industry's small base gives it an

advantage in showing rapid growth. Among industries that had more than \$1 billion worth of exports in 1999, the top export growth industries were industrial machinery and equipment, primary metal industries, instruments and related products, agricultural crops, and rubber and miscellaneous plastics products.<sup>6</sup>

Finally, Table 2.5 shows California export destinations from another perspective, specifically, their importance to California relative to their importance to the United States. For the year 2000, California accounted for 16.6 percent of U.S. exports. If every country were as important to California as to the United States, California would account for 16.6 percent of U.S. exports to each country. However, it does not. For example, in the cases of Taiwan, Korea, and Thailand, California exports accounted for a stunning one-third of U.S. exports.

By this measure, the United States is heavily dependent on California for exports to Asia, and California is much more dependant on Asia than is the rest of the nation. In fact, California's top eight export countries are all Asian, and nine of the top 10 are Asian. This means that a slowdown in Asia will affect California much more than it will affect the rest of the nation, and this is exactly what occurred during the Asian financial crisis.

### ***California Trade in 2001***

Without an adequate formal model, a safe way to predict short-term trends is just to extrapolate past conditions. By this reasoning, Mexico and Asia will continue to grow in importance as destinations.

However, as discussed below, more information is available. Japan's economic fragility is expected to grow worse, so it likely will not take back the top destination spot from Mexico. Furthermore, the Europe economy is expected to strengthen, so that Europe may prove a more inviting export destination than in the past.

Subsequent sections describe the outlook for each region that has proved important to California exporters and importers.

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<sup>6</sup> Fourteen California industries exported more than \$1 billion worth of goods in 1999, while 16 did so in 2000.

**Table 2.5**  
**California Exports and U.S. Exports 2000 (Millions of U.S. Dollars and Percentages)**

Country (Rank: Cal.-U.S.)	Region	California Exports	U.S. Exports	Cal. Share of U.S. Exports (%)
Taiwan (5-7)	Asia	8,018	24,380	32.9
Korea (4-6)	Asia	9,077	27,902	32.5
Thailand (15-22)	Asia	2,141	6,643	32.2
Hong Kong (10-13)	Asia	4,484	14,625	30.7
Singapore (8-10)	Asia	5,264	17,816	29.5
Malaysia (13-17)	Asia	3,106	10,996	28.3
Japan (2-3)	Asia	17,270	65,254	26.5
China (11-11)	Asia	3,854	16,253	23.7
Netherlands (9-8)	Europe	5,132	21,974	23.4
Philippines (16-19)	Asia	2,023	8,790	23.0
Australia (14-15)	Asia	2,643	12,460	21.2
Germany (7-5)	Europe	5,553	29,244	19.0
India (25-31)	Asia	643	3,663	17.6
Mexico (1-2)	NAFTA	19,030	111,721	17.0
Ireland (19-21)	Europe	1,283	7,727	16.6
Sweden (24-27)	Europe	731	4,557	16.0
France (12-9)	Europe	3,110	20,253	15.4
U.K. (6-4)	Europe	6,329	41,579	15.2
Italy (17-16)	Europe	1,674	11,000	15.2
Israel (20-20)	Middle East	1,161	7,750	15.0
Spain (23-23)	Europe	877	6,323	13.9
Switzerland (22-18)	Europe	1,034	9,942	10.4
Brazil (18-12)	Latin America	1,424	15,360	9.3
Canada (3-1)	NAFTA	15,062	176,430	8.5
Belgium (21-14)	Europe	1,128	13,960	8.1
<b>Addendum:</b>				
<b>World</b>		<b>129,721</b>	<b>780,419</b>	<b>16.6</b>

Source: MISER AXESWeb (<http://www.misertrade.org>)

### III. NAFTA in 2001

#### *Summary*

Mexico should experience continued strong growth of between 4 and 5 percent in 2001. The trade balance might worsen, but both imports and exports should grow, as should inflows of foreign direct investment (FDI – cross-border investment meant to control a business). The peso will probably depreciate slightly against the dollar, and inflation should fall from more than 8 percent to somewhere in the 7 percent range. Solid

growth in the 3 to 4 percent range should continue in Canada, and the Canadian dollar may experience a slight appreciation against the U.S. dollar.

