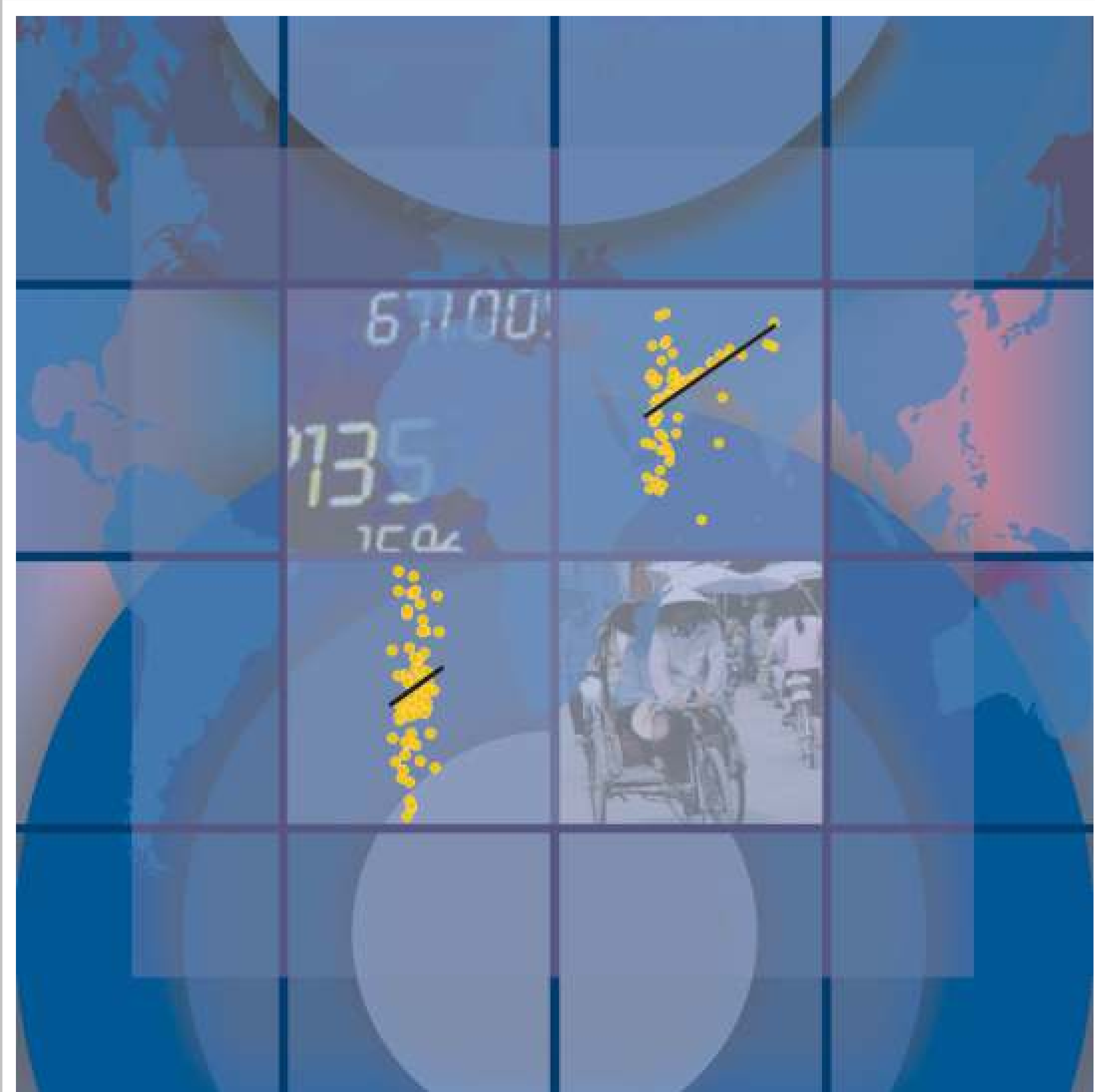
# GLOBAL TRENDS AND PROSPECTS



***Chapter I***

# THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

## A. Introduction

The world economy, after two years of slow growth and rising unemployment, is regaining momentum. Global GDP grew by 2.6 per cent in 2003, up from 1.7 per cent the year before. For 2004, a growth rate of nearly 4 per cent is forecast, similar to the pace experienced at the end of the 1990s (table 1.1). Rising domestic demand in large parts of the world should stimulate the economies of developing countries. In particular, the strong recovery of private investment spending in the United States, combined with increased consumer confidence, looks set to provide a large positive spillover effect on the rest of the world.

The second engine of growth is East and South Asia, where the Chinese economy is surging (at an estimated rate of 8.5 per cent in 2004), India is on a high and stable growth path (of about 7 per cent in 2003–2004) and most of the other emerging-market economies are following close behind (table 1.2). This region is not entirely dependent on the performance of the developed world; rather, it has generated a dynamic that would allow it to push ahead even while the rest of the world still struggles with cyclical and structural problems. In 2004, its average growth rate should approach 7 per cent, and the investment ratio, spurred by an unprecedented investment boom in China, could reach an all time high. In recent years, industrial production growth has been especially important in emerging-market economies in Asia and Europe as well as in Japan, but it has been weak in the euro area, the United States and Latin America (fig. 1.1).

Driven by the dynamism of East and South Asia, and recovery in the United States, global trade expanded significantly in 2003 and well into 2004. World exports of goods increased in volume by nearly 5 per cent in 2003, while prices in dollar terms, for commodities – with some notable exceptions – as well as manufactures, were on the rise. Beyond growth, the good trade performance of China, East Asia and the transition economies of Central and Eastern Europe reflects an ongoing process of relocation of production of manufactures. In some countries of Africa, South America and the Commonwealth of Independent States (CIS), investment in mining and hydrocarbons boosted exports. At the same time, currency

***Table 1.1***

**WORLD OUTPUT GROWTH, 1990–2004[a]**

*(Percentage change over previous year)*

| | *1990–2000[b]* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003[c]* | *2004[d]* |
|---|---|---|---|---|---|---|---|---|
| **World** | **2.3** | **2.2** | **3.0** | **4.0** | **1.4** | **1.7** | **2.6** | **3.8** |
| **Developed countries/regions** | **2.4** | **2.5** | **2.9** | **3.5** | **1.0** | **1.2** | **2.0** | **3.2** |
| *of which:* | | | | | | | | |
| Japan | 1.4 | -1.1 | 0.1 | 2.8 | 0.4 | -0.3 | 2.5 | 4.3 |
| United States | 3.5 | 4.2 | 4.4 | 3.7 | 0.5 | 2.2 | 3.1 | 4.0 |
| European Union | 2.1 | 2.9 | 2.9 | 3.6 | 1.7 | 1.0 | 0.7 | 2.0 |
| *of which:* | | | | | | | | |
| Euro area | 1.9 | 2.9 | 2.8 | 3.5 | 1.6 | 0.9 | 0.4 | 1.8 |
| France | 1.8 | 3.5 | 3.3 | 4.0 | 2.2 | 1.2 | 0.2 | 2.3 |
| Germany | 1.6 | 2.0 | 2.0 | 2.9 | 0.8 | 0.2 | -0.1 | 1.5 |
| Italy | 1.6 | 1.8 | 1.7 | 3.0 | 1.8 | 0.4 | 0.3 | 1.0 |
| United Kingdom | 2.7 | 3.1 | 2.8 | 3.8 | 2.1 | 1.6 | 2.2 | 3.1 |
| **Transition economies** | **-2.5** | **-0.8** | **3.6** | **6.8** | **4.5** | **3.9** | **5.9** | **5.9** |
| **Developing economies** | **4.9** | **1.3** | **3.6** | **5.6** | **2.4** | **3.5** | **4.5** | **5.8** |
| **Developing economies, excluding China** | **4.1** | **0.3** | **3.0** | **5.1** | **1.5** | **2.6** | **3.6** | **5.2** |

***Source:*** UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2004;* OECD, *Quarterly National Accounts*, June 2004; ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2003;* ECE, *Economic Survey of Europe*, No. 1, 2004; ESCWA, *Survey of Economic and Social Developments in the ESCWA Region, 2004*; ESCAP, *Economic and Social Survey for Asia and the Pacific, 2004*; IMF, *World Economic Outlook*, April 2004; OECD, *Economic Outlook No. 75*, 2004; the Project LINK Meeting, April 2004; JP Morgan, *Global Data Watch,* June 2004; Economist Intelligence Unit (EIU), *Country Forecast*, June 2004; and national sources.

***a*** Calculations are based on GDP in constant 1995 dollars.

***b*** Average.

***c*** Preliminary.

***d*** Forecasts.

depreciations in several Latin American countries resulted in major improvements in competitiveness. Impressive export growth from developing countries was mainly related to favourable short-term factors. This could be sustained by the success of ongoing multilateral trade negotiations.

Developing and transition economies played a prominent role in the recovery of world trade in 2002 and 2003: they accounted for around three quarters of the increase in the volume of world merchandise exports. Moreover, some developing countries have become important markets for a wide range of manufactures and commodities. Among the most rapidly growing economies are large developing countries such as China and India. Unlike expansion in the developed regions where the services sector is of key importance, growth in Asian developing economies is generally concentrated in the industrial sector, which is relatively energy-intensive and requires more inputs of primary commodities, such as metals and agricultural raw materials. Moreover, given the size of these countries in terms of population, their level of development and the pace of growth of their real per capita income, some global patterns of consumption may change substantially. For instance, animal and plant sources of energy are being replaced by fossil fuels, especially oil, while higher demand for food and changes in its composition are causing exports of food products to pick up after having remained at low levels. Latin

American food producers have been among those who have benefited from this turnaround.

Based on strong recovery in the United States and Asia's outstanding performance, many observers expect an extended period of growth. But unlike the sustained expansion of the 1990s, when growth in the United States economy at the beginning of the upswing was accompanied by rather small current account deficits, the current global recovery is marked by huge external imbalances.

For its part, the United States economy is increasingly immersed in a trade-financial dynamic with Asia. Expansionary fiscal and monetary policies in the United States are helping to boost demand for Asian goods. Due to the aim of Asian countries to keep their real exchange rates at a competitive level, considerable revenues from trade with the United States have been directly recycled by central banks to the United States in the form of official purchases of United States Treasury bonds. As a consequence, developing countries reported an overall net outflow of capital of $200 billion. This was despite an increase in net private capital flows to developing countries to $83 billion in 2003, compared to the very low level of $13 billion in 2002. This increase was not driven by a recovery of FDI, which actually fell to its lowest level since 1996, but by a surge in "other private capital flows" including credit and short-term capital flows.

Private flows have targeted countries with high domestic interest rates, such as Brazil and Turkey, or those where a currency appreciation is expected, as China. A substantial share of private external financing went to economies that did not need external financing, since they had huge external surpluses in their current account balances and a high rate of domestic investment. In many developing countries, monetary authorities' attempts to avoid a real appreciation of their currencies – that would result in a loss of national competitiveness – can be interpreted as emulating the Asian policy strategy based on competitive exchange rates, independence from foreign capital and long-standing current account surpluses.

This strategy reinforces the need for the developed economies to find a solution for the United States deficit. In this respect, the focus is on continental Europe. In the euro area, macroeconomic policy constraints introduce a bias towards sub-optimal growth performance and raise the possibility of further revaluation. Policy-makers' focus on "reform of the welfare State" and their neglect of macroeconomic stimuli has not paid dividends so far. That exports have recently benefited from the global upswing, despite the strong euro, only underlines the fact that the underlying problem is related to weak domestic demand and not to a loss of competitiveness among the mature high-wage countries of the region. The United Kingdom demonstrates that successful short-term management of the economy is possible if domestic demand is taken as the main pillar of growth and job creation.

Another cause for concern is the fact that the pace of recovery has not been uniform among developing countries. The improvement in the global economy in 2003 has been the result of exceptionally good performances of only a handful of countries, with great variation in the spillover effects on other economies. China has been the lynchpin – its particularly strong growth has, to a large extent, contributed to the acceleration of growth across Asia. Its trade deficits with regional partners have been growing, with particularly beneficial effects for the Republic of Korea, Malaysia and Thailand. India has also continued to see an improved performance, while maintaining a positive external balance. Some smaller East Asian economies that had previously been lagging behind the best performers, caught up and are returning to high growth rates in 2004.

The benefits of rapid Asian growth have also been felt outside the region. The recovery under way in Latin America can be traced to strong Asian demand, resulting in an increase in primary commodity prices and volumes of exports. Cyclical rebounds have been particularly pronounced where growing external demand has coincided with an end to financial and/or political crises, as in Argentina, and huge currency devaluations that improved the overall competitiveness of these countries. Despite the fact that devaluation of its currency considerably improved the export performance of Brazil, the largest economy in the region, the country is struggling to avoid an overvaluation by intervening in the currency market. But at the same time, the central bank is keeping the domestic interest rate high because it

**Table 1.2**

## GDP GROWTH IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 1990–2004[a]

*(Percentage change over previous year)*

| | 1990–2000[b] | 1998 | 1999 | 2000 | 2001 | 2002 | 2003[c] | 2004[d] |
|---|---|---|---|---|---|---|---|---|
| **Developing economies** | **4.9** | **1.3** | **3.6** | **5.6** | **2.4** | **3.5** | **4.5** | **5.8** |
| ***Latin America*** | 3.3 | 2.1 | 0.2 | 3.5 | 0.4 | -0.6 | 1.6 | 4.3 |
| *of which:* | | | | | | | | |
| Argentina | 4.0 | 3.8 | -3.4 | -0.8 | -4.4 | -10.8 | 8.8 | 7.0 |
| Bolivia | 4.0 | 5.0 | 0.3 | 2.3 | 1.6 | 2.7 | 2.4 | 2.5 |
| Brazil | 2.9 | 0.1 | 1.0 | 4.0 | 1.5 | 1.9 | -0.2 | 3.5 |
| Chile | 6.1 | 3.3 | -0.5 | 4.2 | 3.2 | 2.1 | 3.2 | 4.5 |
| Colombia | 2.8 | 0.8 | -3.8 | 2.4 | 1.4 | 1.7 | 3.6 | 3.5 |
| Ecuador | 2.3 | 2.2 | -5.7 | 0.9 | 5.5 | 3.8 | 2.7 | 5.0 |
| Mexico | 3.1 | 5.1 | 3.6 | 6.7 | -0.3 | 0.8 | 1.3 | 3.5 |
| Paraguay | 2.0 | -0.6 | -0.1 | -0.6 | 2.4 | -2.5 | 2.5 | 3.0 |
| Peru | 4.6 | -0.6 | 0.9 | 2.8 | 0.3 | 4.8 | 4.0 | 4.0 |
| Uruguay | 3.2 | 4.4 | -3.4 | -1.9 | -3.5 | -10.7 | 2.5 | 9.0 |
| Venezuela | 1.8 | 0.6 | -5.5 | 3.8 | 3.5 | -9.0 | -9.2 | 12.0 |
| ***Africa*** | 2.5 | 3.1 | 2.8 | 3.2 | 3.6 | 2.9 | 3.5 | 3.9 |
| *of which:* | | | | | | | | |
| Algeria | 1.9 | 5.1 | 3.2 | 2.4 | 2.6 | 4.1 | 6.7 | 6.5 |
| Cameroon | 1.7 | 5.0 | 4.4 | 4.2 | 5.3 | 4.4 | 4.2 | 4.5 |
| Côte d'Ivoire | 3.3 | 4.7 | 1.6 | -2.5 | 0.4 | -1.8 | -3.8 | 0.0 |
| Democratic Republic of the Congo | -4.9 | -1.6 | -4.4 | -7.0 | -2.0 | 3.0 | 5.0 | 7.0 |
| Egypt | 4.5 | 4.5 | 6.3 | 5.1 | 3.5 | 3.0 | 3.1 | 3.0 |
| Ethiopia | 4.3 | -1.9 | 6.2 | 5.7 | 8.9 | 2.7 | -3.8 | 6.5 |
| Ghana | 4.3 | 4.7 | 4.4 | 3.7 | 4.2 | 4.5 | 4.7 | 5.0 |
| Kenya | 2.1 | 1.6 | 1.3 | -0.2 | 1.1 | 1.0 | 1.5 | 2.5 |
| Morocco | 2.3 | 7.7 | -0.1 | 1.0 | 6.3 | 3.2 | 5.5 | 4.5 |
| Nigeria | 2.5 | 1.9 | 1.1 | 4.2 | 2.9 | -0.9 | 6.0 | 3.5 |
| South Africa | 2.1 | 0.7 | 2.0 | 3.5 | 2.8 | 3.0 | 1.9 | 2.5 |
| Tunisia | 4.7 | 4.8 | 6.0 | 4.7 | 4.9 | 1.7 | 6.1 | 6.0 |
| Zimbabwe | 2.5 | 2.9 | -0.7 | -4.9 | -8.4 | -5.6 | -13.2 | -9.0 |
| ***Asia*** | 6.2 | 0.7 | 5.4 | 6.9 | 3.2 | 5.4 | 5.9 | 6.6 |
| ***Asia, excluding China*** | 5.1 | -1.4 | 4.8 | 6.6 | 1.7 | 4.5 | 4.8 | 5.9 |
| West Asia | 3.6 | 2.9 | -0.8 | 6.4 | -0.3 | 4.3 | 5.9 | 4.9 |
| *of which:* | | | | | | | | |
| Iran, Islamic Republic of | 3.6 | 2.0 | 2.5 | 5.9 | 4.8 | 6.7 | 5.9 | 5.5 |
| Jordan | 5.0 | 3.0 | 3.0 | 4.2 | 4.3 | 4.9 | 3.2 | 5.0 |
| Lebanon | 6.0 | 3.0 | 1.0 | 0.0 | 1.3 | 1.0 | 3.0 | 3.0 |
| Saudi Arabia | 2.1 | 2.8 | -0.7 | 4.9 | 1.3 | 1.0 | 6.4 | 2.5 |
| Turkey | 3.8 | 3.1 | -4.7 | 7.4 | -7.5 | 7.9 | 5.8 | 6.5 |
| United Arab Emirates | 3.9 | 1.4 | 4.4 | 12.3 | 3.5 | 1.8 | 7.0 | 5.0 |
| Yemen | 6.1 | 6.5 | 2.7 | 6.5 | 4.7 | 3.6 | 3.8 | 3.5 |
| East and South Asia | 6.7 | 0.3 | 6.5 | 7.0 | 3.8 | 5.6 | 6.0 | 6.9 |
| *of which:* | | | | | | | | |
| China | 10.3 | 7.8 | 7.1 | 8.0 | 7.5 | 8.0 | 9.1 | 8.5 |
| Hong Kong (China) | 4.1 | -5.0 | 3.4 | 10.2 | 0.5 | 2.3 | 3.3 | 6.5 |
| India | 6.0 | 6.0 | 7.1 | 4.0 | 5.5 | 4.6 | 7.4 | 6.5 |
| Indonesia | 4.2 | -13.1 | 0.8 | 4.9 | 3.4 | 3.7 | 4.1 | 4.5 |
| Malaysia | 7.0 | -7.4 | 6.1 | 8.5 | 0.3 | 4.1 | 5.2 | 7.0 |
| Pakistan | 3.8 | 2.5 | 3.7 | 4.3 | 2.5 | 2.9 | 5.5 | 5.5 |
| Philippines | 3.3 | -0.6 | 3.4 | 4.0 | 3.4 | 4.4 | 4.5 | 5.0 |
| Republic of Korea | 5.8 | -6.7 | 10.9 | 9.3 | 3.1 | 6.4 | 3.1 | 6.5 |
| Singapore | 7.7 | -0.9 | 6.4 | 9.4 | -2.4 | 2.3 | 1.1 | 7.5 |
| Taiwan Province of China | 6.4 | 4.6 | 5.4 | 5.9 | -2.2 | 3.6 | 3.2 | 5.5 |
| Thailand | 4.2 | -10.5 | 4.4 | 4.6 | 1.8 | 5.4 | 6.7 | 6.5 |
| Viet Nam | 7.9 | 5.8 | 4.8 | 6.8 | 6.9 | 7.0 | 6.0 | 7.0 |

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**Table 1.2 (concluded)**

**GDP GROWTH IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 1990–2004[a]**

*(Percentage change over previous year)*

| | 1990–2000[b] | 1998 | 1999 | 2000 | 2001 | 2002 | 2003[c] | 2004[d] |
|---|---|---|---|---|---|---|---|---|
| **Transition economies** | **-2.5** | **-0.8** | **3.6** | **6.8** | **4.5** | **3.9** | **5.9** | **5.9** |
| ***CIS*** | .. | -4.1 | 5.3 | 9.3 | 5.9 | 4.8 | 7.7 | 7.1 |
| *of which:* | | | | | | | | |
| Belarus | -1.6 | 8.4 | 3.4 | 5.8 | 4.7 | 4.7 | 6.8 | 5.5 |
| Kazakhstan | -4.1 | -1.9 | 2.7 | 9.8 | 13.5 | 9.8 | 9.5 | 8.5 |
| Russian Federation | -4.7 | -5.3 | 6.4 | 10.0 | 5.0 | 4.3 | 7.3 | 7.0 |
| Ukraine | -9.3 | -1.9 | -0.2 | 5.8 | 9.2 | 4.8 | 9.3 | 7.5 |
| ***Central and Eastern Europe*** | .. | 2.9 | 1.7 | 4.0 | 3.0 | 3.0 | 3.8 | 4.4 |
| *of which:* | | | | | | | | |
| Bulgaria | -1.8 | 4.0 | 2.3 | 5.4 | 4.1 | 4.8 | 4.3 | 4.5 |
| Croatia | 0.6 | 2.5 | -0.9 | 2.9 | 3.8 | 5.2 | 4.4 | 3.5 |
| Czech Republic | 1.0 | -1.0 | 0.5 | 3.2 | 3.1 | 2.0 | 2.9 | 3.5 |
| Estonia | -0.5 | 4.6 | -0.6 | 7.3 | 6.5 | 6.0 | 4.7 | 5.5 |
| Hungary | 1.5 | 4.9 | 4.1 | 5.2 | 3.9 | 3.5 | 2.9 | 3.5 |
| Latvia | -3.4 | 3.9 | 1.1 | 6.8 | 7.9 | 6.1 | 7.5 | 6.0 |
| Lithuania | -2.7 | 7.3 | -1.8 | 4.0 | 6.5 | 6.7 | 9.0 | 7.0 |
| Poland | 4.6 | 4.8 | 4.1 | 4.0 | 1.0 | 1.4 | 3.7 | 5.0 |
| Romania | -0.6 | -4.8 | -1.1 | 2.2 | 5.7 | 4.8 | 4.9 | 5.0 |
| Slovakia | 1.9 | 4.2 | 1.5 | 2.0 | 3.8 | 4.4 | 4.2 | 4.5 |
| Slovenia | 2.7 | 3.9 | 5.1 | 4.5 | 2.9 | 3.0 | 2.2 | 3.5 |

***Source:*** See table 1.1.
***a*** Calculations are based on GDP in constant 1995 dollars.
***b*** Average.
***c*** Preliminary.
***d*** Forecasts.

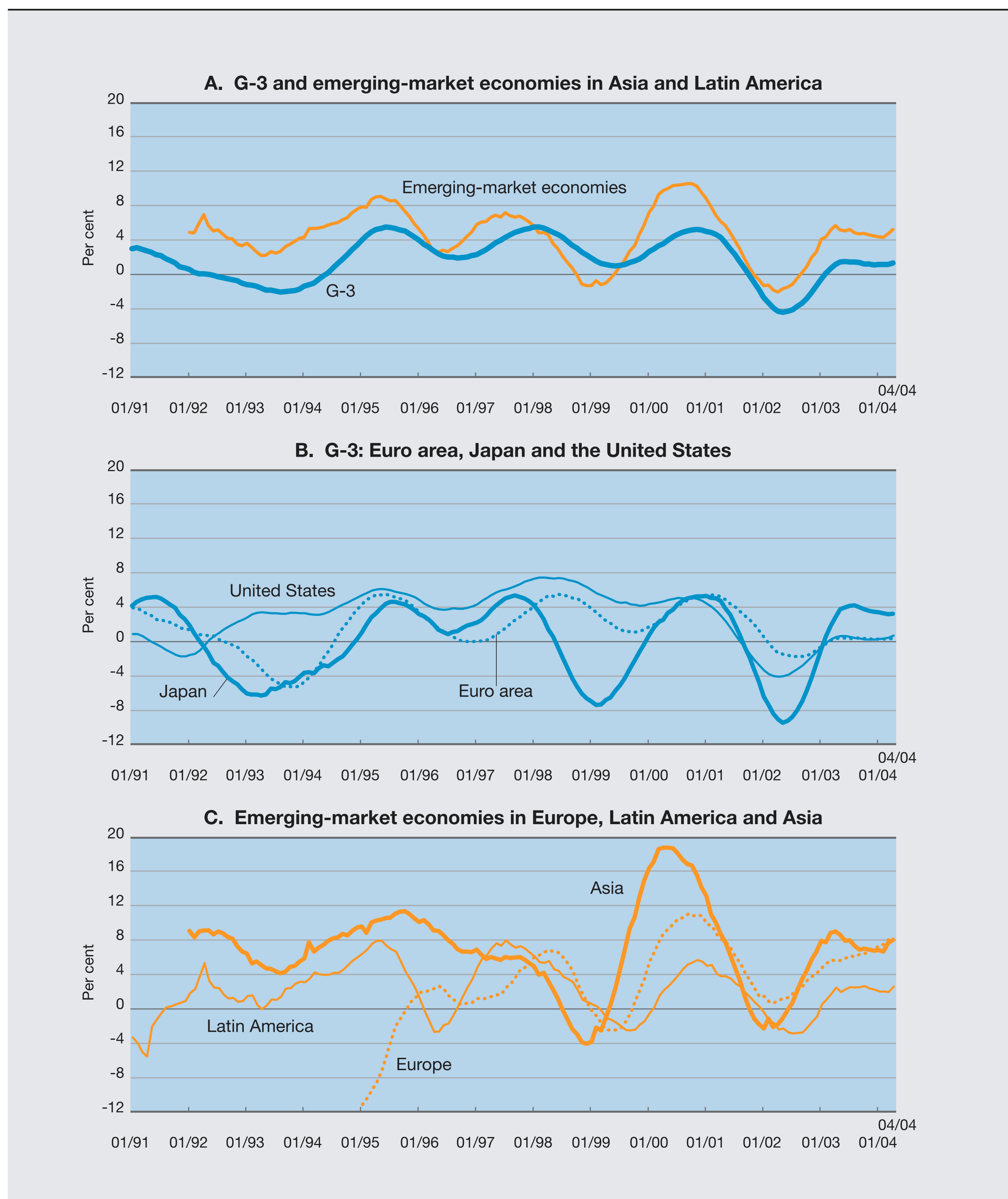
fears a revival of inflation should this incentive for foreign investors be removed too soon.

The structure of demand in the fastest growing economies explains the rise in demand in several commodity markets and the bottoming out of the terms of trade of most developing countries. However, the rise in commodity prices, expressed in dollars, has not substantially improved the terms of trade for all developing countries, as the dollar price of manufactures exported by developed countries has increased at a similar rate. Consequently, even if the growth of the volume of trade continues unabated, the prospects for the terms of trade and the real income of developing countries are less favourable than most commodity prices may indicate. Given that the prices of manufactures exported by developing countries have tended to decrease relative to those of manufactures exported by developed countries, the overall income effect from improved terms of trade is likely to be relatively small.

***Figure 1.1***

**INDUSTRIAL PRODUCTION IN THE G-3 AND EMERGING-MARKET ECONOMIES, 1991–2004**

*(12-month moving average of percentage changes over same period in the previous year)*




**Source:** Thomson Financial Datastream.

**Note:** G-3 comprises the euro area, Japan and the United States. For the purpose of this analysis, emerging-market economies include: the Czech Republic, Hungary, Poland, the Russian Federation and Turkey in Europe; Malaysia, the Republic of Korea, Singapore, Taiwan Province of China, and Thailand in Asia; and Argentina, Brazil, Chile, Mexico and Peru in Latin America.

## B. Developed economies

### 1. Economic policy stimuli have boosted domestic demand and output recovery in the United States

The United States economy in 2003 slipped out of a phase of economic weakness that had begun in 2000. An expansionary monetary policy stance, complemented by an aggressive fiscal policy, substantially improved economic conditions, with real GDP expanding at an annual rate of more than 3 per cent (table 1.1).

The higher growth rate in 2003 was, to a large extent, the result of a recovery in household consumption and a surge in company profits that stimulated investment in equipment and software. Investment in real estate remained buoyant due to low mortgage rates.

A sharp turnaround of fiscal and monetary policies was mainly responsible for the upturn in economic activity. The traditional demand-side stimulus eventually yielded the expected results. In 2003, growth in household consumption was mainly fuelled by a stimulus package involving tax cuts and one-time transfers, designed to increase consumer spending. Part of the growth of domestic demand was due to higher government expenditures, notably a surge in defence spending. The recovery in private consumption, reaching a peak rate of more than 8 per cent in the third quarter of the year, encouraged companies to increase capital investment, particularly in information technology, in the second half of the year.

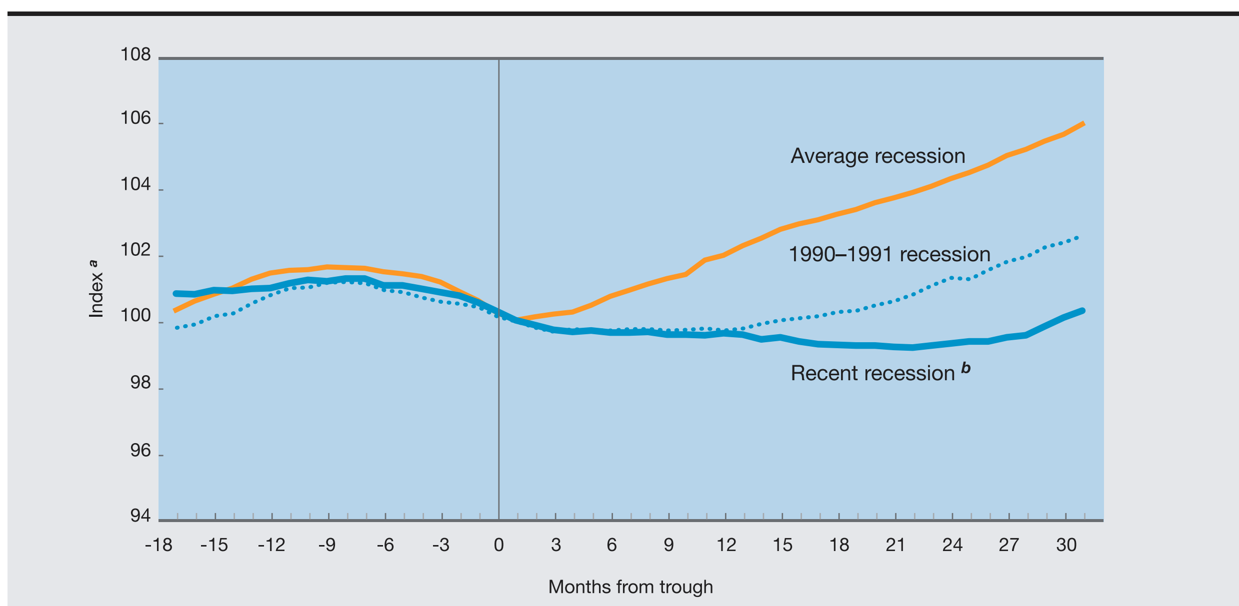
Although there had been signs of a revival of business confidence and of demand for capital goods, the current economic upswing has been the weakest on record in terms of job growth. The last recession and the present recovery have been unique in some ways. Output decline was shorter and milder than in previous recessions, due to the resilience of private consumption and an increase in real estate investment and public expenditures. But the recovery has been slower than previous ones, especially with respect to fixed investment by the business sector and employment (fig. 1.2). The delay in resumption of fixed investment by firms until the second half of 2003 was probably due to overinvestment during the long economic expansion of the 1990s. As for employment, this has been lagging behind output for a much longer period than after previous recessions, even that of 1990–1991 which was marked by a “jobless recovery”.

Companies continued to maintain a hiring freeze because of their low expectations concerning the stability and sustainability of the recovery. Since end 2003, however, non-farm payroll employment has been gradually recovering, accelerating substantially only in the first months of 2004. Unemployment has started to decline since its peak in June 2003, but this decline is partly due to an increase in the number of discouraged workers.

The weak labour market performance since 2002 depressed wage growth at least as much as in other G-7 countries. The nominal growth rate of per capita wages in the private sector fell from 6.5 per cent in the peak year 2000 to 2.4 per cent

***Figure 1.2***

**TOTAL NON-FARM EMPLOYMENT IN THE UNITED STATES**




***Source:*** UNCTAD secretariat calculations, based on United States Bureau of Labor Statistics database and information of the National Bureau of Economic Research's Business Cycle Dating Committee.

***a*** Level at business cycle trough = 100.

***b*** The most recent trough in business activity in the United States economy occurred in November 2001.

in 2003 (OECD, 2004). Especially for middle- and low-wage earners, wages fell in real terms during the period of slow growth. This cyclical weakness of real income growth, which would have weakened consumption growth, was, however, compensated to a large extent by fiscal policy.

A comparison of pre-tax and post-tax personal incomes in the United States reveals the strong impact of fiscal expansion between 2001 and 2004 (fig. 1.3). Whereas growth in personal income and disposable personal income had previously moved in parallel, since the beginning of 2001, tax cuts and other counter-cyclical measures fuelled the growth rate of disposable personal income over that of personal income.

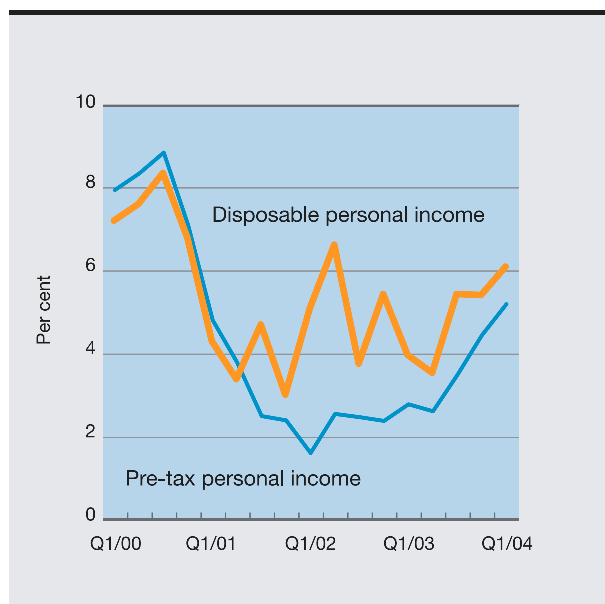
In the course of 2003, wage growth, in particular the so-called supplements to wages and salaries, started picking up; this, along with increasing working hours and, more recently, employment, spurred private consumption. Moreover, the increase in wages and the end of a period of falling unit labour costs led the central bank, the Federal Reserve, to conclude that the period of a deflationary threat had come to an end and the normal cyclical pattern of rising unit labour costs had resumed. Consequently, the Federal Reserve returned to a policy of less aggressive stimulation, increasing its lending rate by 0.25 per cent at the end of June 2004.

Overall, the strong policy stimulus has succeeded in generating growth of domestic demand and profits. Although it could be argued that increased government spending might have boosted domestic demand even more than the tax cuts and investment incentives, the sheer size of the government stimulus seems to have done the job. However, it has created a huge fiscal deficit. The Government aims to reduce the deficit "in the medium term", but further tax cuts in the course of the year will not allow the process of budget consolidation before 2005. The federal deficit is therefore expected to continue to rise during 2004. As a consequence, achieving the announced

***Figure 1.3***

**PRE- AND POST-TAX PERSONAL INCOMES IN THE UNITED STATES, 2000–2004**

*(Percentage growth rate over same period of previous year)*




***Source:*** United States Department of Commerce, Bureau of Economic Analysis database.

budget goal for fiscal year 2005 of bringing down the deficit to 3 per cent of GDP from an expected 6 per cent in 2004 would need a sharp reduction in discretionary public spending.

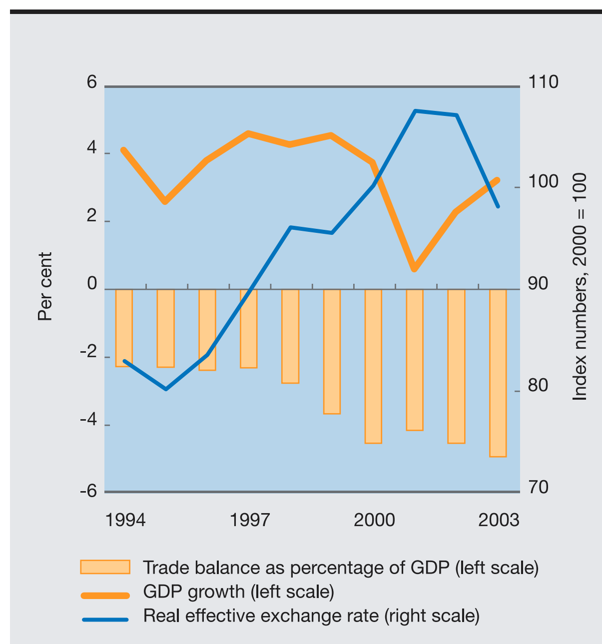
On the external side, the United States economy did not receive much of a stimulus, despite the continued weakening of the dollar, which depreciated vis-à-vis the euro and the yen by 20 per cent and 11 per cent respectively, in 2003 (IMF, 2004a). Indeed, the trade deficit (as shown in figure 1.4) remains a major concern; in the short term, the surge in imports as a result of domestic recovery and weak exports due to slack demand in the EU (i.e. income effect) has more than compensated for the weaker dollar (i.e. price effect). However, in the medium term, the price effect is expected to dominate and the trade deficit to narrow.

In the short term, the effect of a falling exchange rate on the external balance is likely to remain weak, as more foreign companies are hedging their exposure to currencies, which allows them to keep prices low for a while. But successful hedging only delays the effect of exchange rate changes on a country's trade position. The same is true for firms not yet passing the effect of a falling dollar onto consumer prices. A profit squeeze is unavoidable but it cannot be maintained over a long period. Moreover, the demand for imports in response to a weak dollar may not decrease as much as expected due to increasing relocation by United States firms. The sharp increase in import values is also a consequence of a surge in imports of oil and other commodities.

Therefore, the trade balance is expected to deteriorate further in 2004 and the current account balance is likely to remain in substantial deficit, at over 5 per cent of GDP, well into 2005. This will keep a downward pressure on the dollar de-

***Figure 1.4***

**TRADE BALANCE, REAL EFFECTIVE EXCHANGE RATE AND GDP GROWTH IN THE UNITED STATES, 1994–2003**




***Source:*** UNCTAD secretariat calculations, based on United States Department of Commerce, Bureau of Economic Analysis database; and IMF, *Balance of Payments Statistics* database and *International Financial Statistics* database.

spite the improved growth performance of the United States economy.

Foreign demand for United States products will be mainly affected by economic developments in Europe (its second largest export market after Canada) and China. On the one hand, European economies are likely to remain relatively weak and only a further rise of the euro could stimulate United States exports. One possible scenario would be higher growth in Europe, which would calm the upward pressure on the euro. On the other hand, China's economy remains strong and imports are surging, but the exchange rate is pegged to the dollar at a level which might at some point discourage the import of United States products (China accounted for over 20 per cent of United States export growth in 2003). In particular, as United States manufactured exports to China are composed mainly of capital goods and industrial supplies (45 per cent and 34 per cent respectively in 2003 (United Nations, 2004)), any slowdown in capital formation in China would have a visible effect on United States external demand growth.

The outlook for 2004 points to a GDP growth rate of close to 4 per cent. Domestic demand benefited from a further round of tax cuts in April 2004 and recovery in employment, but it may be moderated by several negative factors linked to high oil prices, expectations of rising interest rates and the end of fiscal stimuli that have helped recovery so far.

If the Government aims to reduce the budget deficit in due course, fiscal policy will have to adopt a restrictive stance. A switch of monetary policy to a less expansionary stance would aggravate the high and growing indebtedness of households, mainly due to mortgages, and this could prove to be a major obstacle to a sustainable growth path. So far, the higher indebtedness has had little impact on the overall debt burden, as interest rates have been extremely low. However, rising long-term interest rates and a very low savings rate would cause private consumption to become more volatile than in previous cycles. With fiscal and trade deficits close to 5 per cent of GDP, and moderate but visible inflationary pressures, fiscal and monetary policies are likely to become less expansionary from the second half of 2004, and growth may slow down. This would reduce the export opportunities of many developed and developing countries that are heavily dependent on the United States market.

### 2. *Weak domestic demand hampers economic growth in Western Europe*[1]

After three years of slow growth and quasi-stagnation in 2003, most of the European economies, and the euro area[2] in particular, are still at a low level of economic activity. Unemployment remains very high and the outlook is poor. The real appreciation of the euro, by some 20 per cent since the end of 2001, brought weak export growth in volume terms in 2003, although this recovered in the first half of 2004. Investment growth was negative and private consumption growth flat. The major bright spot in Europe has been the United Kingdom, which has managed to avoid recession since the beginning of the global economic slowdown in 2000 and continues to keep unemployment low.

While the outlook for exporters in the euro area has begun to improve in 2004 thanks to an upturn in the world economy and the stabilization of the exchange rate of the euro, overall economic growth is expected to continue to lag behind the United States, Japan and developing Asia, as domestic investment and private consumption remain weak. It is obvious now that domestic demand is the Achilles heel of the large, relatively closed economy of the euro area, due to the inability of economic policy to lift the income expectations of consumers in the three biggest economies.

A common feature of most countries in the euro area has been the persistent weakness in private consumption, which, more than any other aggregate, was influenced by a shift in economic policy in the mid-1990s. Its aim was to strengthen penetration in foreign markets while, in the largest countries, it was to reform the welfare State. However, macroeconomic fine-tuning was not part of the policy package.

Comparing the development of the main demand-side components from 1996 to 2003 be-

tween the euro area, the United States and the United Kingdom reveals mixed results of this policy change. While the euro area has succeeded in its external objective, it has failed to stimulate the domestic economy by restructuring the labour market, and to reform the government sector.

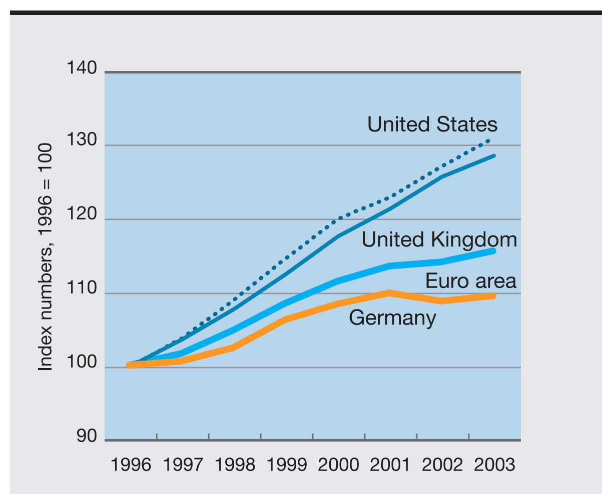
Export performance of the large continental European countries, fuelled by the low value of the euro, was impressive in the second half of the 1990s compared to the United Kingdom and the United States. Germany, the largest and most successful competitor in international markets, increased its real exports in seven years by more than 50 per cent, compared with 20 per cent for the United States (fig. 1.5). By contrast, private consumption in the euro area lagged substantially behind that of the United States and the United Kingdom, where in the seven years up to 2003 it grew by nearly 30 per cent. In the euro area, households expenditure increased by only 15 per cent, and in Germany by less than 10 per cent (fig. 1.6). Since the beginning of the global slowdown in 2000, the expansion of private expenditure has come close to a standstill in the euro area. Germany even recorded falls in private consumption in both 2002 and 2003, while the other two major economies, France and Italy, saw at least minor growth in consumption. The only exception among the more important members of the euro area was Spain, where a strong increase in real estate prices boosted private wealth, construction and consumption.

The main reasons for the dismal consumer demand in the euro area are slow growth of private disposable incomes in most countries, the absence of stimulating macroeconomic policy and the persistence of a high rate of private savings. After the short period of export-driven recovery in 1999 and 2000, the sudden end to employment growth in Europe hit consumer spending much more, and more directly, than in the United States and the United Kingdom, because real wages (real compensation of employees per head) had already begun to stagnate from the mid-1990s onwards (fig. 1.7). Faced with competition from low-wage Eastern European and developing economies and the threat of a massive outflow of jobs, and in order to stimulate employment directly via less capital-intensive production, most Western European economies came under increasing govern-

***Figure 1.6***

**PRIVATE FINAL CONSUMPTION EXPENDITURE, SELECTED DEVELOPED ECONOMIES, 1996–2003**

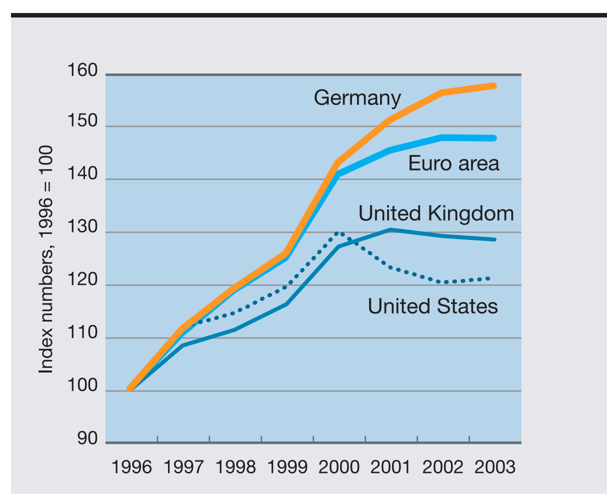
*(1995 prices)*




***Source:*** See fig. 1.5.

***Figure 1.5***

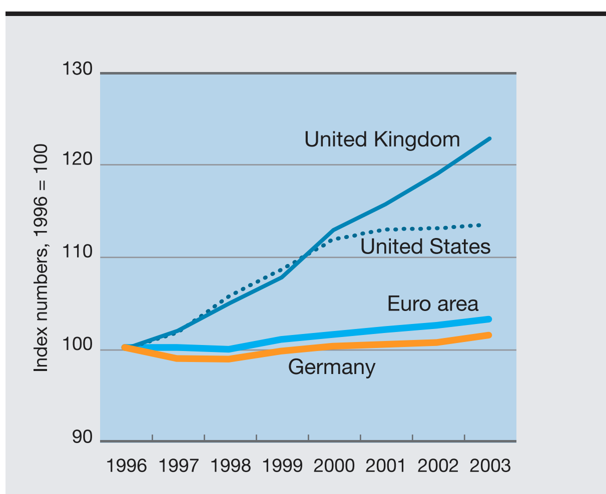
**EXPORTS OF GOODS AND SERVICES, SELECTED DEVELOPED ECONOMIES, 1996–2003**




***Source:*** UNCTAD secretariat calculations, based on European Commission, AMECO database.

*Figure 1.7*

**REAL COMPENSATION OF EMPLOYEES, SELECTED DEVELOPED ECONOMIES, 1996–2003**




***Source:*** See fig. 1.5.
***Note:*** Compensation per employee of full-time equivalent deflated by private consumption deflator.

ment pressure to maintain real wage growth below productivity growth.

However, this policy had a negative impact on domestic demand, and not much of a positive impact on employment. Companies hesitated to hire new workers, despite lower wage costs, due to falling or stagnating private consumption. Germany, the country that pioneered this approach, had both the lowest increase in real wages and the worst job and growth performance. By contrast, in the United Kingdom and the United States, real wages rose without a visible negative impact on employment. In particular, the United Kingdom has experienced the highest growth rate of nominal and real wages since the mid-1990s and the best employment performance. In the United States, as discussed earlier, the Government has taken positive steps to stabilize household disposable incomes since the beginning of the slowdown, thereby bridging the period of slack in employment and wage growth.

In countries with the lowest wage increases, the negative impact of low nominal wage increases on private consumption was somewhat alleviated by low inflation rates or even slight deflation. However, this relief came at a price, namely relatively high real interest rates. In the euro area, countries still have slightly differing inflation rates, but exactly the same nominal interest rates. Germany, the country with the lowest nominal wage increases, also recorded the lowest inflation rate. Hence, in addition to the negative impact of slow domestic demand, the country faces relatively high real interest rates and the concomitant disincentive to invest.

Countries such as Ireland and Spain, on the other hand, which saw both wage and price increases, experienced not only more robust consumption growth, but also lower real interest rates; they were therefore able to sustain a relatively stable growth of private investment. In addition, in these countries, real estate markets still profited from the aftermath of the fall in real interest rates, which was a condition for forming the European Economic and Monetary Union (EMU) in 1999.

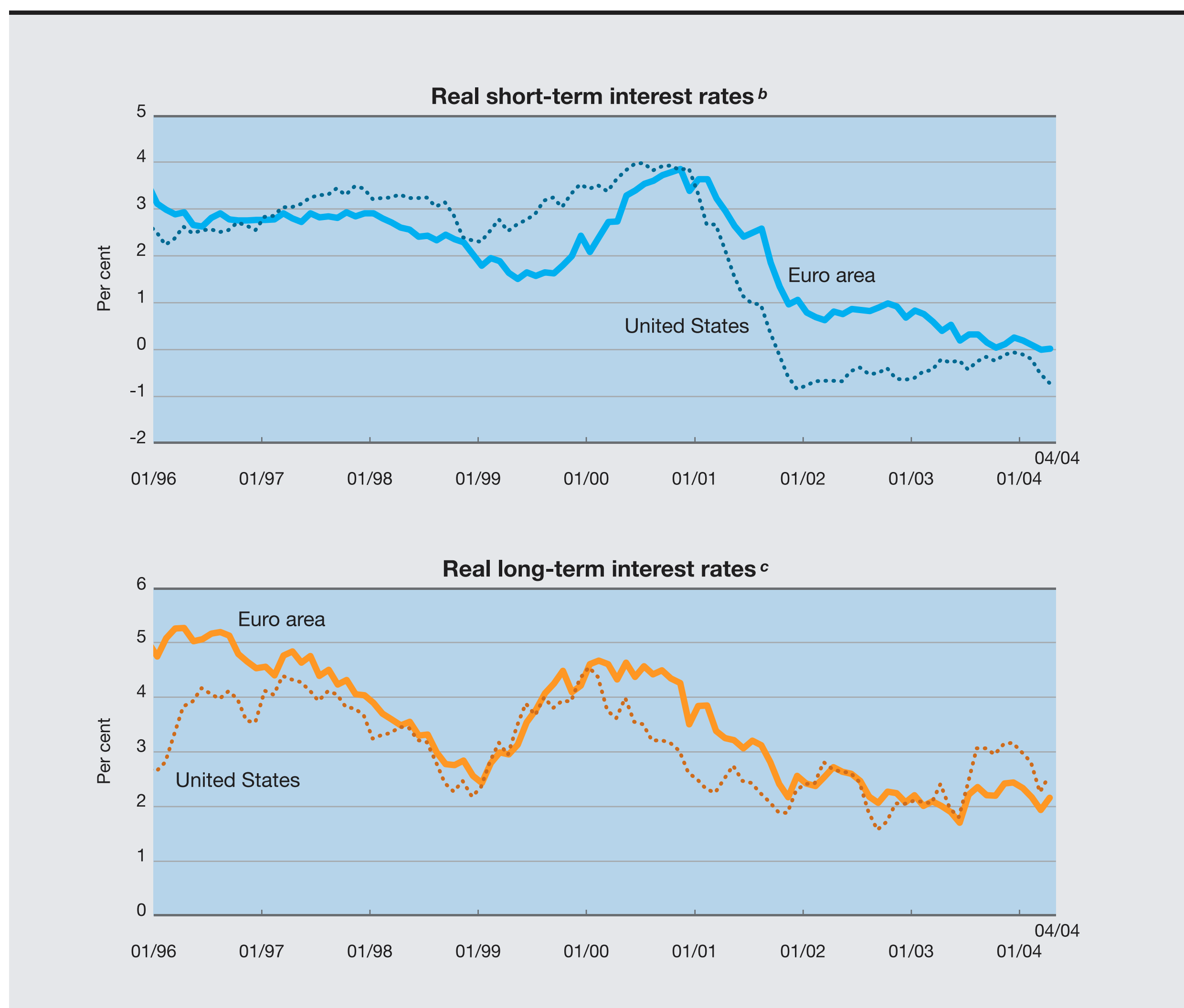
Overall, the positive effect of improved competitiveness through small wage and unit-labour-cost increases in a large and relatively closed economy like the euro area does not compensate for the loss of domestic demand resulting from the diminished income expectations of households. Even more so, if the low-wage approach coincides with rather high real interest rates and a revaluation of the currency.

In the larger countries of the euro area, households did not accelerate their spending by eating into their savings. Indeed, the savings rate remained more or less stable throughout the 1990s, in stark contrast to the dramatic reduction of the savings rate in the United States and the United Kingdom. The fear of job losses, the threat of further cuts in wages as well as warnings about the income effects of an ageing society did not create the right climate to convince households to sacrifice what they perceive to be their insurance against a less secure future.

In the United Kingdom, a fall in the household savings rate, triggered by strong increases in real estate prices against the background of stable employment and growing wages, boosted private consumption. This impulse helped the country to get through the period of global economic slow-

***Figure 1.8***

**REAL SHORT- AND LONG-TERM INTEREST RATES IN THE EURO AREA AND THE UNITED STATES,[a] 1996–2004**




***Source:*** UNCTAD secretariat calculations, based on Thomson Financial Datastream.

***a*** Deflated by core consumer price index.

***b*** *United States*: Federal Funds middle rate. *Euro area*: one-month euro offered rate (Datastream synthetic).

***c*** *United States*: 10-year Treasury bond yields. *Euro area*: 10-year benchmark government bond yields.

down after 2000 without sinking into recession. However, the elevated housing prices in the United Kingdom and the high level of private indebtedness have increased the vulnerability of the economy, especially in the light of monetary tightening by the Bank of England since the end of 2003.

Policy reactions in the euro area concentrated on tackling the "structural" deficits rather than addressing macroeconomic disequilibria by means of expansionary policies. Monetary authorities considered the interest rate to be adequate and appeared to be keeping a margin for manoeuvre should the economic situation worsen. In recent years, real short-term interest rates in Europe have been consistently higher than in the United States (fig. 1.8), despite much higher income growth in the latter. Pro-growth action by the fiscal au-

thorities remains blocked by the regulations of the Stability and Growth Pact. Attempts in some of the larger countries to reduce public budget deficits have added to the weakness of domestic demand and investment. Paradoxically, deficits have been rising in those countries, and have exceeded the threshold of 3 per cent of GDP. However, the public budget deficit of the euro area as a whole has never been in danger of exceeding this threshold.

The contrast between continental Europe and the United Kingdom is again strongly visible in the policy reaction of the latter, where the global economic slowdown after 2000 was tackled by an active counter-cyclical fiscal policy. From 2000 to 2003, the cyclically adjusted government budget balance went from a surplus of 0.8 per cent to a deficit of 2.8 per cent of GDP, giving an average stimulus of almost 1 per cent of GDP per year. In addition to the strong rise in housing prices, this bold policy reaction has helped the United Kingdom avoid recession since the early 1990s, the only one among the world's large industrialized economies to achieve this.

During the past decade, economic policy in the euro area, on the other hand, has tended to treat "structural" measures as substitutes rather than complements to macroeconomic policy. Low growth in wages and unit labour costs is the main instrument chosen to tackle the perceived problem of high wages. This has led to the kind of deflationary bias that the Federal Reserve System of the United States has eagerly tried to avoid. Measures to curb government expenditure, and many other attempts to "reform" the welfare State, have sought to give room to more private incentives and induce more investment. Cost-cutting is the core aim of such a policy approach, complementing firms' attempts to cut production costs in a period of persistent weakness. In a low-inflation environment, this can quickly cross the barrier from disinflation to deflation, as, for the overall economy, the cost of one agent is always the revenue of another. Economic policy that focuses exclusively on the cost side faces a fallacy of composition. Widespread cost-cutting can only be successful if at least one sector accepts running higher deficits. If households save, and private investors inside or outside the country cannot be convinced by low interest rates to spend more, a government that also opts out can only end up with higher deficits. Cost-cutting, without government intervention to stabilize real income, endangers the stability of the whole system and provokes a deflationary trend, even if inflation rates are still slightly positive.

The outlook for the euro area remains rather bleak. Without an aggressive turnaround of economic policy, the stalemate cannot be overcome. Income prospects for households are dim, as nominal wage settlements in 2004 and 2005 are expected to remain modest – close to the inflation target of the European central bank. Real wages will therefore stall, and consumption is not likely to grow.

Even if the euro does not appreciate further, the additional stimulus from the expanding world economy may not be enough to ignite self-sustaining domestic demand growth. The euro area is thus in danger of being trapped in a low-growth, high-unemployment environment for quite some time. This would have adverse consequences for those developing countries for which the EU is a major trading partner.

### *3. Export-led recovery in Japan following a decade of stagnation*

After a decade of stagnation, interrupted only by short-lived episodes of tentative recovery, Japan experienced considerable economic expansion in the second half of 2003, which lifted the annual real growth rate to 2.5 per cent (table 1.1). This performance, compared to the short-lived recoveries in the second half of the 1990s, was more balanced. It was based largely on exports (which had already started recovering in the second quarter of 2002), rather than on government spending, and also on an upsurge of investment in the business sector, as well as a recovery in private consumption since late 2003.