### *Mexico*

Mexico had a banner year in 2000, with growth above 7 percent, lower-than-expected inflation, and a lower-than-expected current account deficit. This was in part due to oil prices, the proceeds of which have gone into debt reduction, an oil stabilization fund, and social programs. Also, the government has been exchanging dollars for pesos, which explains the strong peso and a decline in inflation. The strong growth was also due to strong U.S. growth and increased foreign direct investment. It is also worth noting that there was no election year economic crisis, an extremely important achievement.

What will happen with the expected depreciation of the dollar? This could actually be quite good for Mexico. The United States might shift its sourcing from Europe to Canada and Mexico. In addition, the Canadian dollar and the Mexican peso likely will fall in tandem with the U.S. dollar, helping the global export prospects of the NAFTA countries. The change of sourcing patterns will also encourage foreign direct investment from Europe (especially in light of Mexico's recent free trade agreement with the European Union).

The problems Mexico faces now are an overheating economy and a probable drop in oil prices. New President Vicente Fox will have to keep government spending down. In addition, since much of Mexico's exports to the United States are in high-tech industries, the U.S. tech slowdown will hurt Mexico a bit. Over the long term, Mexico's focus on high-tech exports bodes well, since many of the countries that have developed most rapidly over the past three decades have done so in part through a rapid expansion of manufactured exports and, lately, technology exports.

For 2001, one consensus forecast calls for growth of 4.7 percent in 2001, with a range of 4.0 to 5.5 (Bank One Economic Outlook Center, Arizona State University, <http://www.cob.asu.edu/seid/eoc/mexico/>). Other forecasts, shown in Table 1.1, range from a dreary 3.7 percent to 5.3 percent.

Inflation is expected to fall a bit from more than 8 percent to the 7 percent range, and the exchange rate should fall to more than 10 pesos to the dollar (from 9.76 on January 23, 2001).

The introduction of a tax reform package in March will possibly indicate the course of future reforms.

### *Canada*

Canadian consumers have had strong income gains over the past year. Along with large tax cuts, these gains should help support future consumption and other spending in the Canadian economy during 2001. Canada has held up quite well with the recent U.S. slowdown, growing faster than expected. Merrill Lynch expects the Bank of Canada to lag the Fed in interest rate cuts, helping the Canadian dollar appreciate against the U.S. dollar (although not necessarily against a trade-weighted basket of other currencies). This should help U.S. exporters focusing on Canada.

Growth forecasts in Table 1.1 range from 2.8 percent to 3.8 percent, with the most recent forecasts above 3 percent.

#### **IV. Asia in 2001**

##### *Summary*

The Japanese economy is expected to slow but to retain continued positive growth. The yen is expected to depreciate against the dollar, and export and import growth is expected to rise at rates lower than those of 2000.

China should maintain growth of 7 to 8 percent, with exports rising about 10 percent and imports rising about 20 percent.

The rest of Asia remains more troublesome, though most forecasters expect continued growth. Problems include the continuation of reforms, high fiscal deficits, and vulnerability to high oil prices.

##### *Japan*

Japan's economic performance in 2000 was its best since 1997, sparked in part by an Emergency Economic Package (November 1998) and Policy Measures for Economic Rebirth (November 1999). The recovery was led by business investment, with personal consumption remaining flat.