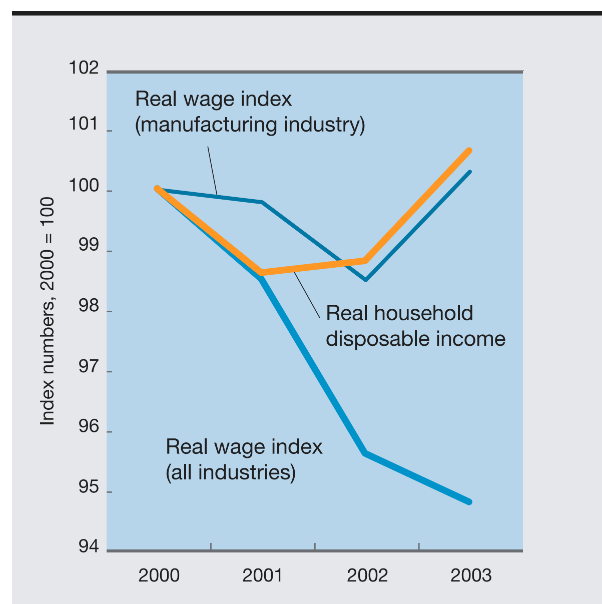
A major determinant of the export drive has been strong demand from China that increased by over 40 per cent in 2003 (33 per cent in current yens (Ministry of Finance, Japan, 2004)). Much of the increase in Japanese exports to China is due

to demand from Japanese firms based there for intermediate goods used as inputs in products destined both for export and for the domestic market. Exports to the United States (still the most important market for Japanese exports), fell by 6 per cent in 2003 (IMF, 2004b). A significant proportion of Japanese exports to China is ultimately destined for the United States via Japanese affiliates in China. This suggests that a change in trade patterns is under way, with a decrease in direct exports from Japan and an increase in exports from China to the United States by Japanese firms. Therefore, although China has been gaining in importance as an export market for the country, the United States market is likely to continue influencing significantly the Japanese export performance in the near future.

On the domestic side, gross fixed capital formation also contributed significantly to growth. As a result of the rapid expansion of exports, firms were able to use up their entire production capacity, and eventually started to increase investment to keep up with higher manufacturing production. This recovery in business investment has been funded by larger corporate profits and less recourse to bank lending, since companies have improved their balance sheet positions.

***Figure 1.9***

**REAL WAGE INDICES AND REAL HOUSEHOLD DISPOSABLE INCOME IN JAPAN, 2000–2003**




***Source:*** UNCTAD secretariat calculations, based on OECD, *Economic Outlook No. 75*, 2004; and Ministry of Health, Labour and Welfare of Japan, database, where all industries include services and commerce.

The recovery in consumer spending was mainly due to a rebound in the disposable income of households. This ultimately put an end to the long-lasting deflationary bias on wages and unit labour costs experienced by Japan during the 1990s. In 2003, investment recovered in those manufacturing sectors that mostly benefited from the upswing in import demand from emerging Asia, and so did manufacturing wages; although in other industries wages were still falling in early 2004. Following the recovery in investment, as well as an increase in government transfers, the real disposable income of households rose in 2003, encouraging an increase in private consumption (fig. 1.9).

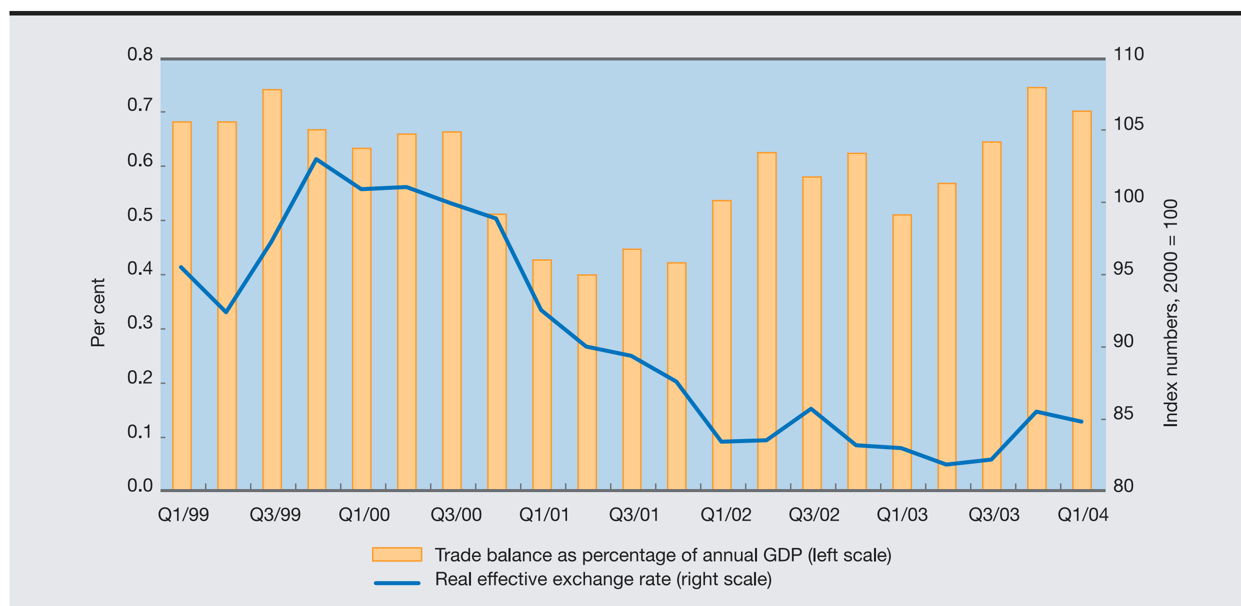
The boom in China and the recovery in the United States, together with a low valuation of the yen in real terms, have contributed significantly to the long-awaited turnaround. Net exports were a considerable source of output growth in 2003 and have continued to grow in the favourable regional and global environment. As the real exchange rate of the yen has fallen by 20 per cent since the end of the 1990s, Japanese exports are more competitive. Consequently, the trade surplus has been growing since 2001, and is expected to grow further in 2004 (to over 3 per cent of GDP) (fig. 1.10).

Although reliance on foreign demand is not the sole element, it does make the export-led recovery of GDP rather vulnerable to external conditions, particularly to currency fluctuations. The threat of losing its competitive advantage vis-à-vis China and the United States at the same time has loomed large over Japan's domestic recovery. This is why the Japanese monetary authorities intervened aggressively to fight upward pressures on the yen in 2003, although they could not prevent a slight real appreciation of the yen at the end of that year.

As in the past, the sustainability of the recovery hinges on the ability of economic policy to foster growth over the medium term, and not to fall back into counter-cyclical action at too early

***Figure 1.10***

**TRADE BALANCE AND REAL EFFECTIVE EXCHANGE RATE IN JAPAN, 1999–2004**




***Source:*** UNCTAD secretariat calculations, based on IMF, *Balance of Payments Statistics* database; OECD, *Main Economic Indicators* database, June 2004; and JP Morgan, *Effective Exchange Rate Indices* database.

a stage. So far, economic expansion has relied only modestly on government consumption; government investment even decreased rather significantly. However, the Government has begun to pursue fiscal consolidation in order to reduce a budget deficit of 8 per cent of GDP, and a central government debt stock that was close to 140 per cent of GDP in 2003 (Bank of Japan, 2004). The strategy followed to reduce the debt will have a significant impact on the sustainability of economic growth. In particular, the official goal of achieving a primary fiscal equilibrium by the beginning of the next decade will require significant tax increases or spending cuts, which could undermine the positive income expectations of households.

Unlike fiscal policy, which could become more restrictive to reduce the budget deficit, monetary policy is not likely to tighten in the near future. The Bank of Japan’s commitment to maintaining an expansionary policy until consumer prices have stopped falling is credible and sustainable, as the very low long-term interest rate amply shows. The Bank’s attempts to arrest deflation by increasing money supply growth seem to have stabilized deflation, but prices continued falling throughout 2003 (consumer prices by 0.3 per cent and production prices by 1.3 per cent), and there are still no clear signs that this will come to an end in 2004 and 2005.

On the whole, the momentum gained from the positive juncture in East and South Asia is continuing in 2004. With exports and investment expanding at a rapid pace in Japan, and private consumption picking up in early 2004, GDP growth is expected to exceed 4 per cent in 2004.

## C. Developing and transition economies

### *1. Dynamic performance in East and South Asia, largely driven by Chinese economic expansion*

Following a moderate slowdown in 2001, East and South Asia have returned to an impressive growth performance since 2002. Regional GDP, which grew by about 6 per cent in 2003 (table 1.2) as a result of strong domestic and external demand, is forecast to accelerate in 2004.

The outstanding performance of East and South Asia has been fostered by supportive fiscal and monetary policies, and by a stable and competitive real exchange rate. Fiscal policy generally maintained an expansionary stance, through both public consumption and investment. Several countries recorded budget deficits of 3 to 6 per cent of GDP in 2003, including Bangladesh, China, India, Malaysia, Pakistan, the Philippines and Viet Nam (ESCAP, 2004). In some countries, such as Malaysia in 2002 and the Republic of Korea in 2003, public expenditure was explicitly used to stabilize the economy in face of slackening private consumption and/or investment. Moreover, economic policy has continued to play a central role in developing infrastructure and providing a favourable monetary environment to the business sector of these rapidly growing countries.

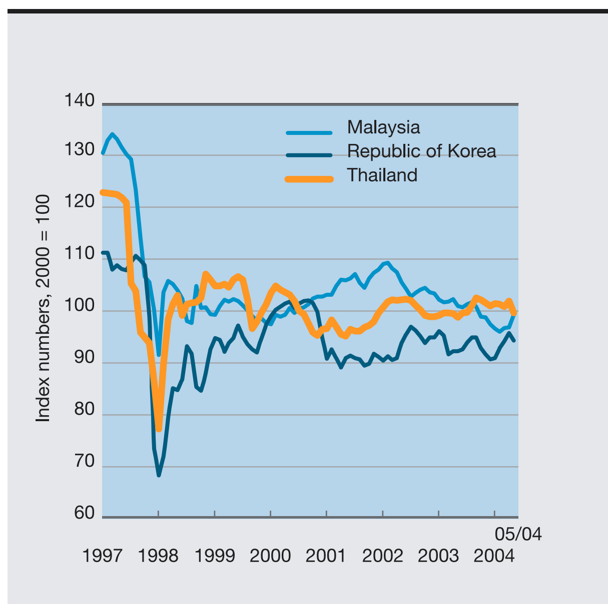
Despite first signs of overheating in China and high investment ratios in the region, interest rates remained at the very low levels they had reached after the Asian crisis of 1997–1998, and some fell even below. Central banks substantially reduced their discount rates, and nominal prime lending rates fell to between 5 and 8 per cent in China, Malaysia, the Republic of Korea, Singapore, Taiwan Province of China, and Thailand. In China, India, Pakistan and Viet Nam, attempts to stabilize exchange rates led to buoyant credit expansion and money supply growth. The central banks of China, India, Malaysia, the Republic of Korea, Singapore and Taiwan Province of China purchased huge amounts of foreign currency, and overall reserves in the region increased from around $970 billion to about $1250 billion during 2003 (IMF, 2004a). As a result, the real effective exchange rate (REER) was fairly stable; it even decreased slightly during 2003 and early 2004 in those countries that had pegged their currency to the dollar, so that, like the dollar, their currencies depreciated vis-à-vis the euro and the yen (fig. 1.11)

The booming economies in East and South Asia, the recovery in the United States and the stability of exchange rates within the region have spurred rapid growth of both exports and imports. Together with the strong investment dynamics, this has favoured a high degree of specialization, thereby promoting intraregional trade. Although the developed countries remain the largest market for developing Asia, during the 1990s and early 2000s there was a major change in Asia's trade patterns. A growing share of intraregional trade has improved the export performance of all the major economies in the region, despite recent overall weakness in the world economy.

China has been playing a central role in these transformations. In 2003 and the beginning of

*Figure 1.11*

**REAL EFFECTIVE EXCHANGE RATE FOR SELECTED ASIAN COUNTRIES, 1997–2004**




***Source:*** JP Morgan, *Effective Exchange Rate Indices* database.

2004, China was a major engine of growth for most of the economies in the region. The country's imports accelerated even more than its exports, with a large proportion of them coming from the rest of Asia. China's exploding import demand value, which registered a 40 per cent increase in 2003 (WTO, 2004a), provided a substantial impetus to some of its important trading partners in Asia, notably Japan and the Republic of Korea.

In China, GDP grew by more than 9 per cent in 2003, driven mainly by the industrial sector. With policy eager to avoid any sharp turnaround, the momentum of that output surge is expected to be maintained in 2004 and well into 2005. Private consumption increased at a rate of nearly 8 per cent, based on the rapidly rising disposable income of households, and reached almost 45 per cent of GDP in 2003. However, a booming investment in fixed capital is at present the main engine of growth (fig. 1.12). The 26 per cent increase in fixed investment in real terms last year was encouraged by easy access to credit (EIU, 2004a). In 2003, there was rapid capacity expansion in some industries, especially steel, aluminium and cement, partly as a result of rocketing domestic demand for private housing. In order to prevent overinvestment, the Government, in April 2004, resolved to freeze new investment in those sectors.

With a rate of growth of about 30 per cent for the second consecutive year (at constant values), exports were a major source of growth in 2003. Part of this expansion was the result of a rush to benefit from export tax rebates, which expired at the end of 2003. Nevertheless, the growth of imports outpaced that of exports, thereby reducing the trade surplus for the second consecutive year, as well as the contribution of net exports to economic growth. In the first half of 2004, the trade balance has turned negative.

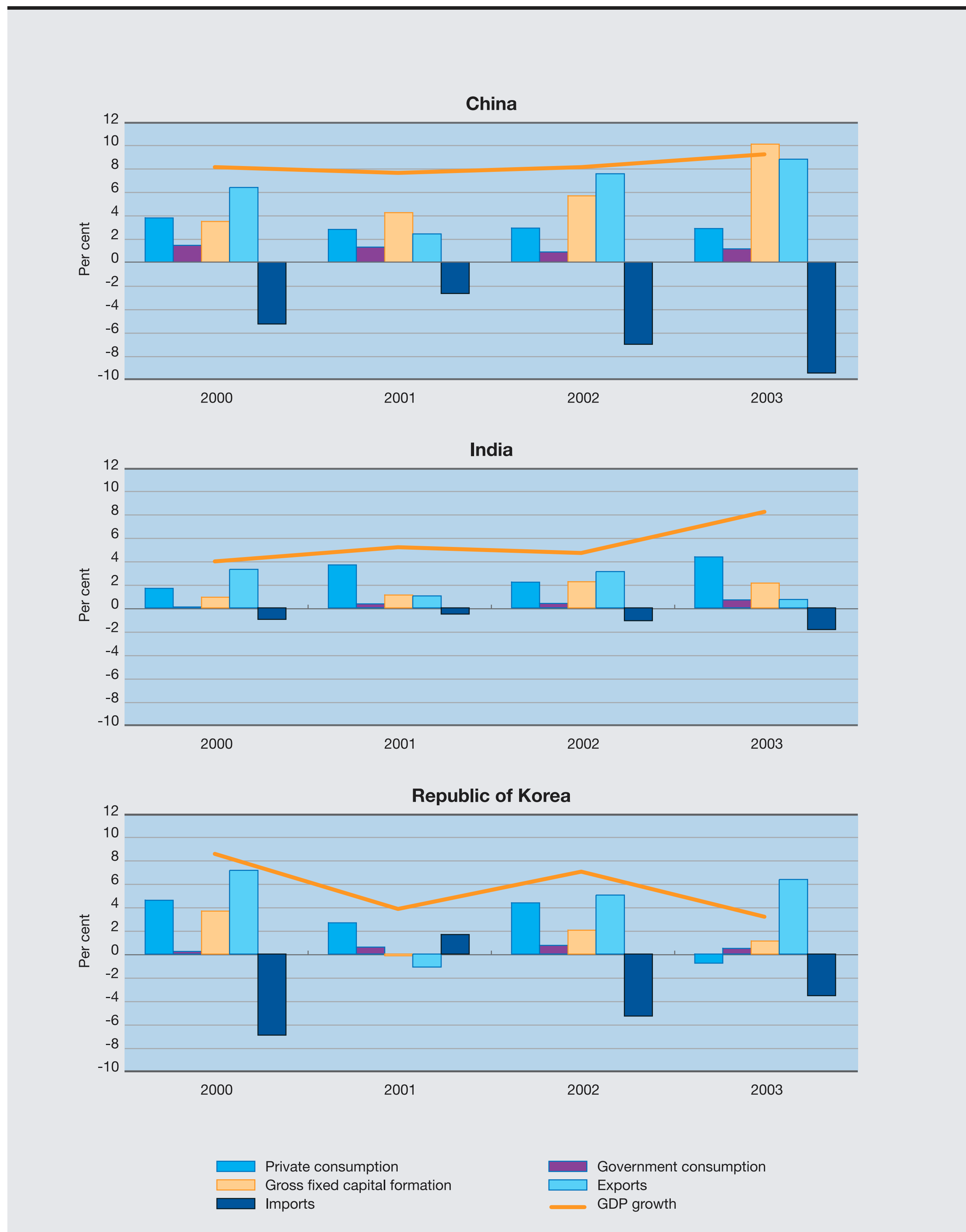
Worrisome indications of possible bottlenecks in some sectors and overinvestment in others have emerged since the end of 2003 (see box 1.1). The beginning of 2004 seems to have marked a significant shift in the overall direction of the Chinese Government's economic policy, from an emphasis in growth[3] to a more balanced approach taking into account the risks and benefits of extremely high growth rates. Its growth targets for 2004 are: 7 per cent for GDP, 8 per cent for foreign trade volume and 17 per cent for broad money supply growth (State Council of the People's Republic of China, 2004). The Government also announced its intention to slow fiscal spending (which has steadily increased since 1999 and exceeded 21 per cent of GDP in 2003), in order to reduce the budget deficit of around 3 per cent of GDP in 2003. A mix of additional monetary measures and administrative restrictions to curb overinvestment, such as credit tightening, is complementing macroeconomic policy.

The Republic of Korea, Singapore and Taiwan Province of China experienced relatively low growth rates in 2003, as a consequence of weak domestic demand. Exports were the major factor of growth. A resumption of consumption and investment (largely linked to export activities) is expected to lead to a substantial recovery of growth in 2004.

In the Republic of Korea, private consumption contracted in 2003, partly due to the sharp reduction of consumer credit by credit card insti-

***Figure 1.12***

**FACTORS CONTRIBUTING TO GDP GROWTH IN CHINA, INDIA AND THE REPUBLIC OF KOREA, 2000–2003**




***Source:*** UNCTAD secretariat calculations, based on Economist Intelligence Unit (EIU), *Country Forecast*, June 2004.

**Box 1.1**

### OVERINVESTMENT AND POLICY CONSTRAINTS IN CHINA

China's policy objective of keeping the exchange rate of the yuan stable had to be put in the context of the objective of controlling domestic credit and investment boom. While the rapid growth of investment normally would have called for a significant tightening of monetary conditions, speculation about an imminent appreciation of the yuan has induced huge private capital inflows fuelling a liquidity balloon and relaxed credit conditions.

The growth of investment in fixed assets, by 26 per cent in 2003, and even further acceleration in early 2004, has become a major concern for policy-makers. Easy availability of credit, together with local government officials' zeal to deliver economic growth, triggered another wave of fixed capacity formation in private and, increasingly, in public investment. In 2003, some industries, especially steel, aluminium and cement, undertook rapid capacity expansion, in some cases doubling their capacity. Given the build-up of capacity under way, China will be able to produce 330 million tons of steel annually in 2005, but, according to many observers, domestic demand will not reach that level until 2010. To fully utilize these capacities, China would therefore have to switch from being a net importer of steel (of about 60 millions tons per year in 2002) to exporting some 30 million tons in 2005. The electrolytic aluminium industries face a similar problem; aluminium factories with a production capacity of 3.1 million tons are under construction, which will lift the country's annual supply of electrolytic aluminium to 10 million tons in 2005, but domestic demand may absorb only half that quantity (China Economic Information Network, 2004; Roach, 2004a).

The danger of such a development is that much of the investment undertaken at present could eventually turn out to be unprofitable, as prices for the goods produced in the new plants might fall well below the prices now obtained in the global and Chinese markets. This would lead to new non-performing loans and exacerbate the problems in the banking sector – a well-known phenomenon of credit-led overinvestment. Chinese officials are especially cautious, in light of their experience of similar overinvestment from 1992 to 1994. Even though the investment bubble then was smaller than the current one, it ended with several years of deflation and left a legacy of non-performing loans. Thus, cooling the overheating economy so as to contain financial losses from a future bursting of the bubble has become top priority for the Government.

However, attempts to subdue the credit boom have been complicated by the de facto fixed exchange rate regime. With United States interest rates having fallen to historic lows in 2003, investors have grown increasingly interested in Chinese assets. This has resulted in immense gross inflows of private portfolio capital, based on investors speculating on an imminent appreciation of the yuan. According to Standard & Poor's estimates, $40 to $50 billion of "hot money" flowed into China in 2003. In the absence of full liberalization of capital account, the main players were Chinese investors repatriating their offshore holdings. Conversion of domestically held foreign currency deposits into yuan-denominated deposits also intensified. As the monetary authorities were determined to defend the exchange rate, they were forced to buy a large proportion of this capital and to emit yuan in exchange. This policy increased liquidity in the banking sector and made it possible for commercial banks to hand out more new loans than the central bank would have wanted.

The central bank only partially succeeded in sterilizing this increase in liquidity by the sale of central bank bills. The monetary authorities also tried to dampen loan growth by increasing the banks' reserve ratio and by requiring commercial banks to become more strict in issuing new loans. However, results have been slow to materialize. Credit growth reached 21 per cent in 2003 – nearly double the 12 per cent average annual growth rate in 1997–2002 (Roach, 2004b). A slowdown in

/...

***Box 1.1 (concluded)***

credit growth in early 2004 proved to be only temporary. Further credit tightening measures were unveiled by the central bank in April 2004, including a further raising of the deposit reserve requirement and closer scrutiny of corporate borrowing. In order to alleviate the liquidity build-up from the inflow of hot money, the central bank has also announced its aim to tighten enforcement of measures restricting capital inflows.

So far, the central bank has been reluctant to raise interest rates in order to cool down the economy, for many reasons. First, this might accelerate the inflow of hot money, as higher interest rates in China would make yuan-denominated deposits even more attractive relative to United States assets. Second, it could make house purchases more costly, thus triggering a sudden fall in real estate prices, which would increase the risk of a hard-landing of the economy. Third, as lending rates and distribution of loans are not yet fully market-determined, part of the credit boom seems to be very inelastic to changes in the interest rate. This is especially true for loans handed out at the request of local governments in an attempt to stimulate growth in their region.

Abandoning the fixed exchange rate and letting the currency appreciate in order to bring liquidity under control does not seem to be an attractive option for the Chinese authorities either, even though they have long considered a possible floating of the yuan. One fear is that a small revaluation at this juncture could attract even more hot money into China, owing to speculation of further appreciations to come. A large appreciation, on the other hand, might substantially hurt Chinese competitiveness in international markets, and it probably would not succeed in curtailing the build-up of capacities aimed at the domestic market, especially overcapacity in steel, aluminium and office space.

With the trade surplus turning into a deficit in the first quarter of 2004, and domestic inflation increasing, pressure for an appreciation of the yuan is abating. In the mid-1990s, China's central bank managed to slow down the economy, without drastic interest rate hikes, by reducing credit growth through other channels such as higher reserve requirement ratios. Even though the increasing openness of the Chinese capital markets has made this task more complicated over the past decade, there is still a good chance that China will be able to manage a soft landing.

tutions, which ended a period of several years of rapid consumer credit expansion. Fiscal policy played a compensatory role, with an increase in government spending and tax reductions. In 2004, two fiscal stimulus packages have been introduced, which should encourage private consumption. Investment spending was very weak in 2003, but should improve in 2004 as a result of growing exports, a fiscal stimulus to expand construction and an expected increase in investment by many of the largest corporations, mainly in the information and communications technology sector. Despite these positive trends in domestic demand, high levels of indebtedness of households and the corporate sector may impose some limits to economic expansion in the near future.

The main driving force of growth in the Republic of Korea in 2003 and 2004 was exports (fig. 1.12). These are highly oriented to China, Japan and the United States, which accounted for nearly 50 per cent of the increase in that country's export revenues in 2003. The central bank, as in China, tried to prevent an appreciation of the won by heavy intervention in the currency market. International reserves grew from $121 billion at the end of 2002 to $156 billion by the end of 2003 (IMF, 2004a).

Exports were also the main determinant of growth in Taiwan Province of China, based on strong demand from Hong Kong (China) and mainland China. Merchandise exports, by value, grew rapidly during most of 2003, reaching a rate of about 23 per cent in early 2004 (Central Bank, Taiwan Province of China, 2004). The expansion of new high-tech production (such as liquid crystal displays), in particular, benefited from a surge in world demand. The sharp increase in investment in these sectors suggests that a new investment cycle might start to reverse the downward trend in the growth of capital formation witnessed since 2001.

Relatively strong economic growth in most countries of the Association of South-East Asian Nations (ASEAN) was largely due to a supportive policy environment that stimulated domestic demand. In Indonesia, Malaysia, the Philippines, Thailand and Viet Nam, it was mainly private consumption that drove economic growth in 2003. The expansion of economic activity and regional trade increased disposable incomes and improved labour market conditions. Personal disposable income was further stimulated by an increase in workers' remittances from abroad (as in the Philippines and Viet Nam) and higher salaries for civil servants, especially in Malaysia and Viet Nam. An expansionary monetary stance, with low interest rates, as well as greater public investment in infrastructure also created conducive conditions for domestic demand.

In most ASEAN countries, private investment has been expanding only moderately and production capacities are still sufficiently large after the strong accumulation of the recent past. Nevertheless, with rising utilization rates, the outlook for private investment is bright. Corporate profitability has increased in the region, and some countries have adopted specific incentives to stimulate private investment.

As these economies have the highest degree of openness in the region (with an export/GDP ratio ranging from 31 per cent in Indonesia to 115 per cent in Malaysia in 2003 (Bank of Indonesia, 2004; EIU, 2004b)), the performance of the external sector usually has a major impact on economic growth. The export performance in 2004 and beyond should be sustained by exports, not only to China, but also, increasingly, to the United States (especially from Indonesia and Malaysia) and Japan (mainly from Indonesia, the Philippines and Thailand).

India recorded a surge in economic growth in 2003, at a rate of more than 7 per cent. This good performance was mainly driven by a sharp increase in private consumption (fig. 1.12), owing partly to strong growth in the agricultural sector. In addition to its direct contribution to growth (agriculture still represents more than 20 per cent of GDP), the good agricultural year increased the incomes of nearly two-thirds of the population. Low interest rates, high liquidity and falling inflation also encouraged domestic demand and accelerated growth in manufacturing and services, especially domestic trade, transport and communications.

Investment in the services sector also contributed substantially to the strong growth performance. This sector – mainly in IT and IT-enabled services – has been given a boost by the shift of back-office functions from developed-country firms to lower cost locations in India with its huge supply of highly skilled professionals in this field. The upward trend in investment and increasing private consumption provide solid internal sources of growth for India over the next few years, complemented by a modest reliance on the external sector.

Other South Asian countries, such as Bangladesh, Pakistan and Sri Lanka also have growth rates of over 5 per cent. In Pakistan, the increase in exports of goods and services has been one of the major growth driving forces, with exports of textiles stimulating manufacturing output. As in India, the recovery of the agricultural sector contributed to growth in 2003, following two years of bad crops. The balance of payments has been showing a surplus in its current account since 2001, resulting from the expansion of exports and current and capital transfers (workers' remittances from abroad and foreign aid). To stimulate production, the monetary authority has pursued a policy of low interest rates, higher credit to the private sector (especially the manufacturing sector) and a stable exchange rate.

Prospects for 2004 indicate continued strong growth in East and South Asia. The two largest

countries, namely China and India, will continue growing at a fairly rapid pace thanks to dynamic domestic and foreign demand. While there might be a slight deceleration of growth in China, owing to recently adopted restrictive measures, there will be an acceleration of growth in other economies, notably the Republic of Korea and Taiwan Province of China, which are recovering from their weak performance in the first half of 2003.

The economic outlook for the ASEAN countries in 2004 and the next few years will also depend on their ability to sustain the growth of domestic demand through an appropriate policy stance. So far, fiscal expansion has played an important role in stimulating economic growth and has offset the negative impact of the recent slowdown of global demand. Monetary expansion has also contributed to encouraging domestic demand, in a context of low interest rates and moderate inflation. In an effort to support economic growth, policy-makers have accepted the necessity of budget deficits in the short term owing to the need for fiscal stimulus.

### 2. Economic performance in West Asia still deeply shaped by the oil sector and political instability

Economic growth in most countries of West Asia has remained considerably unstable, influenced largely by world oil markets, global economic growth and regional conflicts. In 2003, growth rates picked up in the main Arab oil-producing countries, and stayed high in the Islamic Republic of Iran and Turkey. As a result, the region as a whole (excluding Iraq and the occupied Palestinian territory) grew by almost 6 per cent in 2003. In 2004, oil revenues are higher than expected due to high oil prices. However, since regional oil production growth has been slowing down, overall GDP growth may range between 4.5 and 5 per cent.

From a longer term perspective, recent growth has been insufficient to reverse the poor economic performance of the past 25 years. Even excluding war-torn Iraq and the occupied Palestinian territory, real per capita GDP in 2003 was only 6 per cent higher than in 1980. Moreover, this figure hides an even more disappointing trend in several countries. Excluding Turkey, per capita income actually fell by 13 per cent between 1980 and 2003, notably in the oil-exporting economies of Kuwait, Saudi Arabia and the United Arab Emirates, where the decline in per capita GDP ranged from one third to one half. Among the main reasons for this were the downward trend in real oil prices since 1980 and insufficient diversification of production. Investment ratios have been low, except in the Islamic Republic of Iran. In the Arab countries, it plunged from 29 per cent of GDP in 1978 to 16 per cent in 2002. Unemployment is another serious problem in this region of rapid demographic growth; according to estimates of the Economic and Social Commission for Western Asia (ESCWA, 2004), it currently affects 16 per cent of the active population, with the youth unemployment rate close to 30 per cent.

Insufficient investment, growth and job creation are not due to a lack of resources; on the contrary, the region as a whole could be characterized as a "savings exporter". West Asia consistently recorded current account surpluses, which led to the accumulation of international reserves and gave rise to private capital outflows. If investment is scarce, this is largely because of the weakness in domestic markets caused by income inequality, and, in oil-exporting countries, to a high proportion of foreign workers who tend to maximize the remittances they send to their home countries. High wages in the oil sector spill over into the non-oil sectors, thereby hampering their international competitiveness. As a consequence, investment is mainly directed towards hydrocarbons and construction.

Persistent political instability and armed conflicts are also taking a heavy toll on these countries. They inhibit investment, cause a disproportionate allocation of resources for defence purposes and affect fiscal balances.[4] This trend has worsened in recent years. A long period of economic sanctions against Iraq, the subsequent military conflict in that country and the intensification of the crisis in the occupied Palestinian territory have had a negative impact on the performance of almost all the economies in the region.

Countries of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi

Arabia and the United Arab Emirates – have benefited from recent increases in oil revenues. In these economies, the contribution of the oil sector to GDP is substantial: it represents 32 per cent of GDP in the United Arab Emirates, 38 per cent in Saudi Arabia and 45 per cent in Kuwait. Moreover, as government revenue comes mainly from the oil sector (80 per cent in Saudi Arabia and 90 per cent in Kuwait), government expenditure tends to follow trends in the oil market (Central Bank of the United Arab Emirates, 2003; Saudi Arabian Monetary Agency, 2004; Central Bank of Kuwait, 2004).

In 2003, oil production quotas of the members of the Organization of the Petroleum Exporting Countries (OPEC) were increased in response to strong global demand. However, oil production in GCC countries increased even more, in order to compensate for supply disruption in other OPEC countries (Iraq, Nigeria and Venezuela), especially during the first half of 2003. As a result, GCC oil production expanded by approximately 15 per cent during 2003. Moreover, the average price per barrel of crude oil (OPEC basket) rose in 2003 by roughly 15 per cent, to an annual average of $28.1, boosting revenue in the GCC countries. These two factors pushed GDP growth in the GCC countries to rates not seen since the global economic boom of 1999–2000. The group's GDP rose by 6.5 per cent in 2003, with that of Saudi Arabia, the largest GCC member, rising by 6.4 per cent. The increase in oil revenue also helped significantly to improve the fiscal and external balances of the GCC countries.

In early 2004, both oil production and prices in the GCC countries had been expected to decline. In the first quarter, with production from Iraq, Nigeria and Venezuela substantially recovered, the GCC countries cut back their own production slightly in comparison to their 2003 average level. Moreover, in February 2004, OPEC decided to reduce production quotas by one million barrels a day (equivalent to 4 per cent), effective as of April 2004. Contrary to expectations, oil prices actually rose during the first half of 2004: between January and May, average oil prices exceeded their 2003 level by about 16 per cent (International Energy Agency, various). Consequently, at its extraordinary meeting in June 2004, OPEC decided to increase its production target by 2 million barrels a day in July and by another 500,000 barrels in August. The effective increase in production will probably be more modest, since actual supply already exceeds official OPEC quotas. In any case, the prospects for oil production and prices are quite different in mid-2004 than they had seemed earlier in the year. Average prices in 2004 will probably be higher than the previous year, even if they decline somewhat in the second half, and oil production by GCC countries will probably remain at its 2003 level, or may even increase slightly if new production quotas are not fully respected.

With oil revenues substantially exceeding budgetary forecasts, governments may increase public expenditure in 2004 (as they already did in 2003) and still obtain a fiscal surplus. Their balances of payments are also likely to show a substantial surplus, with further accumulation of international reserves. Consequently, current macroeconomic variables will probably remain stable, with exchange rates pegged to the dollar, low inflation, monetary expansion and low interest rates. These general conditions could encourage private activity, especially in construction, financial services, trade and communications. Thus, even if oil production were to stagnate, GDP growth in the GCC countries is projected to exceed 3 per cent in 2004. However, this growth in itself is insufficient to solve social problems and reduce unemployment.

Other countries in the region were harder hit by the Iraq conflict than the oil-exporting GCC countries. The more diversified economies[5] were seriously affected by the deterioration in the investment climate and disruption of regional trade. In 2003, growth rates remained relatively low (and close to zero in per capita terms) in Jordan, Lebanon, the Syrian Arab Republic and Yemen. In contrast, GDP growth remained high in the Islamic Republic of Iran, at 5.9 per cent.

The regional conflicts had the greatest negative impact on the economy of the Syrian Arab Republic. Not only was its oil trade with Iraq interrupted, but also difficulties arising from its proximity to that country deterred private investment. Jordan similarly suffered from the uncertainty and trade disruptions wrought by the conflicts, but some of the negative effects were offset by an

increase in exports and higher defence spending, partly financed by the United States.

The more diversified economies profited largely from the weak dollar. As Jordan, Lebanon and the Syrian Arab Republic have pegged their currency to the dollar, but trade mostly with the European Union (EU) and other non-dollar economies, their export industries have become more competitive with the devaluation of the dollar against the euro and the yen. This has benefited their non-oil exports outside the region and helped them improve their external balance. Another stabilizing element for both growth and the external balance in the more diversified economies was the increase in workers' remittances due to higher GDP growth in the GCC countries. Nonetheless, not all these economies have had a sustainable current account position in the past few years. Lebanon managed to narrow the gap in its external balance slightly; however, the estimated deficit of roughly 15 per cent of GDP in 2004 still remains significant.

In the Islamic Republic of Iran, the economy has been growing, on average, by almost 6 per cent since 2000, driven by a mix of supportive monetary and fiscal policy measures and external factors. Moreover, the reform of the foreign-exchange regime and a real depreciation of nearly 40 per cent between 1999 and 2003 boosted non-oil exports. Other positive developments have been a pick-up in the agriculture sector owing to favourable weather conditions and an increase in oil production and revenue. Agricultural growth has been important for private consumption, since almost 40 per cent of the population still lives in rural areas, and higher oil revenues have expanded both government consumption and capital spending. As in other OPEC countries, growth in oil production is likely to slow down in 2004, with an estimated increase of 3 per cent compared to 11 per cent in 2003 (International Energy Agency, various). Oil revenue will, nonetheless, remain at a relatively high level. GDP growth is expected to decelerate only moderately owing to continuing growth in public and private consumption and investment. The current account balance showed a surplus in 2003. Although imports expanded following a reduction in import taxes, a loosening of import controls and growing domestic demand, they did not pose a problem for the external balance because they were matched by higher export revenues.

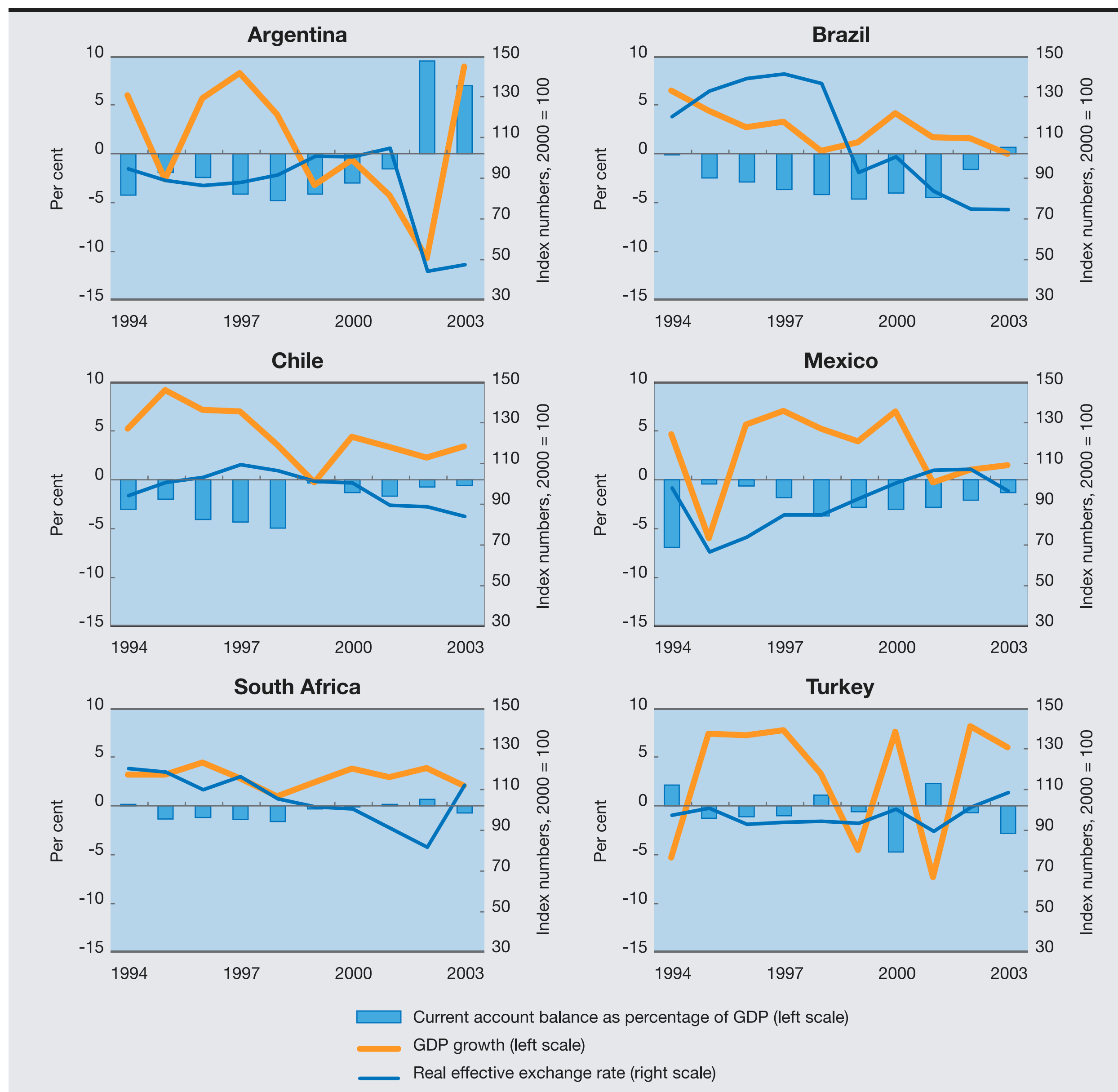
The political and security situation will continue to have an important impact in the more diversified economies in the region. If conditions in Iraq stabilize, the neighbouring countries can be expected to profit from increased trade with that country and from possible involvement in reconstruction activities. An additional impulse could also come from the stronger global GDP growth projected in 2004, that could somewhat push up their growth rates.

In Turkey, the largest economy in West Asia in terms of population and GDP, there has been a considerable decoupling from the rest of the region's conjuncture in recent years. While the rest of the region still heavily depends on the ups and downs of the oil market – either by direct reliance on oil revenue or by workers' remittances – Turkey's economic development has been more closely linked with the economic performance of its main trading partners (the Western European countries, which account for about 60 per cent of its trade) and the repercussions of its 2001 financial crisis.

The Turkish economy has experienced sharp swings in recent years, with severe contractions in 1999 and 2001 followed by rapid recoveries (fig. 1.13). After suffering a banking crisis, a strong nominal depreciation of its currency and a contraction of GDP by 7.5 per cent in 2001, the Turkish economy rebounded by 7.9 per cent in 2002 and 5.8 per cent in 2003 (table 1.2). While the 2002 recovery was primarily driven by exports and government spending, in 2003 private consumption picked up and became the main factor behind growth. Exports of manufactures also expanded, despite the real appreciation of the Turkish lira, but total imports increased even faster. The traditional surplus in the trade in services (mainly tourism) could not balance the widening deficit in the goods trade and the interest paid on the external debt. As a result, the current account deficit was 2.8 per cent of GDP in 2003, and continued to grow rapidly in the first quarter of 2004 (Central Bank of the Republic of Turkey, 2004a). So far, capital inflows, attracted by high interest rates, have enabled the financing of this deficit and the accumulation of international reserves ($45 bil-

***Figure 1.13***

**CURRENT ACCOUNT BALANCE, REAL EFFECTIVE EXCHANGE RATE AND GDP GROWTH, SELECTED DEVELOPING COUNTRIES, 1994–2003**




***Source:*** UNCTAD secretariat calculations, based on ECLAC, Economic Development Division database; South African Reserve Bank, *Statistics South Africa*, database; IMF, *Word Economic Outlook*, April 2004; and JP Morgan, *Effective Exchange Rate Indices* database.

lion in December 2003, compared with $38 billion one year earlier (IMF, 2004a)). Furthermore, the United States has approved a $8.5-billion loan related to the conflict in Iraq. However, the large external debt (equivalent to 62 per cent of GDP) and the reliance of Turkey on short-term private capital inflows to finance the external deficit make the country vulnerable to volatility in the capital markets.

The monetary authorities have kept interest rates high in order to achieve price stability. The

inflation rate went down from 29.7 per cent in 2002 to 18.4 per cent in 2003, and to 8.9 per cent in June 2004 (compared with the consumption price index (CPI) level of June 2003). Hence, even though the central bank's overnight interest rates fell from 36 per cent in 2003 to 24.5 per cent in mid-2004, real interest rates remained high. Domestic interest rates have been even higher in dollar terms, because of the nominal appreciation of the Turkish lira between mid-2002 and early 2004. The strengthening of the lira has also helped stabilize prices, but this has resulted in the real effective exchange rate rising significantly above its pre-crisis level, thereby widening the external deficit. In addition, high interest rates have had a negative impact on the fiscal balance. Even with a primary surplus equivalent to 5.3 per cent of Gross National Product (GNP), Turkey faces an overall fiscal deficit exceeding 11 per cent of GNP in 2003 (Central Bank of the Republic of Turkey, 2004b). Reducing interest rates would alleviate the burden of public domestic debt, but if accompanied by currency depreciation, it could increase that of the public external debt. Although GDP growth is gathering momentum in early 2004, in the medium term, external and fiscal imbalances, that are related to heavy indebtedness, high interest rates and real currency appreciation, represent a challenge to sustained growth.

### 3. Export growth helps economic recovery in Latin America, but sustainable growth remains elusive

In 2003, GDP in Latin America grew at the same rate as the population, by 1.6 per cent, following two years of negative per capita growth. Economic recession had progressively spread to practically all the Latin American countries since mid-1998, marking almost a quarter of a century of subdued economic growth. In 2003, per capita GDP in the region as a whole was only 3.3 per cent higher than in 1980, the investment ratio dropped to a historical low, the unemployment rate reached an unprecedented high, and public discontent with the economic and social results of the reforms of the previous years became an almost general feature of the region (Latinobarómetro, 2003).

Nevertheless, in several respects, the economic situation improved in 2003 and early 2004. The region now faces more favourable external conditions than in previous years, with improved competitiveness, better commodity prices and lower interest rates. Several countries have gained room for manoeuvre in their macroeconomic management, following the shift away from overvalued currencies. Exceptions to this rule are Ecuador and El Salvador, that have adopted the dollar as their legal currency.

However, Latin American countries have not necessarily adopted more supportive policy stances; in some cases, stringent targets related to inflation or primary fiscal balances have received more attention than growth. Moreover, obstacles to substantial and sustainable economic improvement persist: all Latin American countries, in varying degrees, have to deal with weak domestic demand, a high public debt burden, external vulnerability and insufficient linkages between exports and the rest of the economy. The economic recovery under way in 2004 opens a window of opportunity for more proactive economic policies to support recovery of investment and growth and deal with the legacy of a long period of low dynamism, instability and income concentration. Regional growth in 2004 will probably exceed 4 per cent.

During the first half of the 1990s, several governments in the region pegged their exchange rates to hard currencies to fight inflation. Their success with price stabilization, however, came at a high price: it led to real currency appreciation, a loss of competitiveness for manufactures and severe current account imbalances. At the end of the 1990s, when international financial conditions tightened and terms of trade deteriorated for most Latin American countries, an economic slowdown was inevitable. It turned into a severe recession because several governments, fearing the revival of inflation, tried to prevent currency depreciation at any price. They opted for higher interest rates, fiscal restraint and even outright deflation to avoid the unavoidable. Eventually, a majority of countries adopted more flexible exchange rate regimes and depreciated their currencies.

Remarkably, currency depreciations changed relative prices without triggering a revival of inflation. In the months following devaluations,

there was an increase in domestic prices, especially those of tradable goods. But price increases were consistently lower than devaluations, and stabilized quite soon at single-digit rates. For instance, in 1999, the value of the dollar rose 54 per cent in Brazil, while the wholesale price index (WPI) increased by 29 per cent and the consumer price index (CPI) by 9.3 per cent, falling to only 6 per cent in 2000. In Argentina, the value of the dollar surged by 244 per cent in 2002, WPI rose by 114 per cent and CPI by 41 per cent, and in 2003, the increase in consumer prices was as low as 3.7 per cent. There was nothing like the vicious circle of depreciation, inflation and a new depreciation the region had known in the 1980s and early 1990s. Partly, this reflects the fact that, after several years of low inflation, indexation mechanisms were much less stringent than in former devaluation episodes, when more or less all prices tended to be rapidly adjusted to the new value of the dollar. Moreover, nominal wages were quite rigid, due to the prolonged slack in the labour market and a high and rising level of unemployment. Real wages declined, especially in Argentina, Brazil, Uruguay and Venezuela. In Mexico, real wages have been increasing since 1998, but have not yet recovered their pre-crisis (and pre-devaluation) level of 1994 (ECLAC, 2003).

Furthermore, recent devaluations did not lead to unbearable fiscal deficits, as had occurred in past crises. Previously, fiscal and financial crises had provoked uncontrolled monetary expansion and speculative behaviour, which in turn fed further devaluations and inflation, aggravating the fiscal deficit and resulting in a highly inflationary process.

The change in relative prices favoured tradable over non-tradable activities. This was a key element in the substantial improvement of the current account balance of several countries in the region. Simultaneous devaluations and economic contraction or slowdown led to near-balance or even surplus in their current accounts in Mexico (1995), Ecuador (1999), Chile (1999), Colombia (1999), Argentina (2002), Brazil (2002–2003), Uruguay (2002) and the Dominican Republic (2003) (fig. 1.13).

An immediate response to the real devaluations came from imports. In 1999, imports contracted by 15 per cent in Brazil, by 26 in Chile, and by 45 per cent in Ecuador. In 2002, imports in Argentina, Uruguay and Venezuela fell by 56 per cent, 30 per cent and 29 per cent, respectively. Exports were less quick to react, but eventually picked up in 2003. As a result, Latin America passed from having a trade deficit of $23 billion in 2001 to a surplus of $28 billion in 2003, posting a positive current account of its balance of payments for the first time in decades (ECLAC, 2003).

The move towards more flexible exchange rate regimes in Latin America restored the ability to use the exchange rate as a tool of economic policy. It also enlarged the scope of monetary policies, which were previously committed to defending clearly overvalued exchange rates. As a consequence, it was possible to substantially reduce domestic interest rates, despite some volatility following the abandonment of exchange rate anchors or crawling bands in countries such as Argentina, Brazil, Chile, Colombia and Venezuela. However, this has not yet led to any substantial recovery in credit to the private sector, because of a low demand for credit and the conservative behaviour of banks.

Despite low growth rates, fiscal policy in most Latin American countries in recent years has been aimed at reducing imbalances rather than stimulating economic activity. Several governments sought to curb public indebtedness, which had increased dramatically as a result of diverse factors: slow economic growth, high interests rates and the costs of financial crisis and of changes to the pension system. In addition, devaluations had increased the value, in national currencies, of public debts denominated in foreign currencies.[6]

Confronted with a growing public debt and, in some cases, observing the conditions set by IMF-backed adjustment programmes, several countries adopted ambitious fiscal primary surplus goals for 2004: 3 per cent of GDP in Argentina, 3.2 per cent in Uruguay, 4.25 per cent in Brazil and 6.4 per cent in Ecuador. As a result, overall fiscal balances improved, narrowing the deficit from 3 per cent of GDP in 2002 to 2.4 per cent in 2003. This represented, in terms of the primary fiscal balance, almost 1 per cent of regional GDP, resulting in a shift from a deficit of 0.3 per cent of GDP in 2002 to a surplus of 0.6 per cent in 2003 (ECLAC, 2003).

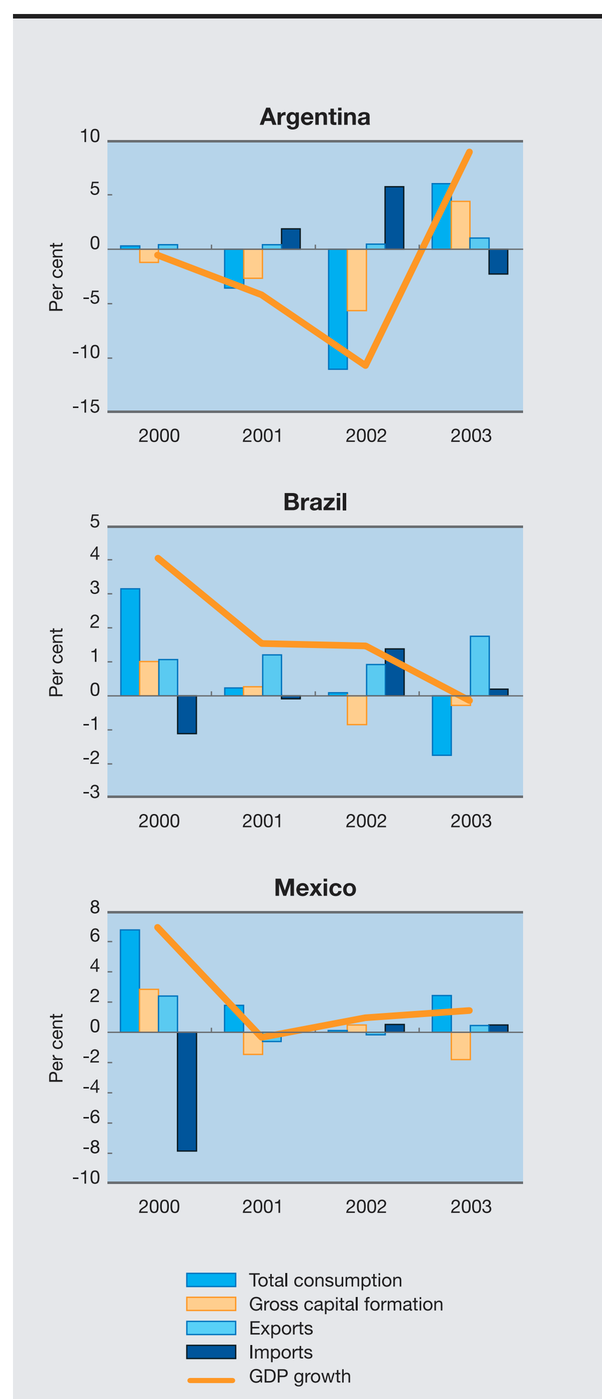
Fiscal adjustments were facilitated by the public sector capturing part of the large increase in earnings (in local currencies) from exports due to the currency devaluations and the rise in commodity prices. In Argentina, a 20-per-cent tax was imposed on primary exports and 5 per cent on exports of manufactures, while in the Andean countries and Mexico, the public sector received windfall revenues from State-owned export firms. However, an improvement in the primary balance also required, in most countries, restrictive fiscal policies, that restrained investment and public wages and prompted tax hikes. Fiscal policy in Latin America, unlike Asia, has tended to be pro-cyclical, tightening its stance during recessions. One exception is Chile, where the Government followed a medium-term surplus target, accepting a deficit when economic growth was below average, as in 2002 and 2003. Another exception is Argentina, after it abandoned the currency board in 2002.

In 2000 and 2001, fiscal adjustment was seen in Argentina as the precondition for capital inflows, which in turn were considered the key factor for economic recovery. In fact, draconian cuts in public spending deepened economic recession and fiscal imbalances and precipitated what they intended to avoid: debt default. After the collapse of the currency board, policy orientation changed radically; improvement of the fiscal balance is now seen as the result, not the prerequisite, of economic recovery. In fact, tax receipts in real terms increased by 25 per cent in 2003 and by 45 per cent over the corresponding period in the previous year in the first five months of 2004, making possible a gradual recovery of non-financial public expenditures and a substantial improvement of the primary surplus.

Another basic change in Argentinean economic policy was in the exchange rate regime. The devaluation was stronger than expected, and took place in the midst of an economic and political crisis. Nonetheless, the economy bottomed out less than six months after the devaluation, ending a four-year recession. While import substitution played an important role in 2002, the rapid recovery of 2003 (with GDP growing at 8.8 per cent) was due mainly to an increase in investment and private consumption (fig. 1.14). Industry and agriculture have been leading the recovery: in 2003,

***Figure 1.14***

**FACTORS CONTRIBUTING TO GDP GROWTH, SELECTED LATIN AMERICAN COUNTRIES, 2000–2003**




***Source:*** UNCTAD secretariat calculations, based on Instituto Nacional de Estadística y Censos de la República Argentina database for Argentina; Instituto Brasileiro de Geografia e Estatística database for Brazil; and Instituto Nacional de Estadística, Geografia e Informática database for Mexico.

***Note:*** Gross capital formation in the case of Argentina refers to gross fixed capital formation.

manufacturing expanded by 16 per cent, construction by 34 per cent and agriculture by 7 per cent, while services grew only by 4 per cent. This is a radical change from the 1990s, when the services sector was the most dynamic. With regard to job creation, during the growth episodes in the 1990s, the employment/GDP elasticity was between 0.2 and 0.3; by contrast, in 2003 and 2004 this elasticity was close to 1, which means that employment has grown as fast as GDP. As a result, the unemployment rate fell from 21.5 per cent in May 2002 to 14.5 per cent in the last quarter of 2003. Real wages, which fell significantly in 2002, are recovering gradually both in the private and public sector (Ministerio de Economía y Producción de la República Argentina, 2004).

The revival of domestic demand, an accommodating monetary policy, restored competitiveness and a substantial trade surplus should allow for continued recovery in 2004, with a growth rate of about 7 per cent. Two possible obstacles may slow down growth: bottlenecks in energy supply (due to low investments in recent years) and a possible debt settlement that may require large payments. The Government aims to maintain a primary fiscal surplus of 3 per cent of GDP, as it believes that exceeding this may halt recovery. In any case, the achievement of sustained growth will require greater investment, both public and private, which will have to be financed mainly with domestic resources (public current surplus, private profits and domestic credit), as has been the case since 2003.

As in Argentina, changes in the real effective exchange rate (REER) in Brazil had a strong impact on trade and on the composition of growth. Brazil's volume of exports in 2003 was 64 per cent higher than its pre-devaluation level of 1998 (during the five previous years, the export volume had increased by only 11 per cent). The volume of imports contracted by 15 per cent between 1998 and 2003, resulting in a switch from a trade deficit of $7 billion in 1998 to a surplus of $25 billion in 2003, and the current account also shifted from a deficit of 4.3 per cent of GDP to a surplus of 0.6 per cent (fig. 1.13).

However, the contribution of external trade to growth has not been complemented by domestic demand (fig. 1.14). Private consumption was affected by a substantial fall in real wages between 2000 and 2003, and a high unemployment rate that reached a record high, of over 13 per cent, in April 2004 (IBGE, 2004). Investment also contracted in 2002 and 2003, partly due to low domestic demand, and partly to the high real interest rate. After the 1999 devaluation, the interest rate set by the central bank (Selic rate) fell sharply, although never below 15 per cent. However, the central bank raised it again in late 2002 and early 2003 in response to a speculative attack against the currency and the threat of inflation. High interest rates attracted short-term capital flows. As a result, the central bank intervened in the foreign exchange market during much of 2003 in order to prevent a strong real appreciation of its currency. This has come at a high cost, since the interest obtained by the central bank on international reserves is much lower than that paid on the public debt issued in order to sterilize the monetary effect of reserves accumulation. More recently, there has been another gradual reduction of the Selic rate, from 26.5 per cent in May 2003 to 16 per cent in April 2004, which is still close to 10 per cent in real terms (Banco Central do Brasil, 2004b). High real interest rates not only weaken domestic demand, but also represent a heavy burden for public accounts; by January 2004, the public domestic debt was over 48 per cent of GDP. Thus fiscal policy has not been directed to providing incentives to economic activity but to generating high primary surpluses in order to assure the servicing of the public debt.