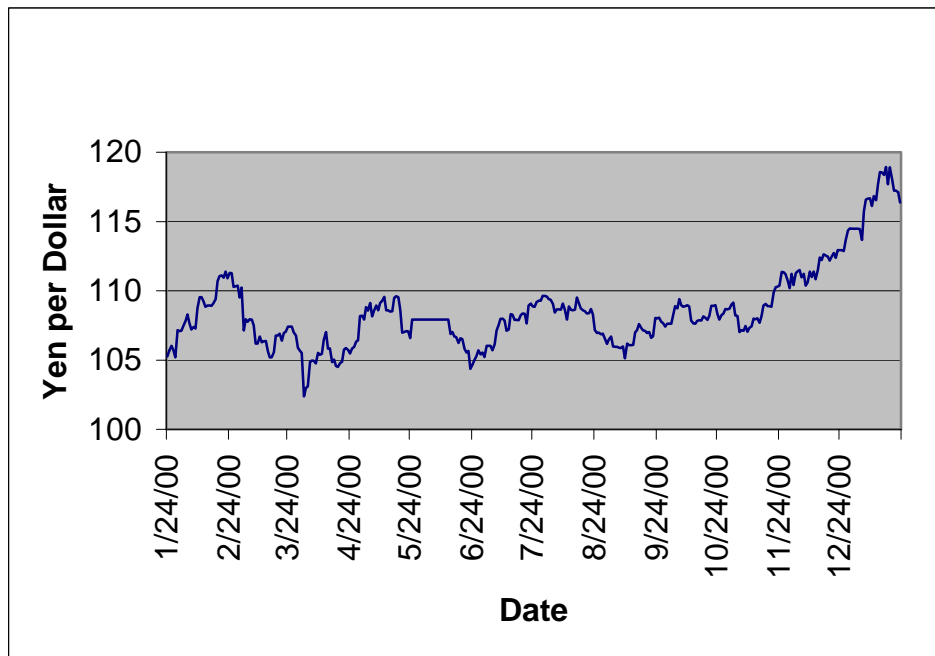
The most recent economic policy intervention was the Policy Package for New Economic Development Towards the Rebirth of Japan (October 2000). The main objective of this package is to avoid a sharp drop in public demand. Its success remains open to question.

For 2001, the government anticipates continued recovery. Importantly for California, the government also anticipates decreases in the growth of exports, from 8.8 percent to 4.0 percent in real terms, and imports, from 9.9 percent to 5.3 percent in real terms (the Cabinet Office of the Government of Japan, 2000).

Other forecasts for Japan call for slower growth in 2001 compared to 2000 (see Table 1.1), but no recession, with the growth fueled by private machinery orders. Some forecasters are calling for any recovery to take place in 2002 rather than 2001, while still discounting the possibility of recession.

In addition to slowing growth, continuing depreciation of the yen might hamper U.S. exports to Japan. In fact, Merrill Lynch expects the yen to move from about 115 to the dollar to 130 to the dollar in light of the slowdown in the Japanese economy. However, the forward rates indicate a flat exchange rate, so it is not clear what will happen. Figure 4.1 shows the yen/dollar exchange rate over the past year. A rise indicates a depreciation of the yen.

**Figure 4.1**  
**Yen/Dollar Exchange Rate**



Source: <http://www.oanda.com>.

### **China**

The big news for China is its potential membership in the World Trade Organization, now under negotiation in Geneva. If not successful in time, then the U.S. Congress will have to vote on Normal Trade Relations again, a difficult situation.

China sees costs and benefits from WTO accession. The costs are strong competition to its agricultural and financial sectors, and foreign competition in general. The benefits are that membership will help the government lock in reforms, attract more foreign firms, reform its state-owned enterprises, have access to most-favored-nation treatment with all other WTO members, and have access to dispute resolution within the framework of the WTO.<sup>7</sup>

In response to the U.S.-China agreement last year and expected WTO entry, China has been cutting its tariffs. This will not only be deflationary, but will allow for greater import penetration and make the country a more favorable investment location. Also as part of the WTO effort, China is training personnel to facilitate trade and is reshaping its trade laws. Smooth implementation is not expected.

<sup>7</sup> Most-favored nation treatment and normal trade relations are equivalent expressions. They simply mean that a trading partner must give China (or any other MFN partner) all the benefits given to other trading partners, even if they were not negotiated directly with China.



Growth is expected to remain about 7 or 8 percent. Export growth is expected to fall from 20 percent to 10 percent, while import growth is expected to stay about 20 percent. As a result, China should remain an inviting though complex market for California exporters.