The Brazilian economy is recovering in 2004, with a growth rate forecast of 3.5 per cent. Even if the country were to show an encouraging trade performance in 2004, more substantial economic growth will require a significant recovery of investment and private consumption. This would be in line with the 2004–2007 national plan, *Plano Plurianual,* that includes investment in infrastructure, social projects and "mass consumption", along with an increase in employment and wages.[7] From a macroeconomic point of view, however, this will also require further cuts in interest rates.

In contrast to the success of Argentina and Brazil in export markets was Mexico's slowdown in export performance. The downturn of the United States economy explains the sudden stagnation of Mexican exports in 2001 and 2002; but while the

growth of United States imports resumed in 2003, those originating from Mexico did not recover, most probably due to a real appreciation of the Mexican peso between 1995 and 2002 (fig. 1.13). Mexico has suffered a loss of competitiveness in manufacturing exports vis-à-vis other developing countries whose exports to the United States boomed in 2003. The slowdown of exports, together with weak domestic consumption, caused a drop in manufacturing production and in capital formation (excluding construction) (fig. 1.14). Trade figures for the first months of 2004 showed a strong recovery of Mexican exports, as a result of the United States economy gaining momentum, as well as high oil prices, and GDP is expected to grow 3.5 per cent in 2004. However, the experience of the last few years shows that for sustained growth in Mexico there needs to be a recovery in domestic demand, which requires more growth-oriented monetary and fiscal policies.

In Bolivia, Chile, Ecuador and Peru, exports have been increasing both in value and volume in 2003 and 2004, despite relatively stable real effective exchange rates in those countries in the last couple of years, and even an appreciation in Ecuador. This is the result of a long-term investment process in the primary sector, especially in hydrocarbons and mining. These investments, and an amelioration in the terms of trade, have contributed to the moderate growth of most Andean economies in 2003 (between 2 and 4 per cent), which is continuing in 2004. Higher exports (mainly of oil, gas, copper and gold) have provided supplementary revenues to the governments. However, this relief does not solve the more structural problem posed by the high public and external indebtedness of Bolivia, Colombia, Ecuador and Peru; this could lead to more restrictive macroeconomic policy stances, especially if prices of export commodities return to lower levels. The contrast between growing primary exports and structural fiscal difficulties has raised questions about the taxes paid by transnational corporations (TNCs) operating in those sectors, as these are significantly lower than what they pay in developed countries and other developing regions (ECLAC, 2001). Another factor that has inhibited economic growth, despite export dynamism, is related to stagnant wages and persistent unemployment, which have subdued domestic demand.

Among the Andean countries, Venezuela is likely to post the highest growth rate (well above 10 per cent) as a result of the normalization of oil production, following the strike between December 2002 and February 2003; this growth would represent a partial recovery from steep GDP contractions in 2002 and 2003. Ecuador should also improve its growth rate in 2004, due to the operation of a new pipeline that permits an increase in oil production and exports. However, the jump in oil production is to some extent a one-off event (further expansion will need new investments), and non-oil sectors are lagging behind. In Chile, low interest rates and a renewed credit supply are encouraging private consumption, and the government is launching several infrastructure projects, mostly based on the build-operate-transfer scheme. These domestic demand factors will give added momentum to an already dynamic export sector, raising GDP growth to around 4.5 per cent in 2004.

All in all, the shift of most Latin American economies towards more flexible exchange rate regimes has helped restore competitiveness in several of them and provided more room for macroeconomic policy. The projected increase in growth rates from 1.6 per cent in 2003 to more than 4 per cent in 2004 would be a significant improvement. However, resuming a sustained growth path requires more fundamental policy changes in order to stimulate domestic demand. Revival of domestic investment and of private consumption requires less restrictive financial and monetary conditions, and in some cases an easing of the public debt burden, reform of the fiscal structure and enhancing the supply of domestic credit. Additionally, a pro-growth environment over a number of years will only be possible if measures aimed at a more equitable distribution of income are implemented.

### 4. Growth remains subdued in Africa, despite improvement in commodity prices

With real GDP growing at 3.5 per cent in 2003, Africa's economic performance improved slightly compared to 2002, when the overall growth rate did not exceed 3 per cent (table 1.2). In sub-Saharan Africa (SSA), however, real GDP remained sluggish, at about 2.5 per cent. The moderately improved growth in Africa appears to have been influenced mainly by higher prices of fuel and most non-fuel commodities and non-ferrous base metals although, in the case of many non-fuel commodities of interest for Africa, prices were still significantly below their more recent peaks of 1996–1997, just prior to the onset of the Asian crisis.[8] Much of the continent also experienced better weather conditions during the year, and significant progress was made in restoring and/or maintaining political stability in several countries including the Democratic Republic of the Congo, Liberia, Madagascar and Sierra Leone.

Nevertheless, continuing political instability in a few countries has undermined economic growth by disrupting existing economic activities and discouraging new investments, not only in the countries concerned but also in neighbouring countries, through negative regional spillover effects. For example, the economic downturn, due to political instability for the third consecutive year, in Côte d'Ivoire, the largest West African economy of the Communauté financière africaine (CFA), had a negative impact on its landlocked neighbours. The economic slowdown in East Africa, due to the drought in Ethiopia, also adversely affected economic growth in the region. Indeed, overall growth rates in Africa mask wide country or regional differences, with the oil-producing regions registering far stronger growth in 2003 than the non-oil producing ones.

With low investment rates and insufficient economic diversification, the region continues to perform below its economic potential. The majority of the population in many countries still depends on the huge informal sector for jobs and livelihoods. While this implies that measuring economic wealth in the formal sector alone almost certainly under-records the level of real income in the whole economy, the growth impact of the informal sector is much less clear-cut.

North Africa, with a real GDP growth of 5 per cent in 2003, recorded the best subregional performance of the region, partly because of improved weather conditions that contributed to strong growth in agriculture. Higher oil prices benefited the economies of Algeria, Egypt and the Libyan Arab Jamahiriya. A reversal of economic policy in Egypt and Tunisia (a loose monetary policy combined with real currency depreciations), and the recovery of tourism after a slump following the September 11 attacks in the United States also helped to improve the conditions for growth. Overall production in the region has also been stimulated by the expansion of telecommunication services. In 2004, the relatively high growth rate is probably set to continue. With average oil prices expected to remain high, the oil-exporting countries should benefit, while the recovery of global demand should have a positive impact on the more competitive economies.

In East Africa, real GDP growth did not exceed 2.5 per cent in 2003, despite an economic rebound in Madagascar, following a severe contraction in 2002, and continuing good performance in Uganda and the United Republic of Tanzania. Economic recovery in Uganda was supported by the injection of considerable foreign aid for improving infrastructure, health and education. Macroeconomic stabilization policies had to grapple with the problem of sterilizing the impact of official development assistance (ODA) flows on the exchange rate. These inflows have increased more or less steadily in recent years, from a gross total of $208 million in 1986 to a net total of about $1 billion. The main sources are the International Development Association of the World Bank, the EU, and bilateral donors such as Denmark, the United Kingdom and the United States. The construction and mining sectors remained robust in the United Republic of Tanzania, but real GDP growth dipped by almost one percentage point to about 5.5 per cent, most probably because of the adverse effects of erratic rainfall on the agricultural sector during much of the year. The economy of the Seychelles performed poorly for the third consecutive year, due to a decline in tourism. Output contracted by almost 4 per cent in Ethiopia, where a severe drought affected agricultural output

(which accounts for 40 per cent of GDP) and raised food prices. Weather conditions in 2004 augur well for harvests, which should lead to a substantial recovery of GDP growth. Recovery in Ethiopia is likely to account for much of the expected growth at the subregional level, of about 5 per cent in 2004.

Central Africa posted a decline in real GDP growth by one percentage point from the 2002 rate, to 3.5 per cent. A nascent economic recovery in the Democratic Republic of the Congo, resulting from the signing of a peace agreement by warring factions, brought to an end a long period of economic contraction (of almost 40 per cent between 1990 and 2001). The subsequent resumption of lending by the World Bank and the IMF has paved the way for financing by other multilateral institutions as well as bilateral donors. In Chad and Equatorial Guinea, real output growth was extraordinarily high (10 per cent or more) because of new investments in the petroleum sector, but remained subdued in several other countries (Burundi, Central African Republic, Congo and Rwanda), which are at different stages of post-conflict reconstruction.

In West Africa, the real growth rate in 2003 averaged 4.4 per cent, a marked improvement from 1.0 per cent in 2002. The rebound occurred in almost all countries, led by Nigeria – the largest economy in the region – where GDP growth recovered strongly from a slight contraction in 2002. This reflected higher oil prices, increased oil production and relatively strong growth in the agricultural sector. Ghana recorded a slight improvement in cocoa production thanks to the mass cocoa-spraying programme launched by the Government in 2001. This was accompanied by a sharp growth in mining, because of an increase in production and in the price of gold; real output growth was about 5 per cent in 2003. In Mali, despite better cereal and cotton harvests and higher gold prices, real GDP growth declined from 4.4 per cent in 2002 to 3.2 per cent in 2003. Economic growth in the subregion could have been higher had the economy of Côte d'Ivoire not experienced a steady contraction since 2000. This mirrors mounting economic problems stemming from political upheavals in the country since late 1999, which resulted in, among other things, falling export revenues. The crisis in Côte d'Ivoire has had a negative economic impact on landlocked countries, such as Burkina Faso, Mali and Niger, which had to use longer trading routes to alternative ports in Ghana and Togo. Likewise, cross-border trade was disrupted.

Economic growth in the Southern African subregion has been weak, owing largely to drought, which triggered an economic downturn in Zimbabwe (real GDP declined by 13.2 per cent in 2003), and a sharp drop in the growth rate of Angola (from 15.3 per cent in 2002 to 3.0 per cent in 2003). In South Africa – the region's largest economy – the weak performance of the agricultural sector owing to bad weather, and of the manufacturing sector due to the appreciation of the rand and weak global demand, adversely affected real GDP growth. This was exacerbated by the tight monetary and fiscal policies adopted to curb inflationary pressures. The real appreciation of the rand left its mark on exports, which contracted in 2003, leading to a current account deficit (fig. 1.13). The central bank intervened in the currency market to stem the appreciation of the rand, but hesitated to cut interest rates for fear of reviving high inflation in an environment of rapidly rising nominal wages. Real GDP growth declined from 3 per cent in 2002 to 1.9 per cent in 2003, but there was a slight improvement in the unemployment situation.

Overall macroeconomic conditions in Africa have improved. Fiscal deficits (excluding grants) as a proportion of GDP have been reduced to single digits in most countries since the mid-1990s. In 2003, inflation averaged 8 per cent for Africa as a whole, for the fifth consecutive year. Indeed, a few countries, including most in the CFA franc zone of West Africa, as well as Egypt, Rwanda, Tunisia and Uganda, have recorded inflation rates below 5 per cent per annum since the late 1990s.[9] Inflation has generally been on a downward trend, with the exception of Zimbabwe. In Ghana, inflation has been erratic, partly because of the massive depreciation of the cedi and heavy government domestic borrowing requirements.

Current account deficits have remained high in almost all African countries owing to relatively inelastic import demand, debt overhang and high dependence on commodities. In particular, in some countries that recorded trade surpluses, the net import of invisibles (services) and interest pay-

ments resulted in negative current account balances.

The depreciation of the real effective exchange rate in Algeria, Egypt, Tunisia, Uganda and, to some extent, Nigeria, should help boost exports in an improving global economic environment (as mentioned earlier, South Africa bucked the trend in this regard with a renewed appreciation of the REER since the end of 2001). However, the success of the depreciation strategies depends largely on the quality of the supply response in these countries. Sometimes this response is beyond the control of governments, particularly for countries that are highly dependent on primary commodities, due to some exogenous factors such as weather.

The region continues to face daunting challenges, which undermine its macroeconomic stability, and its short- and long-term growth potential. These need to be addressed at the national and international levels, as well as within the context of the New Partnership for Africa's Development (NEPAD).[10] Growth prospects are contingent on ensuring expansionary macroeconomic policies without compromising longer term economic expansion. This also means dealing with sources of economic instability, which, for much of Africa, are related to non-economic factors and to external conditions. Critical to increasing the long-term growth potential would be policies, which, *inter alia*, promote human resource development and institution building, improve productivity of the labour force and increase employment, strengthen infrastructure and provide an overall policy environment to facilitate diversification of the economic base, and encourage intraregional trade through a reduction of physical and non-physical barriers to trade. An important contribution from the international community would be to support these policies with enhanced ODA flows (including debt relief) that have a higher grant element within a more flexible framework. This would enable African countries to utilize the flows more effectively and efficiently in order to strengthen their domestic productive capacities to take advantage of existing market access opportunities. This should be complemented by greater market access in the developed countries, including through a reduction of agricultural subsidies within the framework of the Doha Round of the World Trade Organization (WTO).

Prospects for growth also depend upon maintaining political stability and further improving the environment for conflict resolution and prevention, as well as on policies to contain and control the spread of HIV/AIDS, and tropical and communicable diseases, and limit their long-term impact. Real income growth in Africa remains too low for the continent to meet the Millennium Development Goals (MDGs), in particular that of halving poverty by 2015. For most countries, growth would need to be doubled and sustained over a decade in order to meet these targets.

### 5. EU enlargement and rising oil prices support resilient growth in transition economies[11]

The transition economies of Central and Eastern Europe and the Commonwealth of Independent States (CIS), which were relatively unaffected by the global economic slowdown in 2001 and 2002, continued to register growth rates well above the world average in 2003. The Central and Eastern European countries (CEECs) saw an average GDP growth of 3.8 per cent in 2003 (table 1.2), much higher than that of the EU, their major trading partner. However, the economic performance of different groups of countries was mixed. The Baltic States remained the fastest growing area in this subregion. Among the Central European countries, Slovakia registered the highest GDP growth for the second consecutive year, benefiting from FDI-induced exports, particularly in the automotive sector. Growth was also high in those Southern European countries that received higher FDI flows, such as Bulgaria, Croatia and Romania, while countries in the Balkans were recovering slowly in the aftermath of conflicts.

In general, economic growth was mainly driven by domestic demand, particularly by strong private consumption resulting from higher wages and credit availability. Investment growth was modest and government consumption was contained as a result of progress in fiscal consolidation. Only in Poland and Slovakia did net exports contribute positively to economic growth in 2003. Nevertheless, external conditions are playing an increasingly important role in many countries as

global economic activity regains momentum. In addition, in spite of sluggish recovery in the EU, the countries that have recently acceded to the Union appear to be expanding exports and gaining market shares in the EU as a result of the integration process.

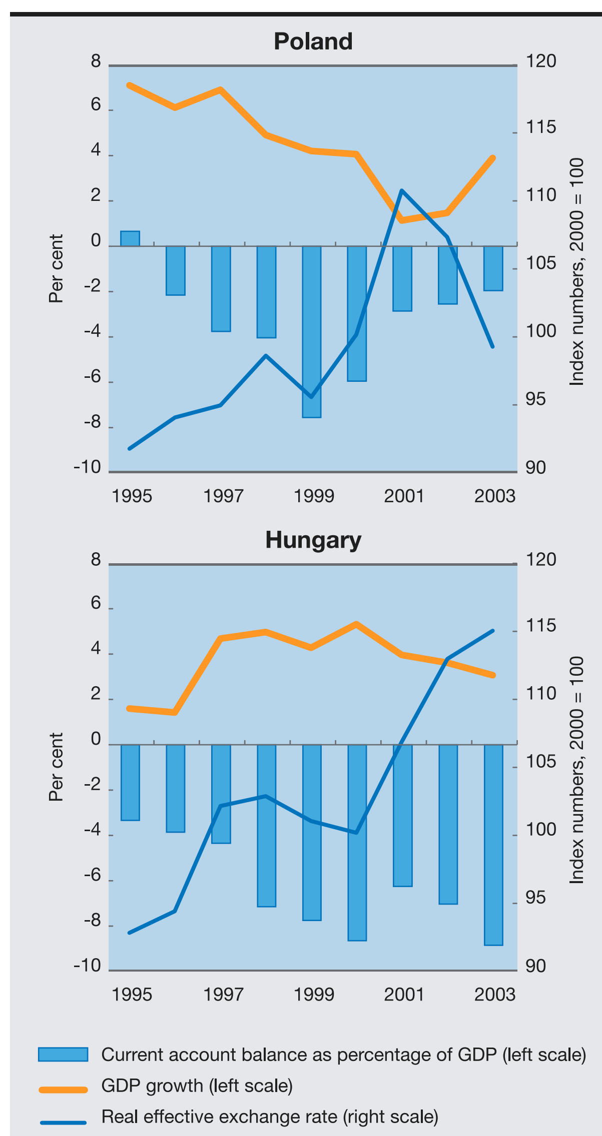
The acceleration of growth in the CEECs was mainly due to the strong economic performance of Poland, the most important country in terms of GDP. The country had been suffering from a very high real exchange rate and low export demand stemming from weak growth in Western Europe. After the turnaround of the real exchange rate, expansion of exports became the major driving force behind the strengthening of the Polish economy. However, there was only moderate growth in domestic demand; investment growth, in particular, although improving, remained negative.

The Polish zloty, which had experienced a long period of real appreciation that caused deterioration in Poland's balance of payments, has been floating freely since 2000. It was only due to a sharp slowdown of growth that the current account balance recovered slightly in 2001 and 2002. The strong depreciation, in real terms, of about 20 per cent between mid-2001 and early 2004 restored competitiveness and led to robust export growth in 2003. The recent revival of foreign demand, through increasing market shares in the EU, has contributed to a narrowing of the current account deficit (fig. 1.15). In addition, monetary policy lowered short-term interest rates in line with the inflation differential with the euro area to the point that this differential almost disappeared between 2000 and 2002, and was negative in 2003 (fig. 1.16). On the fiscal policy side, the budget deficit of 4.5 per cent of GDP in 2003 (Ministry of Economy, Labour and Social Policy, Poland, 2004) may not leave much room for manoeuvre in the near future. Output growth has not helped to reduce unemployment so far; Poland still registers one of the highest unemployment rates in the region, at about 20 per cent. Nevertheless, steady economic growth in 2004, mostly based on booming exports, is expected to translate into increased investment and employment in the medium term.

In contrast with Poland, a significant deceleration of GDP growth took place in Hungary, where a floating currency and the attempt of the central bank to prevent a sudden drop in the exchange rate ended in financial turmoil. Hungary, until recently, had been regarded as one of the most successful transition economies in terms of export

***Figure 1.15***

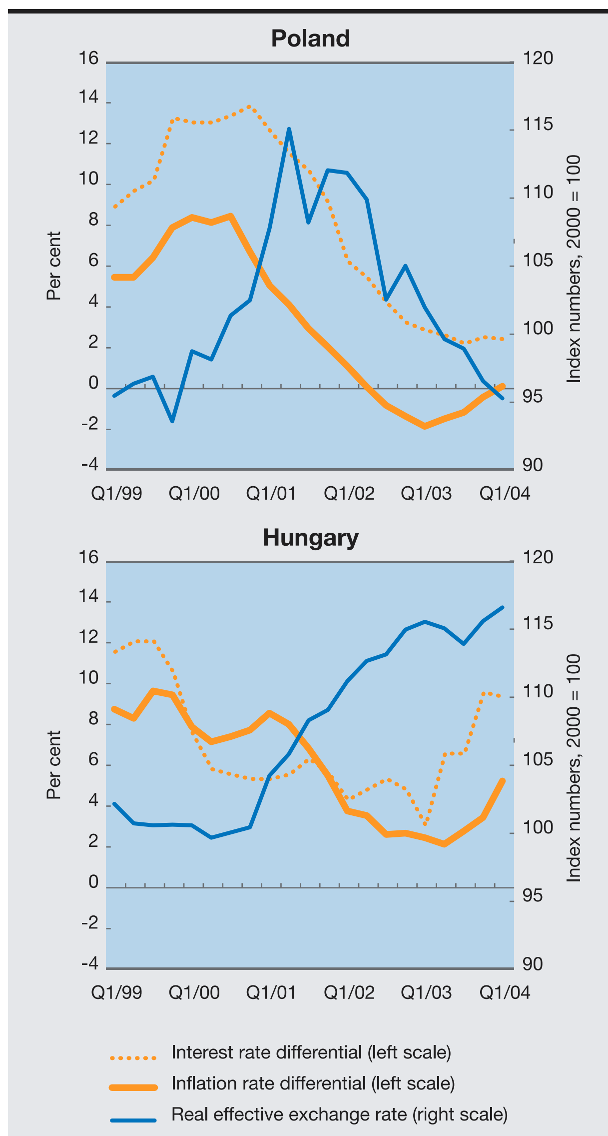
**CURRENT ACCOUNT BALANCE, REAL EFFECTIVE EXCHANGE RATE AND GDP GROWTH IN POLAND AND HUNGARY, 1995–2003**




***Source:*** UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2004*; OECD, *Quarterly National Accounts* database, June 2004; OECD, *Economic Outlook No. 75*, 2004; and JP Morgan, *Effective Exchange Rate Indices* database.

***Figure 1.16***

**NOMINAL INTEREST RATE AND INFLATION DIFFERENTIALS OF POLAND AND HUNGARY WITH THE EURO AREA AND REAL EFFECTIVE EXCHANGE RATE, 1999–2004**




***Source:*** UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; Thomson Financial Datastream; and JP Morgan, *Effective Exchange Rate Indices* database.

competitiveness and economic growth. But after the policy of keeping the Hungarian forint in a crawling peg with the euro was abandoned in 2001, and the narrow band was replaced by a fluctuation band of ±15 per cent around the euro, the currency began to steadily appreciate. Together with excessive wage increases that outpaced productivity growth, the nominal appreciation led to a substantial loss of competitiveness of Hungarian exports. This caused a worsening of the current account deficit, which had already badly deteriorated due to a consumption-induced surge in imports (fig. 1.15). At the same time, fiscal policy had to rein in government spending after the public budget deficit reached 9.3 per cent of GDP in 2002 (Magyar Nemzeti Bank, 2004).

Speculative attacks against the Hungarian forint in early 2003 led to increasing exchange rate volatility. After the central rate of the parity band was devalued in June of that year, a tightening of monetary policy raised the reference rate of interest to 12.5 per cent – the highest in the region – at the end of the year, and increased the interest rate differential with the euro area (fig. 1.16). This response of the monetary authorities reflected conflicting objectives relating to inflation and exchange rates, and created a loss of investor confidence and credibility. Consequently, the positive effects of the devaluation on growth may have been neutralized, as the high interest rates have harmed the domestic economy, particularly investment. In addition, as FDI inflows into Hungary have weakened, the greater dependence of the economy on portfolio investment to finance the current account deficit has increased its vulnerability to external shocks.

The accession to the EU in May 2004 of eight CEECs (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), together with Cyprus and Malta, represents the most significant enlargement, in terms of membership, in the history of the EU. Even though economic integration of the acceding countries with the EU in terms of trade and investment flows is already high, the enlargement is expected to enhance these links and their beneficial effects in the medium term.

The EU enlargement is exceptional not only in terms of the number of countries included, but also in the heterogeneity of their economies. According to Eurostat, the population of the new member States represents 16 per cent of the total population of the EU-25 (455 million) and their area is 19 per cent of the enlarged EU area, while they contribute to only 5 per cent of the total GDP.

Whereas in the acceding countries productivity and GDP have been growing at significantly higher rates than in the EU since the second half of the 1990s, it is estimated that catching up with the EU-15 countries will take several decades, given their low point of departure and, thereby, high potential for productivity gains. In 2002, GDP per capita in Purchasing Power Standards of the acceding countries was only 47 per cent of that of the EU-15, although, compared with the most advanced countries in the EU, the difference is clearly much larger. For the eight acceding CEECs, this figure ranged from 35 per cent in Latvia to 69 per cent in Slovenia. Unemployment rates in 2003 were generally higher in the acceding countries than those of the EU-15 (an average of 14.3 per cent compared to 8 per cent) and employment creation remained subdued (Eurostat, 2004).

While most CEECs have made significant progress with disinflation policies, inflation rates remain well above the euro area rate for a number of them. Short-term nominal interest rates are still much higher than those of the euro, which may put pressure on them to appreciate their currencies, and this may negatively affect their competitiveness. In addition, current account deficits, resulting from high domestic demand that encourages imports, are quite large, and in some cases increasing. These deficits have been mainly financed by the significant amounts of FDI flows attracted to these countries during their period of transition to market economies, and more recently, by the positive expectations resulting from EU enlargement. However, FDI actually declined in the acceding countries in 2003, partly due to the phasing out of the privatization process. Moreover, there is increasing competition for FDI among CEECs. In fact, the pattern of FDI flows in the region is changing. As labour costs increase in the more advanced acceding countries, some of the low-skill activities are moving into the cheaper locations in Southern Europe, where labour costs are much lower. The other CEECs, on the other hand, attract FDI in more knowledge-intensive and higher value-added activities owing to the better skills available in these countries.

Prospects for Central and Eastern Europe in 2004 are for continued solid growth, based on higher domestic demand and expectations of more dynamic export growth deriving from a global economic upturn and accession to the EU, even if the outlook for recovery in the EU remains relatively bleak. However, the need for these countries to address macroeconomic imbalances, associated, in a number of cases, with a twin deficit problem (i.e. current account and fiscal deficits), may lead to a tightening of monetary and fiscal policies. In fact, in 2003 some countries had already seen a reversal of the expansionary stance of the macroeconomic policies they had been pursuing in 2001 and 2002 as a response to the global slowdown. In the medium term, as the acceding countries are expected to adopt the euro, compliance with Maastricht criteria, relating to inflation, interest rates, public deficit and public debt, may impose additional restrictions on macroeconomic policies.

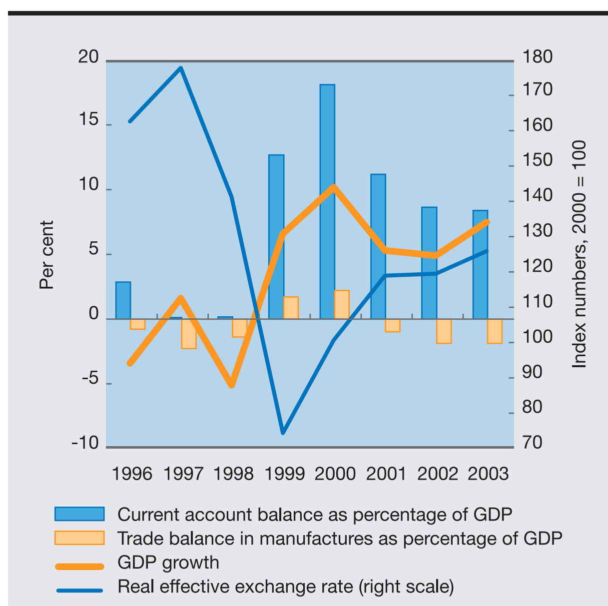
The CIS was among the fastest growing regions in the world in 2003. It registered an average GDP growth rate of 7.7 per cent (table 1.2), as a result of strong economic activity in the largest countries of the subregion. Favourable external conditions in the natural resources sector, particularly high oil prices, which increased the value of exports and encouraged record fuel production, were the main factors contributing to robust growth.

Developments in the CIS were greatly influenced by strong growth in the Russian economy, where increasing domestic demand provided additional stimulus to their exports. In 2003, GDP growth in the Russian Federation was 7.3 per cent, showing very positive indicators in all its components. Domestic demand was high due to rising consumer demand sustained by increasing wages, while investment soared, although mainly in the natural-resources-related industries. Currently, oil and gas exports account for more than half of total exports and about one fifth of GDP, while about one third of the federal budget revenues are directly linked to oil. As a result of higher international commodity prices, the economy registered surpluses in its current and fiscal accounts. An oil stabilization fund was established to support fiscal policy and act as a buffer against adverse exchange rate fluctuations.

Meanwhile, the rouble has been experiencing a real appreciation since 1999 under pressure of a huge current account surplus, which reached levels of above 8 per cent of GDP in 2002 and

***Figure 1.17***

**CURRENT ACCOUNT BALANCE, TRADE BALANCE IN MANUFACTURES, REAL EFFECTIVE EXCHANGE RATE AND GDP GROWTH IN THE RUSSIAN FEDERATION, 1996–2003**




***Source:*** UNCTAD secretariat calculations, based on World Bank, *World Development Indicators, 2004*; IMF, *World Economic Outlook*, April 2004; OECD, *Main Economic Indicators* database, May 2004; JP Morgan, *Effective Exchange Rate Indices* database; and UN-COMTRADE database.

2003 (fig 1.17). Private capital outflows, extremely important in previous years, ground to a halt, and even showed a reversal, with increased corporate borrowing from abroad, thereby reinforcing the tendency to currency appreciation. However, the total capital account was negative due to repayment of the public external debt. The Russian central bank applied an expansionary monetary policy, while purchasing foreign currency to prevent an excessive appreciation.