### *The Rest of Asia*

Asia is the big wildcard in the world economy. Merrill Lynch foresees a steep decline in export growth from Asia to the rest of the world, due in part to the U.S. technology slowdown. In addition, capital spending has failed to recover to the levels it had reached before the Asian financial crisis.

However, Merrill is about the most pessimistic of the forecasters. The IMF and World Bank both foresee growth rates in excess of 6 percent including China – on par with 1999 but a bit below 2000. This translates into 4 or 5 percent growth, excluding China. The biggest risks to Asia's economic performance are the expected slowdowns in the U.S. and Japanese economies and excessively high oil prices.

Because of their reliance on export performance, the Asian economies must find ways to bolster domestic demand – not simple given debt levels that have increased in recent years.

In the Asian financial crisis economies – Korea, Indonesia, Malaysia, the Philippines, and Thailand – reforms have progressed, albeit slowly, with non-performing loans falling and bank credit starting to level off or rise (Asian Development Bank 2000 and 2001). Foreign direct investment flows to the five have stayed positive and at the same levels (in nominal terms) as in the mid-1990s. Korea and Malaysia appear to have gone the furthest in cleaning up corporate balance sheets, and the new regime in the Philippines is generally taken to be positive for that country.

Other positives include falling real estate vacancy rates and rising per capita levels of GDP (though GDP per capita now compared to before the crisis is higher only in Korea). Gross domestic investment has picked up smartly in Korea and Thailand. Non-performing loan ratios in banks have fallen in all countries except the Philippines, and they are 10 percent or less in the Philippines, Malaysia, and Korea. Corporate restructuring is proceeding in Korea, with the top four chaebols all (slowly) implementing plans.<sup>8</sup> Finally, monetary policy has improved. Only the Malaysian currency remains pegged to the U.S. dollar; and Korea, Philippines, and Thailand have moved to inflation targeting.

Continuing problems include large fiscal deficits and the pace of further restructuring. Reforms have slowed recently in Indonesia, the Philippines (before the regime change), and Thailand. Indonesia's financial restructuring in particular is regarded as too slow. Furthermore, remaining problems among some of Korea's chaebols suggest further bank weakness in that country. Finally, while Malaysia has progressed on banking and corporate governance reforms, foreign direct investment still lags in that country, and foreign direct investment has been an important contributor to Malaysia's growth.

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<sup>8</sup> Chaebols are Korean multi-industry business groups similar to conglomerates.

Regarding currencies, Merrill Lynch forecasts slight depreciations in the Korean won, the Singapore dollar, and the Taiwan dollar. It forecasts slight appreciations in the Indonesian rupiah and the Thai baht.

## **V. Europe in 2001**

### ***Summary***

Growth is expected to continue at about 3 percent or a bit less, and the euro is expected to appreciate against the dollar. Imports from the United States are expected to outpace exports to the United States

### ***Outlook for Europe***

One of the major economic events in Europe during the last two years was the introduction of the euro and its subsequent collapse.<sup>9</sup> Although reflecting in part Europe's slow economic growth, the weakening of the euro also reflected extensive European investment in the United States. The euro's valuation trend has started to reverse, as shown in Figure 5.1. In this figure, as in the previous yen graph, a rise in the line is a euro depreciation.

Forecasters expect a euro/dollar rate of less than 1.10 and probably around one to one, due in part to lower European foreign direct investment in the United States (though watch foreign direct investment in Mexico!) and due in part to slower interest rate cutting by the European Central Bank.

Throughout Europe, private consumption should stay strong due to continuing employment creation of greater than 1 percent – good by European standards – and tax cuts in a number of countries, including Belgium, Denmark, Germany, Greece, France, Italy, Luxembourg, Netherlands, Portugal, Finland, and Sweden.