Recovery of the Russian economy in the aftermath of the 1998 crisis was mainly based on the strong depreciation of the exchange rate of its currency – which boosted competitiveness – and on higher oil prices. As the rouble is recovering its value, the gains from that depreciation are eroding, with negative effects in the external competitiveness of the non-fuel-related sectors of the economy. In fact, the balance of trade in manufactures has been deteriorating in recent years, while the share of manufactured exports in the Russian Federation's total merchandise exports has been declining. This situation raises concerns about the vulnerability of the Russian model of growth: it is strongly based on the natural resources sector, and is therefore extremely dependent on the evolution of highly volatile commodity prices.

Unless the country makes significant progress in shifting its export structure towards a more diversified pattern, with a higher share of manufactures, it seems unlikely that the Government's objective of doubling its GDP in 10 years will be met, as the high oil prices registered in 2003 and early 2004 cannot be guaranteed to remain at the same levels. Indeed, although the outlook for the CIS region in 2004 is positive due to the persistently high oil prices, growth is likely to be less rapid in the medium term, if those prices decline. Additionally, the outlook for the Russian economy may be negatively affected by banking liquidity problems that emerged in mid-2004. ■

## Notes

1 As the analysis in part one of this report covers mainly 2003 and the first months of 2004, countries which acceded to the European Union (EU) in May 2004 are not included in this section, which is concerned primarily with the EU.

2 Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

3 Rapid and sustained GDP growth had been considered necessary for enabling the Chinese economy to tackle several challenges, especially in the labour and fiscal areas. The sharp increase of the labour force in the cities (mainly due to rural migration) and a relatively high unemployment rate put pressure for the creation of urban jobs. In the fiscal area, the Government needs to increase resources for financing the social security system and capitalizing the banking system.

4 For instance, since 1985, defence expenditures have absorbed, on average, 35 per cent of annual current public expenditures in Saudi Arabia.

5 These include the Islamic Republic of Iran, Iraq, Jordan, Lebanon, the Syrian Arab Republic, Yemen and the occupied Palestinian territory. The conflicts in Iraq and the occupied Palestinian territory render any reliable assessment of their economic situation difficult; they are therefore excluded in this section's analysis.

6 In Colombia, the debt of the non-financial public sector increased from 25.4 per cent of GDP in December 1996 to 60.6 per cent in December 2003 (Banco de la República, Colombia, 2004). In Brazil, the public sector debt almost doubled between 1996 (30 per cent of GDP) and 2003 (58 per cent) (Banco Central do Brasil, 2004a). In Argentina, public debt represented 29 per cent of GDP in 1994, 51 per cent in 2001 and 158 per cent in December 2003; this sharp increase left no choice but to suspend payments on part of the debt (Ministerio de Economía y Producción de la República Argentina, 2004).

7 In the long run, the *Plano Plurianual 2004–2007* is aimed at launching a growth process based on the expansion of the mass-consumption market, which includes gradual access of working families to goods and services provided by modern firms. This mass-consumption-led growth would be sustained by large productivity gains, based on scale economies linked to the size of the domestic market and increased exports, as well as on the process of learning and innovation embedded in investment that is aimed at expanding the production capacity of mass consumption goods in modern sectors (Ministério do Planejamento, Orçamento e Gestão, 2003).

8 However, the gains in Africa's terms of trade seem small, in particular considering the increase in the manufactured import price index and the weakness of the dollar, in which commodity prices are quoted (see chapter II, section on commodity prices).

9 In most countries, however, considering the high weight of food in the price index, inflation is generally sensitive to availability of food, which in turn depends on weather conditions.

10 NEPAD was established in 2001 by the Organization of African Unity to develop an integrated socioeconomic framework for Africa.

11 As the analysis in this report covers 2003 and the first few months of 2004, Eastern European countries which acceded to the EU in May 2004 are included in this section.

**Chapter II**

# INTERNATIONAL TRADE AND FINANCE

## A. International trade

### 1. Global trade recovery: developing and transition economies play a major role

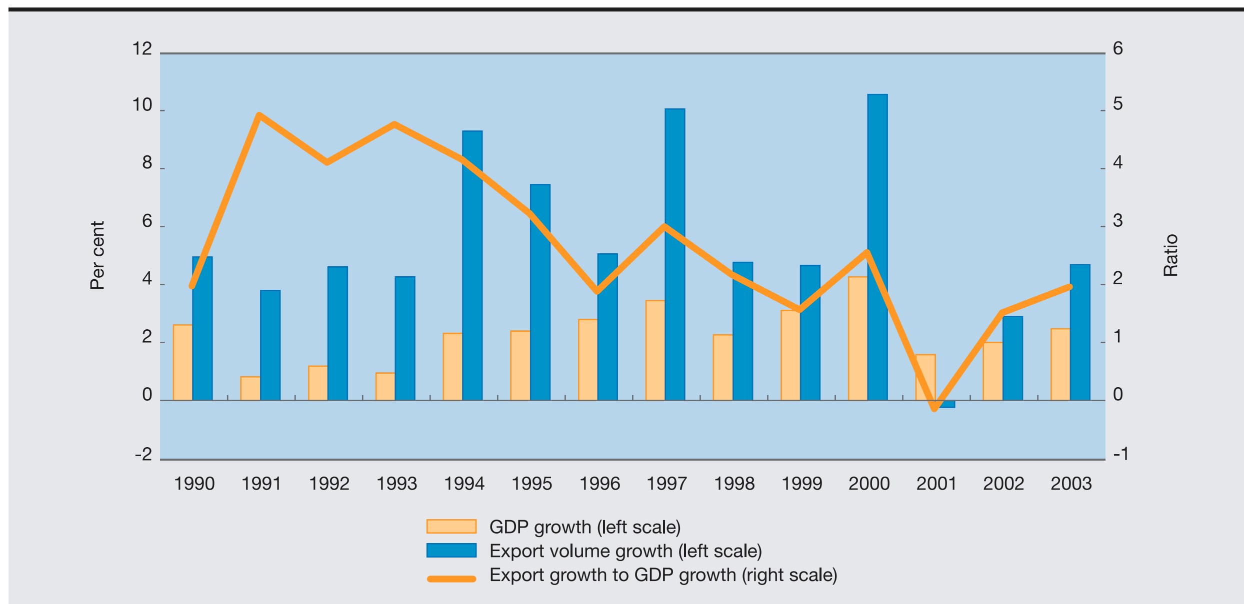
Global trade increased significantly in 2003, after sluggish growth in 2002 and a slight contraction in 2001. Total merchandise exports grew by 15.5 per cent in current dollar prices. However, unlike the trade expansion of the second half of the 1990s, which was mainly the result of high export volumes, the growth rate in 2003 was characterized by a surge in the unit value of exports (denominated in dollars). This concerned manufactures as well as commodities, and put an end to the downward trend in prices that had begun in 1995. One important reason for these price increases was the depreciation of the dollar vis-à-vis other major currencies. By contrast, total export volume expanded at the more modest pace of 4.9 per cent, compared to the average annual growth rate of the 1990s of 6 per cent, approximately three times the world's average GDP growth in that decade (fig. 2.1). The ratio of export growth to GDP growth fell to the more moderate pre-1990 levels, before trade liberalization and integration processes in developing countries accelerated world trade growth in relation to that of world GDP (*TDR 2003*: 44–49).

Not only was growth in export volume in 2003 slower than in the 1990s, but the origins have also changed. Between 1990 and 2000, developed countries accounted for most of the world's export growth. This was not due to exports rising faster in developed than in developing countries (actually the converse was true, as can be seen in table 2.1), but to the fact that, on average, 70 per cent of total exports originated in developed countries (including intra-EU trade), and only 25 per cent in developing countries during the 1990s. By contrast, the recovery of world trade in 2002 and 2003 was propelled mainly by developing countries: developed countries accounted for about 21 per cent of the increase in the volume of exports in 2003, developing countries for 66 per cent, and transition economies for 12 per cent. This shift is attributable not only to sluggish exports in most developed countries and regions but also to rapid expansion of export volumes in some developing regions (especially East and South Asia) and in the transition economies of Central and Eastern Europe and the Commonwealth of Independent States (CIS).

***Figure 2.1***

**WORLD GDP AND EXPORT VOLUME GROWTH, 1990–2003**

*(Annual growth rates and ratio of export growth to GDP growth)*




***Source:*** UNCTAD secretariat calculations, based on WTO, *International Trade Statistics* database.

The contribution of developed and developing countries to growth of world imports by volume was more balanced, at around 40 per cent and 50 per cent, respectively, in 2002–2003; transition economies accounted for the remaining 10 per cent. Imports in developed countries remained more dynamic than exports, due to the persistent growth of United States imports. Even with a lower growth rate of imports, the extra imports by developed countries have a significant impact on world trade. For instance, even though United States imports increased by 8.8 per cent in 2003, compared to 40 per cent for Chinese imports, the expansion of imports in absolute value terms was almost the same for the two countries: $105 billion in United States compared to $118 billion in China (WTO, 2004a).

Weak export dynamism in developed countries in recent years has been partly the result of weak GDP growth. In Western Europe, faltering domestic demand within the region explains the low growth of export volumes between 2001 and 2003, since intraregional trade accounts for approximately two thirds of the region's exports. In the United States, the economic downturn in 2001, together with the global slowdown of growth, affected both imports and exports (fig. 2.2). In 2002 and 2003, that country's imports recovered much faster than exports, fuelled by an expansionary economic policy and a strengthening of the dollar until 2002. During the recent recovery, the geographical structure of United States imports changed significantly: imports from China continued to grow – by 52 per cent in current value between 2001 and 2003 – while those from Japan and the ASEAN countries contracted, leaving total imports from Asia almost unchanged. The share of Canada and Mexico in United States imports decreased, while that of the EU increased (USITC, 2004). As for exports, these began to recover in the last quarter of 2003, favoured by the real depreciation of the dollar. So far, however, this has not contained the United States widening trade deficit, equivalent to 5 percentage points of GDP in 2003, up from 2.4 points in 1997 and 4.6 in 2000 (see fig. 1.4).

**Table 2.1**

**EXPORT AND IMPORT VOLUMES OF GOODS, BY REGION AND ECONOMIC GROUPING, 1990–2003**

*(Percentage change over previous year)*

| | *Export volume* | | | | *Import volume* | | | |
|---|---|---|---|---|---|---|---|---|
| | *1990–2000*[a] | *2001* | *2002* | *2003* | *1990–2000*[a] | *2001* | *2002* | *2003* |
| World | 6.0 | -0.2 | 2.6 | 4.9 | 6.7 | -0.2 | 2.7 | 6.0 |
| Developed economies | 5.3 | -0.9 | 0.6 | 1.5 | 6.2 | -1.3 | 1.4 | 3.5 |
| *of which:* | | | | | | | | |
| Japan | 2.6 | -9.5 | 7.9 | 4.9 | 5.3 | -2.0 | 2.0 | 7.1 |
| United States | 6.7 | -5.7 | -4.1 | 2.7 | 9.1 | -2.9 | 4.6 | 5.5 |
| Western Europe | 5.4 | 1.8 | 0.6 | 0.8 | 5.0 | -0.4 | -0.5 | 2.0 |
| Developing economies | 7.6 | 0.6 | 6.2 | 10.8 | 8.0 | 0.4 | 5.3 | 11.7 |
| *of which:* | | | | | | | | |
| Africa | 3.4 | 2.2 | 0.8 | 7.5 | 4.2 | 6.1 | 2.0 | 7.9 |
| Latin America | 9.3 | 2.7 | 0.2 | 5.2 | 11.6 | 1.3 | -7.5 | 2.3 |
| West Asia | 5.3 | 3.3 | -5.0 | 3.3 | 3.2 | 7.6 | 2.7 | 1.2 |
| East and South Asia | 8.1 | -0.8 | 10.5 | 14.0 | 7.8 | -1.7 | 9.8 | 15.9 |
| Transition economies | 6.6 | 8.2 | 8.1 | 12.4 | 6.0 | 15.0 | 7.3 | 11.0 |

**Source:** UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; WTO, *International Trade Statistics* database; ECLAC, *Statistical Yearbook for Latin America and the Caribbean* database; and Japan Customs and Tariff Bureau database.

*a* Average.

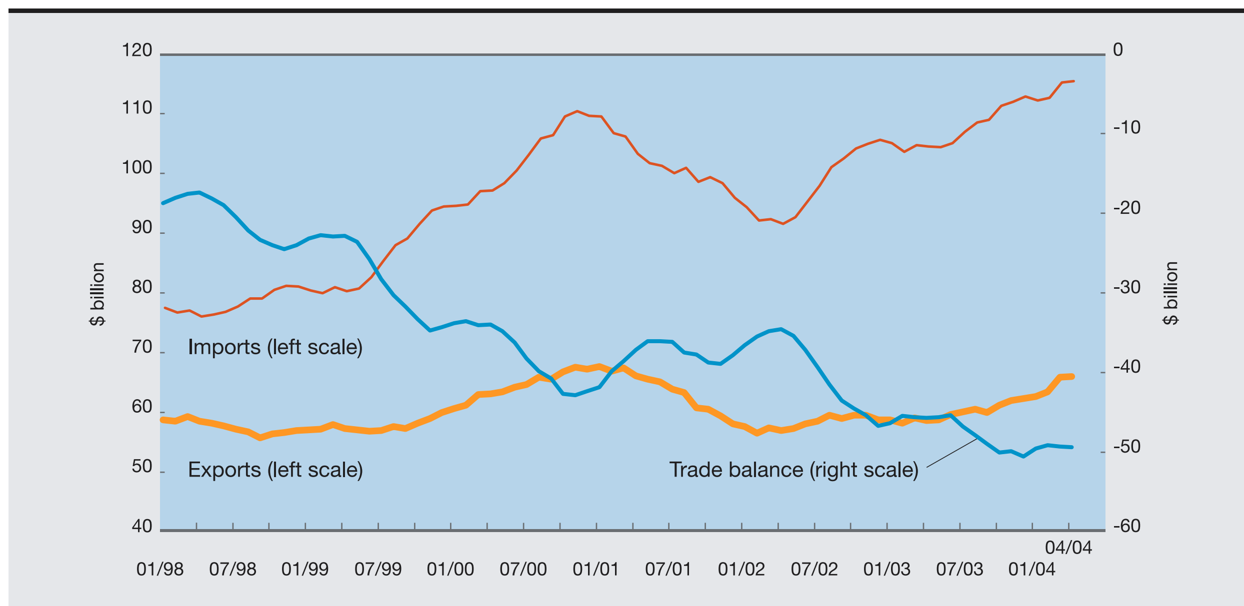
Japan's trade surplus continued to grow in 2003, but at a much slower pace than in 2002. Import volumes picked up following an appreciation of the yen and improved domestic economic conditions. Although the United States remains Japan's largest trading partner, bilateral trade between these two countries declined. As Japan's manufacturing has been steadily moving to lower cost locations abroad, especially to China, many of the goods (mainly information technology and electronics products, automobiles and machinery) previously exported directly from Japan to the United States are now finalized and shipped to the United States by Japanese subsidiaries based in China. This would also explain why Japanese exports of capital and intermediate goods to other Asian countries, especially to China, have grown dramatically. In 2003, Japanese exports to China grew by 44 per cent in current dollar terms, much of the increase being driven by demand of intermediate products from Japanese subsidiaries that produce goods destined for both the Chinese market and for exports. As mentioned in chapter I, this expansion gave a major boost to Japan's economic recovery in 2003–2004.

In developing economies, trade volume recovered in 2003, albeit with varying intensity in different regions. East and South Asia experienced the most rapid growth of both imports and exports, continuing their strong growth trend of recent years, except for a slight contraction in 2001. Intraregional trade expanded at an even higher rate, growing more than sixfold over the last three decades. At present, 35 per cent of East Asian exports go to other economies in the region, com-

***Figure 2.2***

**MONTHLY EXPORTS AND IMPORTS OF GOODS AND TRADE BALANCE IN THE UNITED STATES, 1998–2004**

*(Billions of dollars, 6-month moving averages)*




***Source:*** UNCTAD secretariat calculations, based on United States International Trade Commission (USITC), *Interactive Tariff and Trade DataWeb*.

pared to less than 24 per cent in 1985 (United Nations, 2004). This massive increase in intraregional trade has been partly due to higher import demand from within the region, notably from China, but also to a reorganization of production processes into regional production networks, which have resulted in increased trade flows of industrial supplies and intermediate goods. These are produced in the more industrialized countries in the region such as the Republic of Korea and Singapore, and are finalized in countries with low-cost labour, mostly China (*TDR 2002*, chapter III).

The expansion of East Asian trade has occurred together with a substantial change in the destinations of exports. Deeper production-sharing practices within the region have contributed substantially to the rise of intraregional trade flows. In particular, China's emergence as a major production site for labour-intensive stages of production and assembly has exerted a huge impact on such flows, both within Asia and between Asia and the rest of the world. Goods that were previously processed and exported by other Asian countries are now finalized in China for export. This phenomenon explains, in large part, the increasing bilateral trade imbalances between China and its major trading partners; China has recorded growing trade surpluses with North America and Europe, while widening its trade deficit with the rest of Asia. At the same time, the rapid growth of industrial activity in China is increasing its demand for energy and industrial raw materials, which it imports from other developing countries and transition economies. Consequently, China is playing a fundamental role in international commodity markets, as further discussed in the next subsection.

West Asia (excluding Iraq) saw a large growth of exports in terms of volume and value. Oil-exporting countries benefited from significant increases in oil prices. In 2003, they were, on average, 15.8 per cent above their 2002 level (table 2.2), and rose at a similar rate in the first half of 2004. Furthermore, oil exports of several West

Asian countries expanded significantly in volume during 2003, due to the strong global demand and to the fact that they had to compensate for sharp cuts in supply from Iraq, Nigeria and Venezuela. Imports also registered a significant increase, but much slower than exports, thus enlarging the oil-exporters' external surplus. The largest non-oil-exporting country in the region, Turkey, also experienced strong growth in exports, mainly to Western Europe, but imports grew even faster due to an overvalued lira.

In Africa, both exports and imports rose by almost 8 per cent each in volume, and 22 per cent and 17 per cent respectively in value. Much of the export expansion came from a few oil exporters: Algeria, Angola, Egypt, the Libyan Arab Jamahiriya and Nigeria accounted for almost 60 per cent of the growth in regional export value. However, several other countries in the region also saw higher exports: 23 out of 53 countries recorded an increase in exports of more than 15 per cent, and only six experienced a contraction (WTO, 2004a). This could be attributed largely to higher commodity prices (especially oil, mining and agricultural raw materials) and to improvements in the supply side, with greater crop production in several countries.

Trade in Latin America has been recovering slowly from its downturn of 2001 and 2002, but the situation differs by country and subregion. Between 2001 and 2003, a halt of the buoyant trade growth experienced in Mexico during the nineties, had a major impact on regional figures, since that country accounts for roughly 45 per cent of Latin American exports and 50 per cent of its imports. Due to the United States slowdown and persistent appreciation of the Mexican peso, exports of manufactures were down, and only picked up in 2004, in a delayed reaction to the recovery of United States imports. In 2003, Latin American export growth was mainly due to the solid performance of the Southern Common Market (MERCOSUR) and some Andean countries.

In MERCOSUR, real exchange rate depreciations in previous years and price increases of some important export products restored the profitability of tradables in manufactures and primary commodities, and attracted investments towards them. Moreover, the introduction of new agricultural techniques lowered costs and permitted an expansion of the planted area and of exports, particularly of soybeans. In 2003, the value of exports rose significantly in Argentina (15 per cent), Uruguay (17 per cent), Brazil (21 per cent) and Paraguay (36 per cent) (ECLAC, 2004a). In Brazil, exports have been increasing steadily in volume and value terms following the devaluation: they grew by more than 50 per cent between 1999 and 2003. In several Andean countries, exports grew as a result of several large investments in hydrocarbons and mining, undertaken mainly by transnational corporations (TNCs) as part of their long-term strategies; in these cases, the real exchange rate or other short-term considerations played a minor role. In Bolivia and Ecuador, new pipelines substantially expanded the capacity for transportation of oil and gas, and have already enabled an increase in production and exports. In Chile and Peru, the completion of investment projects in copper- and gold-mines along with rising commodity prices boosted mineral exports in the second half of 2003 and the first quarter of 2004. The increased supply capacity in Latin American primary production matched dynamic demand, especially from China. This country became an important market for Brazil (more than 6 per cent of its total exports), Argentina, Chile, Costa Rica and Peru (around 9 per cent of these countries' exports) in 2003. But even when Chinese demand was not directed at Latin American countries, it nevertheless contributed to the increase in commodity prices, thereby indirectly having a favourable impact on the region's export revenues (see subsection 2 below).

The external trade of the transition economies, which has been very dynamic for more than a decade, was not interrupted even by the 2001 global slowdown. In 2003, both imports and exports expanded by 27 per cent at current values, with almost all countries increasing their exports and imports by more than 20 per cent (WTO, 2004a). For the Central and Eastern European countries (CEECs) that acceded to the EU in May 2004, expectations related to accession prompted an ongoing process of relocation of production and generated additional trade flows between these countries and the EU. This process did not lose momentum even during the period of quasi-stagnation of trade and GDP in Western Europe, mainly the euro area, that began in 2001 (table 2.1).

***Table 2.2***

**WORLD PRIMARY COMMODITY PRICES, 1998–2003**

*(Percentage change over previous year)*

| *Commodity group* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|---|
| **All commodities**[a] | **-13.1** | **-13.9** | **2.0** | **-2.9** | **-2.0** | **8.1** |
| **Food and tropical beverages** | **-14.9** | **-18.5** | **1.0** | **0.0** | **-2.0** | **1.0** |
| *Tropical beverages* | -17.3 | -20.9 | -13.2 | -22.0 | 8.7 | 6.0 |
| Coffee | -28.5 | -23.2 | -16.2 | -28.5 | 0.0 | 3.2 |
| Cocoa | 3.7 | -32.1 | -22.2 | 22.7 | 63.3 | -1.3 |
| Tea | 4.3 | -7.0 | 6.8 | -20.2 | -9.5 | 8.4 |
| *Food* | -14.1 | -18.3 | 5.3 | 5.0 | -4.0 | 0.0 |
| Sugar | -21.2 | -30.0 | 30.5 | 5.6 | -20.3 | 2.9 |
| Beef | -7.0 | 6.1 | 5.7 | 10.0 | -0.3 | 0.5 |
| Maize[b] | -15.0 | -11.1 | -3.0 | 1.2 | 10.5 | 7.2 |
| Wheat | -19.9 | -10.9 | 3.5 | 9.2 | 16.2 | -0.7 |
| Rice | 1.3 | -18.6 | -18.1 | -15.2 | 11.0 | 4.2 |
| Bananas | -3.1 | -9.9 | -2.3 | 38.8 | -9.6 | -28.8 |
| **Vegetable oilseeds and oils** | **7.1** | **-23.3** | **-22.8** | **-8.5** | **26.2** | **17.1** |
| **Agricultural raw materials** | **-10.8** | **-10.3** | **1.9** | **-1.9** | **-6.7** | **17.5** |
| Hides and skins[b] | -13.1 | -5.9 | 11.2 | 5.5 | -2.9 | -16.8 |
| Cotton | -8.3 | -22.9 | 3.5 | -20.9 | -3.3 | 38.0 |
| Tobacco | -5.5 | -7.0 | -3.3 | -0.3 | -8.2 | -3.5 |
| Rubber | -29.8 | -12.6 | 7.9 | -14.1 | 33.1 | 41.7 |
| Tropical logs | -1.2 | -7.2 | 3.8 | 6.3 | -10.5 | 20.2 |
| **Minerals, ores and metals** | **-16.0** | **-1.8** | **12.0** | **-9.9** | **-1.8** | **12.1** |
| Aluminium | -15.1 | 0.3 | 13.8 | -6.8 | -6.5 | 6.0 |
| Phosphate rock | 2.4 | 4.6 | -0.4 | -4.5 | -3.3 | -5.9 |
| Iron ore | 2.8 | -9.2 | 2.6 | 4.5 | -1.0 | 8.5 |
| Tin | -1.9 | -2.5 | 0.6 | -17.5 | -9.4 | 20.6 |
| Copper | -27.3 | -4.9 | 15.3 | -13.0 | -1.2 | 14.1 |
| Nickel | -33.2 | 29.8 | 43.7 | -31.2 | 13.9 | 42.2 |
| Tungsten ore | -6.4 | -9.3 | 12.1 | 45.5 | -41.8 | 18.0 |
| Lead | -15.3 | -5.0 | -9.7 | 4.9 | -4.9 | 13.8 |
| Zinc | -22.2 | 5.1 | 4.8 | -21.5 | -12.1 | 6.3 |
| **Crude petroleum** | **-31.8** | **38.7** | **55.6** | **-13.3** | **2.0** | **15.8** |

***Source:*** UNCTAD, *Commodity Price Bulletin*, various issues.
***a*** Excluding crude petroleum.
***b*** These series have been revised from *TDR 2003*.

On the contrary, CEECs actually gained market shares inside the EU in 2003. The trade of CIS countries was no less dynamic in 2003, with higher values and volumes of imports and exports. In this group of countries, commodity exports (particularly oil and gas) have dominated.

World trade in services (transport, travel and other commercial services) grew by 12 per cent in 2003, twice as much as in 2002 (WTO, 2004b). As with trade in goods, however, much of this expansion seems to have been due to an increase in prices of some services. Moreover, transport

services accounted for the bulk of the expansion, while travel services (tourism) continued to be subdued. Transport services grew in 2003 in terms of both volume and value as a result of the global recovery of merchandise trade, which required increased shipments of commodities. Once again, the expansion of demand was driven, to a large extent, by China, and partly by the Iraq conflict. Costs of maritime transport increased sharply in 2003 and early 2004, ending the declining trend of previous years. An indication of the increased costs of freight is provided by the Baltic Dry Index: its average level climbed from 1,138 points in 2002 to 2,617 points in 2003 and 4,805 in January–May 2004.[1] A sustained demand of shipping transport services, especially from East Asia, resulted in a supply shortage following several years of relatively little shipbuilding and large-scale decommissioning of ships. Higher freight costs also reflected rising costs of insurance and fuel, in addition to increased costs of using older merchant ships (ECLAC, 2004b).

Travel services, measured by the number of international tourist arrivals, have not recovered from their 2001 downturn. After an annual increase of 4.2 per cent between 1990 and 2000, they declined in 2001 (by 0.5 per cent) and grew only by 2.7 per cent in 2002, before contracting again by 1.2 per cent in 2003 (World Tourism Organization, 2004). The fall in the number of arrivals in 2003 was concentrated in East and South-East Asia (by 11 per cent) and in North America (by 7 per cent). East and South-East Asia and Canada were severely hit by the outbreak of Severe Acute Respiratory Syndrome (SARS) during the second quarter, while security concerns discouraged arrivals to the United States, which fell for the third year in a row. Tourism in Europe stagnated (only Eastern Europe showed an increase), as a result of slow economic growth that hampered intraregional tourism, and of a strong euro. By contrast, in most developing regions, excluding East Asia, arrivals increased significantly in 2003. Tourism in Latin America and the Caribbean grew as a result of devaluations of their currencies (especially vis-à-vis the euro), a reorientation of tourists from the United States to destinations seen as closer and safer, and the recovery of intraregional tourism. Intraregional travel has also been important in the Middle East (including Egypt), where arrivals expanded by 10 per cent.

### 2. Commodity prices on the rise, mainly driven by expanding demand in China

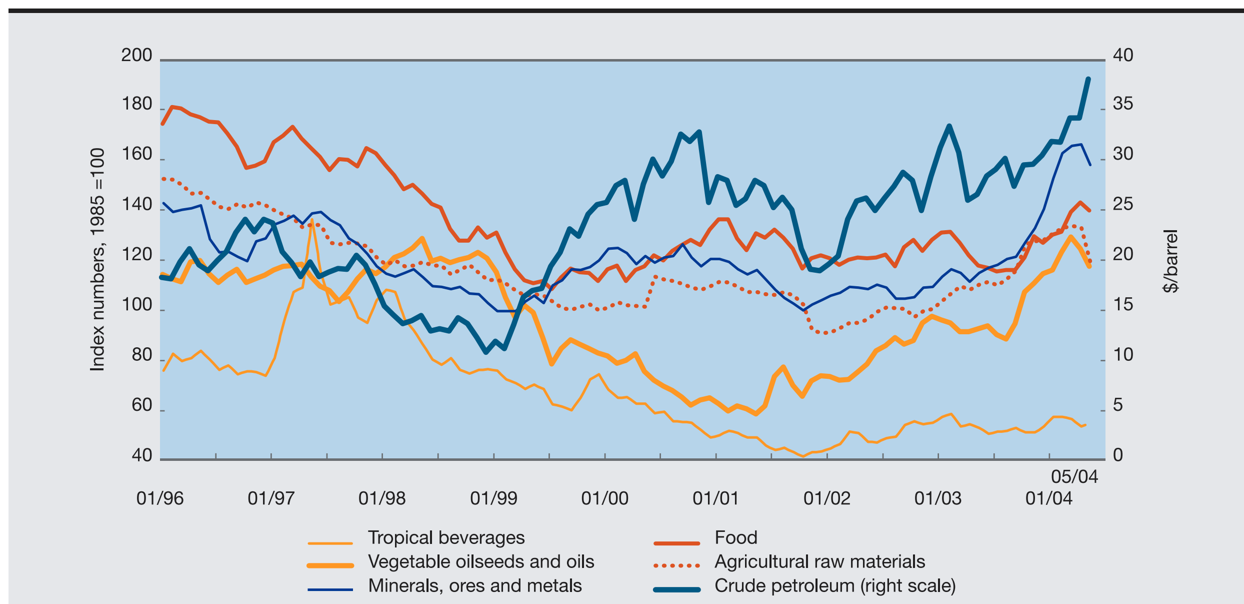
After a long period of decline, commodity prices in current dollar terms have been on the rise since 2002, and for some commodity groups they are approaching their levels of the previous peaks of 1996–1997. Prices have been increasing consistently for all commodity groups, the largest increases being in vegetable oilseeds and oils, agricultural raw materials and minerals, ores and metals groups (table 2.2). Price increases of food and tropical beverages were only very modest (fig. 2.3). For coffee and cotton, price increases have brought some relief to producers in developing countries that have been faced with a critical situation in recent years. However, for some other commodities, such as bananas, producers continue to suffer the negative consequences of an oversupplied market.

In general, recent commodity price increases can be explained by higher demand stemming from global economic recovery and, particularly from the rapidly expanding economic activity in Asian countries, especially China. In addition, supply has adjusted fairly slowly to the increased demand as a result of cutbacks in production that followed previous long-lasting price declines. However, there are some additional factors that may introduce a nuance to the classical supply-and-demand interpretation of a commodity price hike. While a cyclical commodity price upswing is undeniable, a closer look reveals that commodity price increases are not impressive enough to warrant alluding to a commodity boom or a bull market.

Along with commodity price indices, the unit value indices (in dollars) of manufactured goods exported by developed countries also increased by over 9 per cent in 2003 (UN/DESA, 2004). This implies that overall commodity terms of trade did not actually improve, and for some commodity groups they may even have considerably worsened. Likewise, it is important to take into account the impact of the depreciation of the United States dollar. As international commodity prices are usually quoted in that currency, movements in the dollar exchange rate are reflected in these prices.

***Figure 2.3***

**COMMODITY PRICE INDICES BY COMMODITY GROUP, AND CRUDE PETROLEUM PRICE,[a] 1996–2004**




***Source:*** UNCTAD, *Commodity Price Bulletin*, various issues.

***a*** Crude petroleum, average of Dubai/Brent/Texas equally weighted ($/barrel).

Typically, commodity prices move in the opposite direction to the dollar exchange rate. A depreciating dollar means that commodity prices rose much less or fell in terms of other major currencies. As a result, demand for commodities in consuming countries whose currencies are not pegged to the dollar has not fallen with the higher dollar prices, and might even have increased. For many large consumers, the surge in commodity prices has been matched by the sharp depreciation of the dollar in recent years. While the UNCTAD Combined Commodity Price Index in terms of current dollars increased by over 8 per cent in 2003, in terms of Special Drawing Rights (SDRs) it decreased by 1.3 per cent (fig. 2.4). Similarly, IMF (2004c) estimates of non-fuel primary commodity prices showed an increase of 7.1 per cent in terms of dollars in 2003, but a decline of 0.9 in terms of SDRs and of 10.6 per cent in euros.[2] Given these exchange rate movements, the export earnings of African commodity producers in the CFA zone have been negatively affected, as their currencies are pegged to the appreciating euro.

Additionally, the weak dollar, together with the low global interest rates, lifted international investors' demand for commodities. They have been more attracted by expectations of the higher returns that commodities could provide in comparison to other assets. Although this form of speculative investment normally focuses on precious metals, this time it has augmented demand for other metals as well, and even for some soft commodities. The role of these investment funds has thus added to the already considerable volatility of commodity markets, and it may negatively affect the prices of raw materials if international interest rates return to more normal levels. In fact, the upward trend in commodity prices seems to have stopped or even reversed in the second quarter of 2004, which may be partly the result of increasing expectations of higher interest rates. However, in the first half of 2004, commodity price indices remained significantly higher than in the same period of the previous year.

Once account is taken of the above-mentioned factors, which do not directly relate to

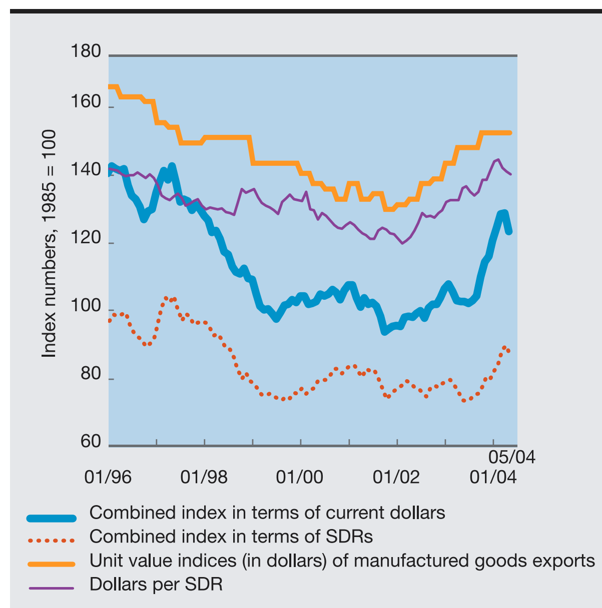
commodity supply-and-demand fundamentals, the major structural factor that has been pushing up world commodity prices in 2003 is the increasing demand from China. The continued rapid growth of the Chinese economy has necessitated increasing amounts of commodity inputs to meet its industrialization and development requirements. Consequently, in recent years, China has become the world's largest consumer of many commodities and, as Chinese production cannot cope with the pace of demand, it has also become an essential importer. Table 2.3 shows the magnitude of Chinese consumption growth in comparison with global consumption and with consumption growth in other countries for certain commodities. At the same time, as China is also the largest producer and major exporter of several commodities, it has become a key country in international commodity markets, with a critical influence on price levels.

Chinese upward pressure on prices is particularly important in agricultural raw materials and metals and minerals, but it has also been strongly felt in vegetable oilseeds and oils. In the case of soybeans, China's imports more than doubled at a time when they actually declined in the rest of the world. Since China accounts for more than one third of global soybean imports, this could explain why total world imports of soybeans registered an increase of nearly 17 per cent (United States Department of Agriculture, 2004). The increasing importance of China in the global market is partly a reflection of the changing food consumption patterns in the country, including the increased use of soybean residuals as animal feed for meat production. Booming Chinese soybean demand in 2003, combined with reduced production in the United States as a result of negative weather conditions and decreasing stocks, stimulated the agricultural sector in many South American countries, particularly in Argentina, Bolivia, Brazil and Paraguay.

In the raw materials sector, cotton and rubber are outstanding examples of the Chinese effect on demand and prices. Problems in the cotton market, in particular the negative effects of agricultural subsidies in developed countries on prices, have been high on the international agenda; four African cotton-producing countries (Benin, Burkina Faso, Chad and Mali) highlighted this issue at the WTO trade talks in Cancun in September 2003.

***Figure 2.4***

**COMMODITY PRICE INDICES,[a] UNIT VALUE INDICES OF DEVELOPED-COUNTRY MANUFACTURED EXPORTS AND EXCHANGE RATE, 1996–2004**




***Source:*** UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; and United Nations Statistics Division, *Monthly Bulletin of Statistics*, various issues.

***a*** In dollars and SDRs.

However, cotton prices rose considerably in 2003, thanks to increased global demand resulting from the previously low prices relative to competing fibres and to the dynamism of the Chinese textile industry that has encouraged a rapid increase in cotton mill consumption. Even though China is the largest cotton producer, it has had to import raw cotton in the last two years owing to the depletion of its own stocks due to poor weather conditions. China's raw cotton consumption in the 2002–2003 season increased by more than 12 per cent, representing over 30 per cent of total consumption, while demand from the rest of the world stagnated. Thus, thanks mainly to China's imports, global cotton imports grew by nearly 5 per cent, even though imports in other countries fell. Cotton import demand in China in the 2003–2004 season is expected to be about one fifth of world imports, up from only 1.6 per cent in 2001–2002 (International Cotton Advisory Committee, 2004).

**Table 2.3**

**GROWTH IN THE CONSUMPTION OF SELECTED PRIMARY COMMODITIES IN 2003: CHINA AND THE REST OF THE WORLD**

*(Percentage)*

| | *Consumption growth* | | | *Contribution of China to global consumption growth* | *Share of China in global consumption* |
|---|---|---|---|---|---|
| | *China* | *Other countries* | *World* | | |
| Copper | 9.6 | 1.0 | 2.6 | 67.4 | 19.5 |
| Cotton | 12.3 | 0.3 | 3.7 | 93.5 | 30.5 |
| Natural rubber | 11.1 | 3.6 | 4.9 | 39.2 | 18.5 |
| Oil | 11.1 | 1.5 | 2.1 | 34.4 | 7.0 |
| Soybeans | 32.3 | 0.9 | 4.9 | 84.9 | 16.3 |

***Source:*** UNCTAD secretariat calculations, based on United States Department of Agriculture (USDA), *Oilseeds: World Markets and Trade*, April 2004; International Cotton Advisory Committee (ICAC), *La volatilité des prix sur le marché mondial du cotton*, 2004; International Rubber Study Group, 2004; International Copper Study Group, *Copper Bulletin*, 2004; and International Energy Agency, *Oil Market Report*, May 2004.

In the case of rubber, growing demand in China, the world's leading consumer country for this commodity (owing to the rapid expansion of the automotive industry) has driven up rubber prices. In 2003, China's natural rubber consumption grew by over 11 per cent, compared to the nearly 5 per cent increase at the global level, and represented 18.5 per cent of global consumption (table 2.3). China currently produces only about one third of its total annual consumption.

Similarly, the booming manufacturing and construction sectors in China have pushed up demand for metals and minerals, resulting in price peaks for some of them such as copper, iron ore and nickel, mostly driven by strong stainless steel consumption and production. In the case of copper, Chinese imports of refined copper have doubled in the past three years, accounting for more than 17 per cent of world imports in 2002. For the near future, even though there are some concerns about overheating of the Chinese economy, leading to capacity bottlenecks and the possibility of growth slowing down, Asian demand for commodities is expected to remain firm, with China playing the leading role followed, in time, by India. In fact, measures announced by the Chinese Government to prevent overheating of the economy may be an additional factor explaining the weakening in the upward trend in commodity prices during the second quarter of 2004. A side-effect of China's high demand for commodities was found in the freight market, where prices exploded partly because of lack of ships, inefficiencies in Chinese ports and high oil prices.

The economic boom in China is also highly energy intensive; the resulting strong demand is therefore playing a fairly decisive role in global markets (particularly for coal and oil). Unlike other commodities, for coal the impact on the global market arises mainly on the export side. As both the largest producer and consumer of coal in the world, China can reasonably satisfy most of its own coal needs. However, strong coal consumption in the domestic market has been reducing the amount of coal available for export, thereby pushing up world coal prices. In the oil sector, the weight of oil in the fuel-energy mix in China is relatively limited due to the importance of coal and the comparatively low use of road transportation and individual automobiles. As a consequence, China's share in world oil demand is fairly low, accounting for only 7 per cent of total demand

(table 2.3). Nevertheless, China's growth in demand for oil has doubled in the last decade, which is one of the main reasons for the current tight oil markets. As a result of escalating industry needs and increasing automobile use, China has overtaken Japan to become the second largest oil-consuming country in the world. With net oil imports increasing by 33.4 per cent in 2003, China was responsible for over one third of the growth of global oil demand (IEA, various).

Crude petroleum prices have been growing steadily since May 2003 and during the first half of 2004, reaching, in nominal terms, a record level since the beginning of the 1990s. Apart from growing demand, prompted by China and by the global economic recovery, the oil market is vulnerable to uncertainties surrounding the possibility of supply disruptions, even though the market is not in a structural deficit position and supply could be expanded. One major reason for the tightness is geopolitical tensions in the Middle East, and particularly in Iraq. Although in other important producers, like Nigeria and Venezuela, oil production has recovered after serious cuts in early 2003 due to internal conflicts, these precedents have added to uncertainty in oil markets. In addition, the low level of oil reserves in consuming countries, mainly in the United States, combined with a cold winter and the actions of speculators, increased the pressure on the demand side. Last, but not least, OPEC tried to prevent a decline in prices, even though it increased its production in order to compensate for the reduction or suspension of exports from Iraq, Nigeria and Venezuela in the first half of 2003. This policy of high prices is mainly favouring the production and exports of non-OPEC oil-producing countries, such as the Russian Federation, where oil production is more costly.

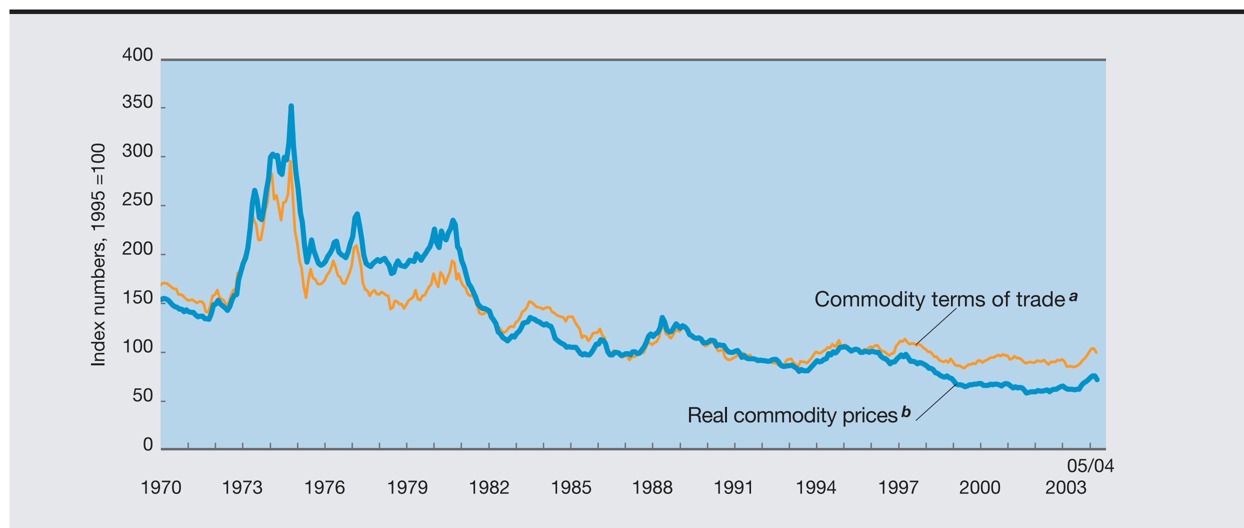
Once again, the depreciation of the dollar has had a major influence on oil prices, as OPEC calculates in dollars but has to take into account the increasing costs of its imports from the non-dollar areas. At the beginning of 2004, OPEC was keeping prices in the upper part of the $22–$28/barrel band established in 2000, and even exceeding it. For the second quarter of 2004, it announced a reduction in quotas based on expectations of oversupply in a season of relatively low demand (a previous reduction came into effect in November 2003). However, considering that prices were much higher than expected in the second quarter of 2004, a formal increase of OPEC production was decided in June 2004, effective as of 1 July (two million barrels/day) and 1 August (a supplementary 500,000 barrels/day). It is important to note that OPEC as a whole has been producing above its official target in recent months.

The sustained increase in oil price has raised concerns worldwide about the negative repercussions this may have on global economic recovery.[3] Particularly hard hit are the many developing countries that are highly dependent on oil imports and normally more energy-intensive than developed countries. On the other hand, for oil producers it means higher real income, which can create growing demand for exports from the rest of the world. So far, the dangers stemming from higher oil prices should not be overestimated as long as higher import prices in developed countries do not translate into accelerating inflation and restrictive actions of the major central banks.

Despite the recent commodity price increases described above, viewed over a longer term perspective, and in real terms, they still remain at very low levels and considerably below their levels of the 1970s and early 1980s. This is the case for commodity producers in developing countries as well as for commodity consumers in the developed economies. From the point of view of commodity producers, the result of deflating commodity prices by the unit value indices of manufacturing exports of developed countries (in dollar terms) is usually considered as an approximation of commodity terms of trade. Figure 2.5 shows that the commodity terms of trade have continued their deteriorating trend in the long term. On the other hand, from the point of view of commodity consumers, it confirms that the real value of commodities obtained by deflating their prices with the consumer price index (CPI) of developed countries (using the CPI of the United States as a proxy) is now significantly lower than that of a quarter of a century ago. A clear example is that of oil: the recent dramatic increases in oil prices have provoked much debate, particularly as they reached record levels in current dollar terms. Figure 2.6 shows that in real terms, the oil price for consumers in developed countries is still relatively low compared to the levels recorded at the time of previous sharp oil price hikes in the 1970s.

**Figure 2.5**

**COMMODITY TERMS OF TRADE AND REAL COMMODITY PRICES, EXCLUDING PETROLEUM, 1970–2004**



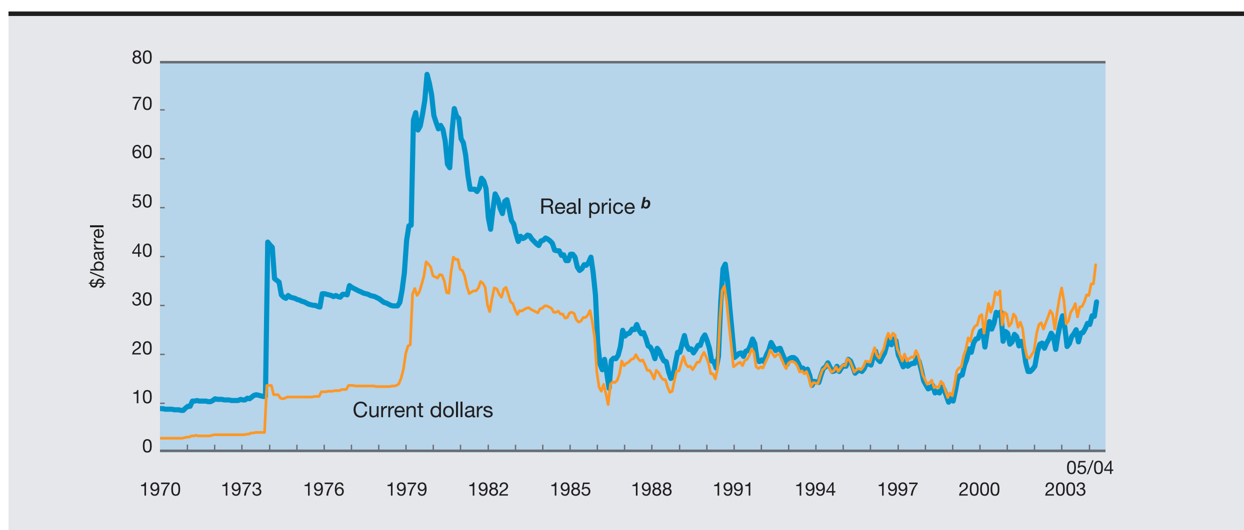

***Source:*** UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; United Nations Statistics Division, *Monthly Bulletin of Statistics,* various issues; and IMF, *International Financial Statistics* database.

***a*** Combined index of commodity prices in terms of current dollars deflated by unit value indices of manufactured goods exports of developed countries.

***b*** Combined index of commodity prices in terms of current dollars deflated by United States CPI.

**Figure 2.6**

**CRUDE PETROLEUM PRICES,[a] NOMINAL AND REAL, 1970–2004**




***Source:*** UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; and IMF, *International Financial Statistics* database.

***a*** Crude petroleum, average of Dubai/Brent/Texas equally weighted ($/barrel).

***b*** Deflated by United States CPI (1995 = 100).

***Table 2.4***

**EXPORT VOLUME, PURCHASING POWER OF EXPORTS AND TERMS OF TRADE OF DEVELOPING COUNTRIES, 1980–2003**

*(Average annual percentage change)*

| | *1980–2003* | *1980–1985* | *1986–1990* | *1991–1995* | *1996–2003* |
|---|---|---|---|---|---|
| All developing countries | | | | | |
| Volume indices of exports | 10.1 | 2.1 | 16.6 | 14.7 | 5.3 |
| Terms of trade | -1.3 | -3.9 | -0.7 | 0.3 | 0.5 |
| Purchasing power of exports[a] | 8.7 | -2.2 | 15.9 | 15.2 | 5.9 |
| Non-oil exporters | | | | | |
| Volume indices of exports | 11.9 | 8.3 | 18.4 | 16.5 | 6.6 |
| Terms of trade | -0.5 | -2.8 | -0.8 | 0.9 | -0.7 |
| Purchasing power of exports[a] | 11.3 | 4.7 | 16.7 | 17.5 | 5.8 |
| Major exporters of manufactures | | | | | |
| Volume indices of exports | 13.7 | 10.3 | 21.1 | 18.6 | 7.3 |
| Terms of trade | -0.2 | -1.5 | 0.6 | 0.5 | -1.2 |
| Purchasing power of exports[a] | 13.5 | 9.8 | 22.0 | 19.3 | 6.1 |

***Source:*** UNCTAD, *Handbook of Statistics*, various issues; and table 2.1.
***a*** The value index of exports deflated by the import unit value index.

Developing countries as a whole experienced a deterioration in their terms of trade between 1980 and 2003, by an average rate of 1.3 per cent per annum (table 2.4). Consequently, although their export volumes rose strongly, the purchasing power of those exports increased much less. The sharpest decline in the terms of trade occurred in the first half of the 1980s which, combined with very slow growth in export volumes, implied a fall in the purchasing power of exports during this period. In the subsequent periods between 1986 and 2003, the terms of trade stabilized, and hence the volume and purchasing power of exports rose broadly in parallel.

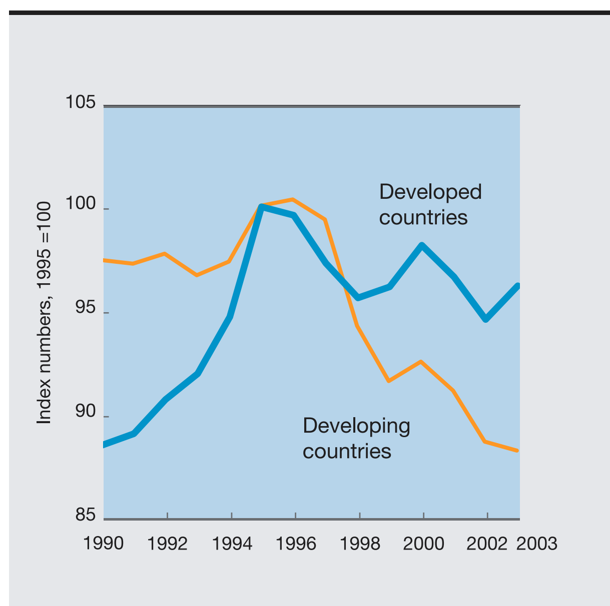
If the major oil-exporting countries are excluded, the decline in the terms of trade between 1980 and 2003, on average, has been smaller. But as with the group of developing countries as a whole, the terms of trade of the non-oil exporters declined for all the sub-periods shown in the table except for the first half of the 1990s. Consequently, the growth in the purchasing power of exports has almost constantly been below that of export volumes. Nevertheless, as discussed above, world market prices for a number of commodities have been increasing over the past two years.

In this context, the report of the meeting of eminent persons on the impact of commodity problems on the development of commodity-dependent countries, organized by UNCTAD in 2003, offers a wide range of actions that can improve conditions in commodity markets (UNCTAD, 2003). A particularly important action would be diversification into those products for which global market demand is likely to remain strong for a number of years.

The decline in the terms of trade during the period 1996–2003 was strongest for those developing countries for which manufactures have been

***Figure 2.7***

**PRICES OF UNITED STATES IMPORTS OF MANUFACTURES, BY ORIGIN, 1990–2003**




***Source:*** UNCTAD secretariat calculations, based on United States Bureau of Labor Statistics database.

the main source of export earnings. This indicates that the manufactures exported by developing countries may have acquired features in world markets that had traditionally been associated with primary commodities, namely a secular downward trend in the terms of trade and the dilemma of fallacy of composition (*TDR 2002*, chapter IV). Indeed, looking at the evolution of the level of index numbers for major exporters of manufactures over the entire sample period, it was highest in terms of export volumes and lowest for the terms of trade in the most recent years of the sample period (i.e. between 2000 and 2003). The evolution of the price index of United States' imports of manufactures also shows a strong and positive correlation between the evolution of prices and the level of per capita income of exporting countries. Moreover, it shows that, compared to imports from developed countries, the decline in prices of United States imports from developing countries has been strong over the past five years, and that prices are now at their lowest level since 1990 (fig. 2.7)

Summing up, the decline in the terms of trade continues to be a problem for exporters of primary commodities, even though sustained import demand from China may prolong the recent price increase for some commodities. But it appears that it is increasingly becoming a problem for developing-country exporters of manufactures as well. Indeed, as discussed in *TDR 2002* (chapter IV, section B), evidence shows that the degree of deterioration in the terms of trade for developing countries' manufactures vis-à-vis those of developed countries reflects the level of technology embodied in their manufactured exports.

## B. Capital flows and finance

### 1. *Capital flows from developing to developed countries*

Since 1999, developing and transition economies have experienced sizeable and growing surpluses in the current account of their balance of payments. This is primarily the result of persistent surpluses in their trade of goods and services ($240 billion in 2003) and rising current transfers ($90 billion in 2003, almost twice their 1999 value), while the deficit in net income payments ($122 billion in 2003) increased at a slower pace due to declining international interest rates. As a counterpart to their current account surplus, they recorded a net export of capital of more than $200 billion to the rest of the world in 2003. Thus they further increased their net export of capital to developed countries by 45 per cent from the already high level of 2002 (table 2.5).

East Asia and West Asia continued to have the highest current account surpluses, and some large Latin American countries also registered surpluses. Transition economies as a group had a moderate surplus, though this was concentrated in the members of the Commonwealth of Independent States (CIS), while EU acceding countries continued to receive net capital inflows to finance their current account deficit of $32 billion (IMF, 2004c).

Despite this large overall net capital outflow from the developing to the developed countries, the fact that there was an increase in "net *private* capital flows" to developing countries, from $13 billion in 2002 to $83 billion in 2003 (table 2.5) was interpreted by many international observers as a positive sign for the developing countries' growth prospects. The World Bank, for example, suggested that "this increase in private capital inflows offers significant opportunities for developing countries to invest in infrastructure and facilitate trade finance to foster a self-reinforcing cycle of sustained capital flows, economic growth and poverty reduction." (World Bank, 2004)

Since the net private capital inflows (in bonds, equities and other capital flows) into developing countries were more than offset by their net accumulation of foreign currency reserves – resulting in total net outflows of $200 billion – this interpretation is misleading. In order to properly assess the role of overall capital flows to developing countries, outflows in terms of rising reserves have to be taken into account. For example, a large proportion of the private gross capital inflows into China has been attracted by expectations of a revaluation of the Chinese currency, despite low interest rates in China. These inflows have, to a large extent, been bought up by the Chinese central bank and invested, at higher interest rates, in United States Treasury bonds, thereby financing the United States budget deficit, but not real investment within China.