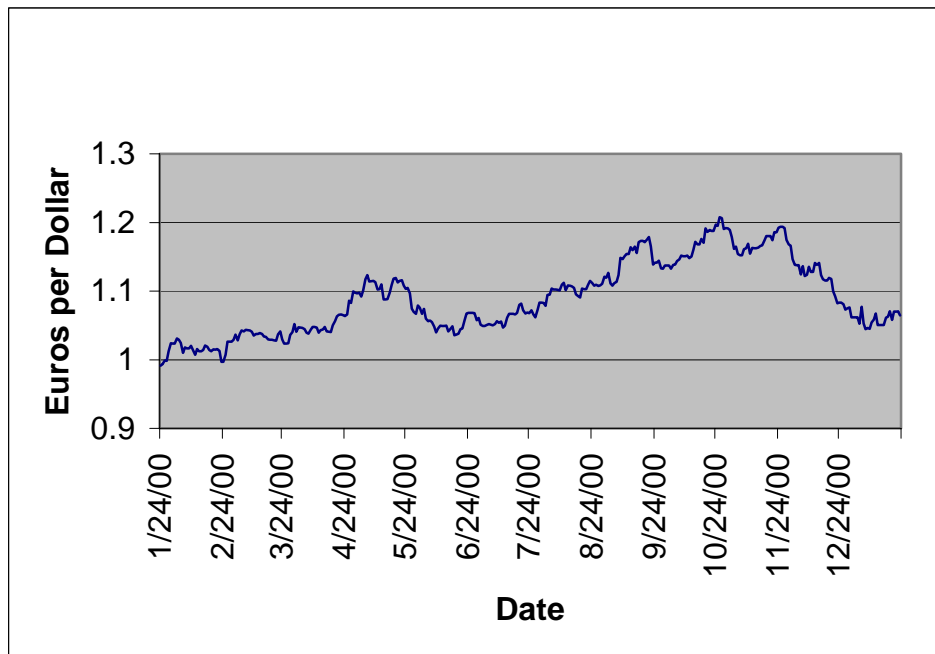
Growth is expected to register about 3.0 percent.

In its forecast of October/November 2000, the European Commission expected goods exports to increase by 6.2 percent in 2001 (down from 8.2 in 2000) and goods imports to increase by 7.6 percent (down from 7.9 in 2000). The commission expected the trade deficit with the United States to worsen (from Europe's point of view) to 4.7 percent of GDP from 4.5 percent.

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<sup>9</sup> The euro depreciated from about 0.85 to the dollar upon its introduction on January 1, 1999, to almost 1.21 to the dollar on October 27, 2000. The euro/dollar exchange rate is often reported in terms of dollars per euro. Restated, this means the euro fell from about U.S.\$1.17 upon its introduction to almost 82 cents on October 27, 2000.

**Figure 5.1**  
**Euro/Dollar Exchange Rate**



Source: <http://www.oanda.com>

## **VI. Latin America, Africa, and the Middle East in 2001**

These regions are not major trade partners with California, but could become larger trade partners and should not be ignored.

Latin America is expected to grow about 3.5 to 4 percent (about the same as last year), with Brazil growing about 3.7 to 4.1 percent. A weakening dollar should help Argentina, which retains a strict peso-dollar peg of one to one.

In Africa, growth is expected to hit 3.4 percent, above 2000's 2.7 percent. Growth should remain around 3.0 percent in South Africa, the keystone of the continent's economy. In addition, the Africa Growth and Opportunities Act presents special investment opportunities. The act is well known throughout the continent. Countries to look at include Botswana, Ghana, Mozambique, and Tanzania. The first of these is a stable democracy with extremely high long-term growth rates, while the other three are coastal economies and politically stable countries that are now making serious efforts to attract foreign firms. Other countries may make good prospects as well.

Growth in the Middle East is expected to hit 3.8 percent, up from 3.1 percent.

## **VII. Conclusion**

There is expected to be a slowdown in worldwide growth and trade, but no recession. Inflation is expected to be benign, and interest rates are expected to fall generally.

The dollar is expected to appreciate against the yen and depreciate against the euro.

Best trade opportunities appear to be in Europe, China, Mexico, and possibly Canada, with investment opportunities in Africa. Asia also remains a promising area, but with higher risk than the others mentioned.

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