But the accumulation of reserves not only puts the figure for net private capital flows in perspective, it also hints at the fact that many national policy-makers were concerned that the

*Table 2.5*

**NET CAPITAL FLOWS AND THE CURRENT ACCOUNT: DEVELOPING AND TRANSITION ECONOMIES, 1996–2003**

*(Billions of dollars)*

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **Developing economies** | | | | | | | | |
| Private capital flows | 200.1 | 139.5 | 45.6 | 59.7 | 23.9 | 27.3 | 12.9 | 82.9 |
| Private direct investment | 100.7 | 126.5 | 129.7 | 145.6 | 149.7 | 161.4 | 112.0 | 102.5 |
| Private portfolio investment | 83.8 | 39.8 | 33.1 | 64.7 | 8.5 | -86.3 | -91.1 | -78.1 |
| Other private capital flows[a] | 15.6 | -26.8 | -117.3 | -150.5 | -134.4 | -47.9 | -8.0 | 58.3 |
| Official flows | -16.0 | 42.6 | 36.8 | 8.3 | -13.8 | 23.0 | 11.6 | 2.7 |
| Change in reserves[b] | -86.0 | -90.2 | -32.5 | -79.7 | -96.6 | -108.3 | -170.6 | -320.9 |
| Current account balance | -79.4 | -51.8 | -23.5 | 43.6 | 114.3 | 70.3 | 136.2 | 199.5 |
| **Africa** | | | | | | | | |
| Private capital flows | 9.1 | 4.0 | 9.1 | 11.8 | 1.1 | 6.5 | 7.2 | 9.5 |
| Private direct investment | 3.6 | 7.9 | 6.9 | 9.8 | 8.2 | 23.9 | 12.3 | 14.3 |
| Private portfolio investment | 2.8 | 7.0 | 3.7 | 8.3 | -2.2 | -8.8 | -0.7 | 1.8 |
| Other private capital flows[a] | 2.7 | -10.9 | -1.6 | -6.3 | -4.9 | -8.5 | -4.4 | -6.6 |
| Official flows | -3.0 | 3.3 | 4.7 | 3.5 | 3.1 | 1.9 | 4.2 | 4.1 |
| Change in reserves[b] | -6.7 | -11.2 | 2.7 | -3.4 | -13.2 | -12.5 | -7.6 | -14.4 |
| Current account balance | -5.5 | -6.5 | -19.5 | -15.9 | 5.4 | -1.5 | -7.4 | -3.9 |
| ***Sub-Saharan Africa*** | | | | | | | | |
| Private capital flows | 6.9 | 0.7 | 8.1 | 10.3 | 1.5 | 3.5 | 6.1 | 7.6 |
| Official flows | -2.7 | 4.4 | 5.2 | 4.0 | 4.0 | 3.0 | 5.6 | 5.3 |
| Change in reserves[b] | -4.0 | -6.2 | 1.6 | -3.8 | -6.5 | -2.4 | -3.2 | -5.7 |
| Current account balance | -6.3 | -9.3 | -17.8 | -15.3 | -2.5 | -9.3 | -12.5 | -12.0 |
| **East and South Asia** | | | | | | | | |
| Private capital flows | 118.6 | 34.0 | -50.6 | 2.7 | -4.2 | 10.1 | 24.8 | 84.3 |
| Private direct investment | 53.4 | 56.5 | 56.1 | 66.4 | 67.4 | 60.5 | 53.1 | 49.3 |
| Private portfolio investment | 32.0 | 6.3 | 8.4 | 56.6 | 20.1 | -54.4 | -57.6 | -58.4 |
| Other private capital flows[a] | 33.1 | -28.8 | -115.0 | -120.2 | -91.7 | 4.0 | 29.3 | 93.4 |
| Official flows | -13.2 | 25.2 | 17.5 | 1.8 | 4.0 | -2.0 | -1.9 | -8.6 |
| Change in reserves[b] | -46.1 | -35.9 | -52.6 | -87.1 | -60.8 | -90.7 | -157.8 | -245.3 |
| Current account balance | -40.8 | 15.3 | 113.8 | 106.5 | 86.8 | 90.1 | 131.7 | 148.3 |
| ***China and India*** | | | | | | | | |
| Private capital flows | 48.4 | 37.9 | -4.6 | 10.3 | 13.8 | 43.0 | 44.7 | 101.8 |
| Official flows | 2.3 | 1.5 | 5.6 | 7.0 | -0.5 | 0.9 | 2.4 | 5.7 |
| Change in reserves[b] | -34.4 | -40.5 | -9.1 | -14.6 | -16.6 | -56.0 | -94.3 | -148.6 |
| Current account balance | 1.2 | 33.9 | 24.6 | 12.4 | 15.4 | 16.7 | 40.2 | 32.6 |
| ***First-tier NIEs*** | | | | | | | | |
| Private capital flows | 11.5 | -14.8 | -23.5 | 18.5 | 10.1 | -16.2 | -10.1 | -10.9 |
| Official flows | -11.3 | 11.2 | -3.6 | -19.9 | -6.9 | -7.8 | -7.4 | -13.7 |
| Change in reserves[b] | -8.8 | -7.6 | -31.9 | -55.9 | -43.1 | -28.8 | -44.4 | -75.9 |
| Current account balance | -2.2 | 6.1 | 64.9 | 58.4 | 41.4 | 52.0 | 63.6 | 86.5 |
| **West Asia[c]** | | | | | | | | |
| Private capital flows | 2.0 | 9.6 | 8.4 | -7.9 | -24.9 | -16.3 | -27.6 | -22.9 |
| Private direct investment | 4.1 | 5.2 | 5.1 | 3.9 | 7.7 | 8.1 | 6.9 | 8.9 |
| Private portfolio investment | 1.0 | -2.7 | -6.2 | -4.5 | -12.3 | -15.8 | -19.0 | -24.3 |
| Other private capital flows[a] | -3.1 | 7.2 | 9.5 | -7.3 | -20.4 | -8.6 | -15.4 | -7.4 |
| Official flows | 7.4 | 6.7 | 5.2 | 6.6 | -11.0 | -3.2 | -5.4 | -11.0 |
| Change in reserves[b] | -18.0 | -16.6 | 10.3 | -0.2 | -27.4 | -10.6 | -3.1 | -25.6 |
| Current account balance | 6.0 | 6.3 | -26.6 | 10.0 | 68.9 | 36.3 | 27.6 | 51.5 |

/...

**Table 2.5 (concluded)**

**NET CAPITAL FLOWS AND THE CURRENT ACCOUNT: DEVELOPING AND TRANSITION ECONOMIES, 1996–2003**

*(Billions of dollars)*

| | *1996* | *1997* | *1998* | *1999* | *2000* | *2001* | *2002* | *2003* |
|---|---|---|---|---|---|---|---|---|
| **Latin America and the Caribbean** | | | | | | | | |
| Private capital flows | 70.4 | 91.9 | 78.6 | 53.2 | 51.9 | 26.9 | 8.5 | 11.8 |
| Private direct investment | 39.6 | 56.9 | 61.5 | 65.5 | 66.4 | 68.9 | 39.6 | 30.0 |
| Private portfolio investment | 47.9 | 29.2 | 27.2 | 4.4 | 2.9 | -7.2 | -13.7 | 2.9 |
| Other private capital flows[a] | -17.1 | 5.8 | -10.1 | -16.6 | -17.4 | -34.7 | -17.4 | -21.1 |
| Official flows | -7.2 | 7.3 | 9.5 | -3.4 | -9.9 | 26.3 | 14.6 | 18.2 |
| Change in reserves[b] | -15.2 | -26.5 | 7.2 | 11.1 | 4.8 | 5.4 | -2.0 | -35.5 |
| Current account balance | -39.1 | -66.8 | -91.2 | -57.0 | -47.0 | -54.5 | -15.8 | 3.8 |
| **Transition economies** | | | | | | | | |
| Private capital flows | 17.7 | 38.1 | 31.8 | 26.9 | 18.3 | -6.7 | 34.1 | 48.3 |
| Private direct investment | 15.3 | 17.5 | 23.3 | 25.6 | 25.3 | 27.7 | 27.3 | 16.8 |
| Private portfolio investment | 1.2 | 23.0 | 5.3 | 1.3 | -2.4 | -9.4 | -7.5 | -9.4 |
| Other private capital flows[a] | 1.2 | -2.4 | 3.3 | -0.1 | -4.6 | -24.9 | 14.3 | 41.0 |
| Official flows | 10.9 | 5.7 | 10.5 | -1.9 | -0.7 | 2.8 | -8.3 | -9.9 |
| Change in reserves[b] | -5.2 | -13.9 | -2.1 | -13.0 | -20.3 | -5.2 | -25.4 | -43.0 |
| Current account balance | -16.0 | -29.0 | -27.9 | -4.8 | 14.6 | 17.8 | 9.6 | 7.8 |

***Source:*** UNCTAD secretariat calculations, based on IMF, *World Economic Outlook*, April 2004.

***Note:*** It should be noted that IMF data underlying this table have been substantially revised in 2004. On the basis of IMF data published in spring 2003, the net private capital inflow to developing countries in the United Nations definition amounted to $51.8 billion in 2002. The difference is due in part to the new inclusion of Hong Kong (China) in the aggregate data for 2004, in part by substantial revision of the figure for portfolio investment for other East Asian countries.

***a*** "Other private capital flows" comprises other long- and short-term net investment flows, including private borrowing and residuals not covered under other items; due to limitations in data coverage such residuals may also include some net official flows.

***b*** A minus sign in the lines for change in reserves indicates an increase.

***c*** Including Israel and Egypt, excluding Turkey.

effects of such inflows on the exchange rate would destabilize their economies. This concern is reflected in the decision of some developing countries' monetary authorities to purchase foreign currency to prevent the inflows from triggering an appreciation of their national currencies, as this would have hurt their competitiveness in world markets. Furthermore, private capital is not going primarily to countries that are in need of financing for infrastructure development; rather, it is going mainly to those countries that, at present, do not need foreign capital to finance investment, e.g. China – which has lately shown that as much as 40 per cent of its GDP can be used to finance investment without having to depend on outside capital. In these countries, the national authorities' problem is not a lack of investment, but an excess of it, leading to an overheating of the economy.

## 2. *Regional developments*

Changes in net capital flows, including the accumulation of foreign reserves, have differed markedly across regions and countries. In 2003, both the amount of private capital inflows to developing economies and the increase of those flows were concentrated in a few regions and countries. East and South Asia, especially China

and India, were the main recipients of net private capital flows to developing economies, accounting for almost all the increase in such flows (table 2.5). Developing Asia and the newly industrializing Asian economies continued to increase their large external surpluses, from $132 billion to $148 billion, due to their favourably competitive position and a pick-up of growth in the United States. Moreover, the main component of the increase in net private capital flows into this region was not foreign direct investment (FDI), which actually fell slightly, but "other private capital flows", which include credit and short-term capital flows. A significant proportion of this increase, however, consisted of speculative investment, based on expectations of a revaluation of the regional currencies. Consequently, governments in the region absorbed a large share of these inflows to prevent a real appreciation of their currencies and a loss of competitiveness.

Recent currency depreciations in many Latin American countries have enabled those countries to increase their competitive position, thus reducing their reliance on external capital to finance their development. The region managed to stage a modest economic recovery in 2003, while at the same time turning the current account from a deficit of $15.8 billion into a surplus of $3.8 billion (table 2.5) – the first surplus in decades. Much of this was the result of external surpluses in Argentina, Brazil and Venezuela, while countries such as Chile, Ecuador and Mexico reduced their current account deficits. However, even if this recovery increases the room for manoeuvre in policy-making, many of these countries still have to resort to international financial markets for refinancing or restructuring the payments of the principal of their external debt. As a result, they are still exposed to the risk of a tightening of the conditions governing access to those markets, even if those operations do not involve net capital movements.

In Brazil and Argentina, the nominal devaluations in 1999 and 2002 contributed to major improvements in competitiveness. Inflationary pressures have been kept in check by low levels of domestic demand in Brazil and by substantial excess capacity in Argentina. Manufacturing exports have picked up, while the improved competitiveness of domestic firms has promoted import substitution. In Venezuela, high oil prices and low domestic demand led to another year of a huge current account surplus in 2003.

Argentina's improved competitive position allowed the country to stage a strong economic recovery, with an annual GDP growth rate of almost 9 per cent, without running into new current account deficits. This performance is all the more remarkable since many economists had warned that the current lack of access to global capital markets, due to pending negotiations on restructuring the country's foreign debt, would seriously hinder growth prospects. In fact, the only relevant gross capital inflows were debt arrears from the public and private sectors ($10.6 and $2 billion respectively), while the Government made net payments on non-defaulted debt and the private sector continued to export capital, albeit to a much lesser extent than in 2001 and 2002. Approximately half of the $8 billion current account surplus was used to accumulate international reserves, following the national authorities' goal of maintaining the real exchange rate at a competitive level and reducing the economy's vulnerability to external shocks (INDEC, 2004).

The situation in Brazil has not been quite as positive. The positive effects of the devaluation on exports, combined with the negative impact of slow economic growth on imports, led to a current account surplus of $4 billion. FDI fell sharply in 2002 and 2003, and short-term private capital flows displayed high volatility, with successive phases of net outflows and inflows since mid-2002. During much of 2003, there was an accumulation of international reserves through financing by the IMF and by short-term private capital inflows that were attracted by high interest rates. In response, the Government, in an attempt to avoid appreciation of the exchange rate, recycled the capital to the United States at very low yields; at the same time it had to pay the difference between the low United States yield and the high interest on the public debt issued in order to sterilize the monetary effects of accumulated reserves.

In Venezuela, the Government introduced strict exchange controls so as to restrain the massive capital outflows from the private sector, which totalled almost $10 billion per year in 2001 and 2002

(Banco Central de Venezuela, 2004). At the same time, it re-established a fixed exchange rate regime. As a result, the external surplus, fuelled by high oil revenues, led to a rapid accumulation of international reserves.

In Africa, the reduction of the current account deficit has been due to rising prices in commodity markets – especially oil – rather than the result of improved competitiveness. Modest GDP growth, compared to other regions, meant that imports grew slower than exports. The current account deficit for Africa as a whole therefore narrowed, from $7.4 billion to $3.9 billion. For sub-Saharan Africa, the current account deficit fell only slightly (table 2.5). Capital inflows, both official and private, thus remained almost stagnant, at a low level. The most important capital inflow was FDI, much of which was concentrated, as in 2002, in the oil sector of relatively few countries (Algeria, Angola, Chad and Nigeria). In South Africa, where short-term inflows were attracted by high domestic interest rates, the Government and central bank opted for intervention in the currency market, in order to restrain the appreciation of the rand due to the inflow of hot money.

In the Russian Federation and the transition economies of Central and Eastern Europe, conditions continued to diverge markedly. Rising oil prices and export volumes in the Russian Federation increased the current account surplus by almost a third, to $39.5 billion, while the financing requirements of Central and Eastern Europe rose by almost half, to $31.7 billion (or 3.9 per cent of the region's GDP). Bosnia and Herzegovina, Croatia, The former Yugoslav Republic of Macedonia, Serbia and Montenegro, and the Baltic countries, in particular, had to rely heavily on foreign finance. Estonia's current account deficit rose to 13.7 per cent of GDP, thereby remaining above 10 per cent for the second year in a row. Some of the larger EU acceding countries also continued to experience large current account deficits, running at 5.5 per cent of GDP in Hungary and 6.5 per cent in the Czech Republic (IMF, 2004c).

As in the Russian Federation and parts of Africa, West Asian oil producers benefited from rising oil prices and accelerating global economic growth, which increased global oil demand and boosted that region's exports. As a group, these countries almost doubled their current account surplus, from $27.6 billion to $51.5 billion (table 2.5). Since the improvement in the balance-of-payments position in the region stemmed mainly from oil revenues, the largest oil exporters – Saudi Arabia, Kuwait, Qatar and the United Arab Emirates – recorded the biggest increases. As a result, there was a large net export of capital from the region.

### 3. Large build-up of reserves

Developing countries in all the regions have increased their reserve holdings by huge amounts. Their purchase of foreign currency reached a net value of $320.9 billion, with the largest purchases made by Asian countries. China bought $117.1 billion and India $31.7 billion. The Russian Federation came third with purchases of $27.2 billion, followed by Brazil with $11.5 billion and Malaysia with a little more than $10 billion. Turkey, Indonesia and Mexico also bought significant amounts (IMF, 2004a).

This unprecedented accumulation of reserves is part of an attempt by developing countries to adapt to the continuing volatility of private international capital flows. The most recent volatility in 2003 and 2004 has been partly due to increased speculation about a sharp devaluation of the dollar. Since 2002, confidence in the dollar among international investors has been faltering due to the persistently high current account deficit of the United States. As investors began shifting part of their portfolios from United States assets into assets of other – developed, developing or transition – economies, many currencies came under pressure to appreciate.

Monetary authorities in countries with a de facto or formal fixed exchange rate vis-à-vis the dollar were confronted with the decision to either sterilize the net inflows or to abandon their unilateral fixing of the exchange rate. Those countries that decided to maintain their fixed exchange rate regimes consequently accumulated substantial dollar reserves. The most widely debated case is that of China, which has been keeping its currency, the yuan (renminbi), within a narrow band of

around 8.28 yuan to the dollar after the 1994 devaluation. Here, investors' distaste for United States assets, amplified by their appetite for Chinese assets, led to an enormous increase in gross foreign private capital flows into China. Speculation of an imminent appreciation of the yuan further augmented the capital flows by adding a stream of "hot", speculative money. This prompted the Chinese central bank to buy large quantities of dollars to defend its currency peg. Malaysia and Hong Kong (China), which belong to the small group of economies in Asia that have a fixed exchange rate pegged to the dollar, also bought United States assets, mainly Treasury bonds, in large quantities (box 2.1).

But even a number of countries that do not have a formal currency peg felt obliged to intervene in the foreign-exchange market to prevent an excessive appreciation of their currency. Hardly any developing country today has a truly free-floating currency. Instead, most of them have attempted to dampen excessive volatility in their exchange rate on the one hand, and to keep their exchange rate at a rather competitive level, on the other. With the dollar depreciating, monetary authorities in all countries, with or without a formal exchange rate arrangement, have been in a similar position. True, "dirty floaters" have not felt as obliged to buy foreign reserves as the official "peggers", but, nevertheless, many of them have considered some form of intervention necessary to avoid being adversely affected by a currency appreciation.

During 2003, the Indian monetary authorities, for example, increased their foreign currency holdings by 46 per cent to prevent short-term speculative inflows from jeopardizing their economic policy goals. In Brazil, the central bank bought dollars in order to keep the real from excessive appreciation, because a loss of competitiveness would have hurt economic recovery in South America's largest economy. In the Russian Federation, the central bank saw in the strong rouble a threat to that part of the economy that is not oil dependent, and also bought dollars in large quantities.

The fear that excessive capital inflows could lead to an overvaluation of developing countries' currencies was not unfounded. Following stabilization policies in the early 1990s, many countries had experienced an overvaluation of their currencies that harmed domestic industries, hurt the international competitiveness of their export-oriented industries and diminished their ability to earn the foreign currency necessary to finance the imports needed for pursuing a balanced growth path. Keeping the exchange rates stable at a convenient level is seen as a strategy that gives them the long-term ability to finance imports of capital goods and consumer goods when faced with volatile capital flows.

The exchange rate stabilization strategy also reflects lessons drawn from the experiences of the currency crises in East and South-East Asia and Latin America, which painfully drew the attention of developing countries to the risks of an overvalued exchange rate and of an over-reliance on foreign capital to finance the resulting current account deficits. While the Asian crisis only hit countries that had some kind of fixed or rigid exchange rate, the capital flight from Brazil in the run-up to the Brazilian presidential elections in 2002 – that was controlled only with a large IMF loan package – has shown that even countries with a flexible exchange rate regime are not immune from currency and financial crises, as long as they depend on a constant inflow of foreign capital to finance their current account deficit or external debt repayments.

However, in some of the countries that have accumulated reserves over the past two years to prevent overvaluation, their unilateral attempts to cope with excessive capital inflows has led to problems in stabilizing the domestic economy. While most countries have succeeded, to a large extent, in sterilizing the inflows, China recently has had problems keeping an investment and credit boom under control. The boom was fuelled by the Government's expansionary policy combined with a liquidity increase resulting from capital inflows and consequent purchases of dollars.

Other countries have been faced with rising fiscal costs stemming from their attempts to sterilize the consequences of their immense purchases of reserves. As mentioned above, buying foreign reserves in the foreign exchange market leads to an increase in liquidity in the domestic money market. In order to reduce the liquidity, central

**Box 2.1**

## ASIA'S SAVINGS AND THE UNITED STATES' EXTERNAL DEFICIT

Given the large trade imbalance between the United States and Asia and the enormous accumulation of United States bonds by Asia's investors and central banks, it has been suggested that the fate of the United States economy is in the hands of Asian investors. According to this argument, if Asia were to stop financing that country's current account deficit, the results could be dramatic: the demand for United States bonds would collapse, the dollar would depreciate, interest rates would soar and the economy would suffer a slowdown. It is further contended that developing Asian countries such as China would then finally have the possibility to use the capital they had exported to the United States in recent years for investment and consumption at home. However, closer inspection shows that these arguments are disputable.

### *What would happen to Asia if it decided to no longer finance the United States' external deficit?*

At present, the United States imports more goods from Asia than it exports to the region. This is only possible because Asian investors (both private investors and central banks) are willing to purchase United States assets in exchange for the goods they export to that country. If this were to slow down, demand in the United States for Asian products would fall, and the price of United States assets relative to Asian assets (that is, the exchange rate of the dollar vis-à-vis the Asian currencies) would also decline. This would affect Asian exporters: their sales prices and volumes would come under pressure. Asian producers for the domestic market would also be hurt as imports into Asia would become relatively cheaper, leading to greater consumption of imported rather than domestically produced goods. Together, these two mechanisms would lead to a falling Asian surplus in its trade (and current account) balance with the United States, which would reflect a diminished net capital flow from Asia to the United States.

In the unlikely event that Asian investors decided to sell existing dollar assets and import American goods from the receipts, while not selling any of their products against fresh United States assets ("repatriating their savings"), the dollar would have to depreciate to an extent that would turn Asian current accounts into deficit. This would reverse the net capital flow from Asia to the United States. As this might imply a further dollar depreciation, the adverse effects on Asian firms would be dramatic.

Thus Asia cannot profit from a "repatriation" of its foreign capital investments. An appreciation of the major Asian currencies – yen, won or yuan – against the dollar would slow down export expansion and dampen profits and economic growth. Only if national economic policy managed to stimulate domestic demand by cutting interest rates, and thereby stabilizing overall monetary conditions, would the Asian countries be able to remain on their high and stable growth path. However, this might prove difficult, since interest rates are very low and a significant proportion of private investment in Asia, particularly in developing countries such as China, is in the export-oriented sector, which would be hurt by an appreciation of the local currency against the dollar. In Asia, if government policies failed to restructure their economies by replacing United States demand for their goods by domestic demand, the region's overall GDP growth would slow down, albeit not as much as its export growth. Moreover, there would be a "net inflow of capital" from the United States only if GDP in these Asian countries were to fall short of what is used up domestically for consumption and investment at the new exchange rate of their currencies to the dollar.

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**Box 2.1 (continued)**

***What would happen to the dollar if the Asian central banks stopped buying United States Treasury bonds?***

Recently, Asian countries have experienced large current account surpluses and large gross capital inflows from abroad. The central banks have kept their exchange rates constant by buying United States Treasury bonds, but they have also started to diversify their foreign-exchange reserve holdings. If they were to completely stop buying United States assets, and there were no private Asian investors willing to invest in United States assets, the effect would be much the same as described above: there would be a gap between the goods that United States consumers can buy and the goods and assets they can sell at the current exchange rate. Therefore, the only possible adjustment would be a depreciation of the dollar. Again, this would hurt Asian exporters and undermine economic growth in the region.

However, it is unclear how much the dollar in this case would really depreciate. A significant share of the gross private capital inflows into Asia at present is probably "hot money" from investors betting on an imminent appreciation. If the currencies actually did appreciate, this pressure could ease. This might be the case especially for China, whose former overall trade surplus dipped into deficit at the beginning of 2004.

***What would happen if Asian central banks diversified their dollar bonds into different assets?***

Risk considerations might induce Asian central banks to sell United States bonds and to buy other assets, such as European bonds. As long as private investors did not counteract this shift in investments, such a move would increase the demand for European assets at the expense of United States assets. If, at the same time, Asian central banks tried to prevent their own currencies from appreciating against the dollar, as they have done over most of the past two years, the only possible adjustment would be in the exchange rate of the euro. The euro would then appreciate against both the dollar and the Asian currencies, while the exchange rate of the dollar vis-à-vis Asian currencies would remain unaltered.

***Would a fall in the exchange rate of the dollar vis-à-vis Asian currencies hurt the United States?***

This question is not easy to answer. However, some theoretical considerations and historical experience suggest that the effects will be far from dramatic, and completely different from what developing countries experienced when their currencies depreciated sharply.

Since United States companies, governments (state and federal) and households are not highly indebted in yen or yuan, a fall in the value of the dollar would not increase their debt service. Consequently their net wealth would not decline and neither would their financing costs increase. Hence, the depreciation would not directly slow down the United States economy.

Further, there is no direct link between the willingness of foreigners to hold United States Treasury bonds and higher domestic interest rates in the United States. An appreciation of the Chinese cur-

.../...

**Box 2.1 (concluded)**

rency, for example, would significantly reduce investors' expectations of short-term gains, thus leading to a redirection of the flow of some of the short-term funds from China to the United States. This would compensate, at least in part, for the reduced holdings of United States Treasury bonds by foreign investors. Additionally, since investors in the United States usually hold a certain proportion of their gross wealth in foreign assets (denominated in foreign currency), their (net) dollar wealth would increase with the depreciation. This in turn would increase the demand for United States assets (both bonds and stocks). If the drop in demand for United States Treasury bonds from the foreign central banks were bigger than the increase in domestic demand for these bonds, the interest rate might rise. However, the additional demand for equities would put upward pressure on stock prices, thereby counteracting the negative effect of the rising bond yields on companies' investment plans.

Even more important, any interest rate movement as a reaction to a shift in foreign and household demand for United States bonds would be compensated by a shift in the portfolios of financial intermediaries and in the behaviour of the United States' central bank, the Federal Reserve. In the medium and long term, the price of bonds, and thus the long-term interest rate, is determined by the central bank's short-term policy rate and expectations of changes in that rate. The Federal Reserve fixes the short-term interbank interest rate by providing unlimited amounts of liquidity to the federal funds market if it wants to keep the federal fund rate close to its target rate. If domestic banks perceive the current and expected future short-term interest rates as being too low relative to the long-term interest rate, they will borrow from the Federal Reserve in the federal funds market and buy longer running Treasury bonds. This increases the price for this type of Treasury bond, thus lowering the long-term interest rate.

Thus, as long as the dollar depreciation does not provoke a change in the Federal Reserve's monetary policy stance, or changed expectations of banks about the future course of the Federal Reserve's monetary policy, long-term interest rates will not be affected by the change in the rest of the world's willingness to buy Treasury bonds.

Of course, the assumption of the Federal Reserve's monetary policy and corresponding expectations remaining unaffected by a depreciation of the dollar may not be justified. A huge currency appreciation in Asian countries could, theoretically, force the central bank to act. A strong depreciation of the real effective exchange rate of the dollar would dramatically increase the international competitiveness of United States exporting firms. Demand and prices for their products would increase, both through stronger export demand and import substitution. After a certain time lag, this would result in an increase in the profitability of the sector producing tradable goods and a pick-up in investment. At the same time, consumer prices would start to rise due to increased import prices. If the Federal Reserve's monetary policy were to remain unchanged, overall monetary conditions that reflect effects of interest rates and the exchange rate would in fact loosen. Consequently, in order to keep the economy on the targeted growth path, the Federal Reserve would have to react to a depreciation of the dollar by increasing nominal interest rates.

However, this would not necessarily hurt overall United States growth. With the tradable sector booming, production would merely shift from the non-tradable to the tradable sector, without necessarily having a negative impact on GDP growth. However, the composition of growth would alter: with rising import prices, consumer prices would increase and real wages fall. A slower growth in consumption demand would be the consequence. At the same time, export demand would increase.

banks regularly issue stabilization bonds against domestic money. However, if the domestic interest rate is higher than the rate on United States Treasury bonds (which has been the case for most developing countries, but not for China), the monetary authority has to pay the bond-holders more than it can get from recycling the reserves in United States Treasury bonds. The resulting costs then have to be borne by the developing country's general budget, and consequently by the taxpayer. In the spring of 2004, the Republic of Korea, which has also been heavily intervening in the foreign-exchange market, had currency stabilization bonds worth more than 30 trillion won ($27 billion) outstanding. Brazil and South Africa had to face high costs of sterilizing their increased reserves.

While the accumulation of reserves by developing countries slowed slightly in the first months of 2004 compared to late 2003, the basic trend of heavy interventions in the foreign-exchange market and corresponding sterilization has remained intact in 2004. Compared to both the long-term historical average as well as the corresponding figures from the same months in 2003, most developing countries continued to accumulate foreign reserves at a rapid pace. However, with the recovery in the United States gaining hold – and thus that country's assets becoming more attractive for private investors – and the increase in the long-term United States interest rate, the flow of speculative money to developing countries decreased somewhat in the second quarter of 2004. This alleviated the need of developing countries to counteract these inflows with foreign currency purchases. This is a further indication that in most countries, reserves have recently been accumulated as a bulwark against volatile capital flows, and not to set aside resources to pay future imports.

However, there are some exceptions to this general trend, mainly in countries concerned about the medium- and long-term debt sustainability. In Brazil, for example, such concerns led to outflows of short-term capital and increased the cost of external financing; as a result, the Government decided to use international reserves to make debt repayments to the IMF in December 2003 and the first quarter of 2004, and to avoid an excessive depreciation of the real. New purchases of foreign assets by Brazil's central bank would thus at least partly be interpreted as an attempt to rebuild those diminished reserves in order to prepare for new speculative outflows of private capital or impending debt repayments.

### 4. *Financing conditions*

The improved balance-of-payments situation of many developing countries has reinforced the fall in the risk premiums of their sovereign bonds. In early 2004, the yield spread on Brazilian bonds fell below 500 basis points for the first time since 1998, down from more than 2,000 basis points in early 2003. The risk premium on Turkish bonds more than halved, to around 300 basis points. Even for the Russian Federation, which defaulted on its debt in 1998, the yield spread fell to roughly 200 basis points. EU acceding countries gained from the prospect of joining the European Economic and Monetary Union (EMU): Hungarian and Polish risk spreads fell to historic lows of around 50 basis points and slightly below 100 basis points respectively (fig. 2.8).

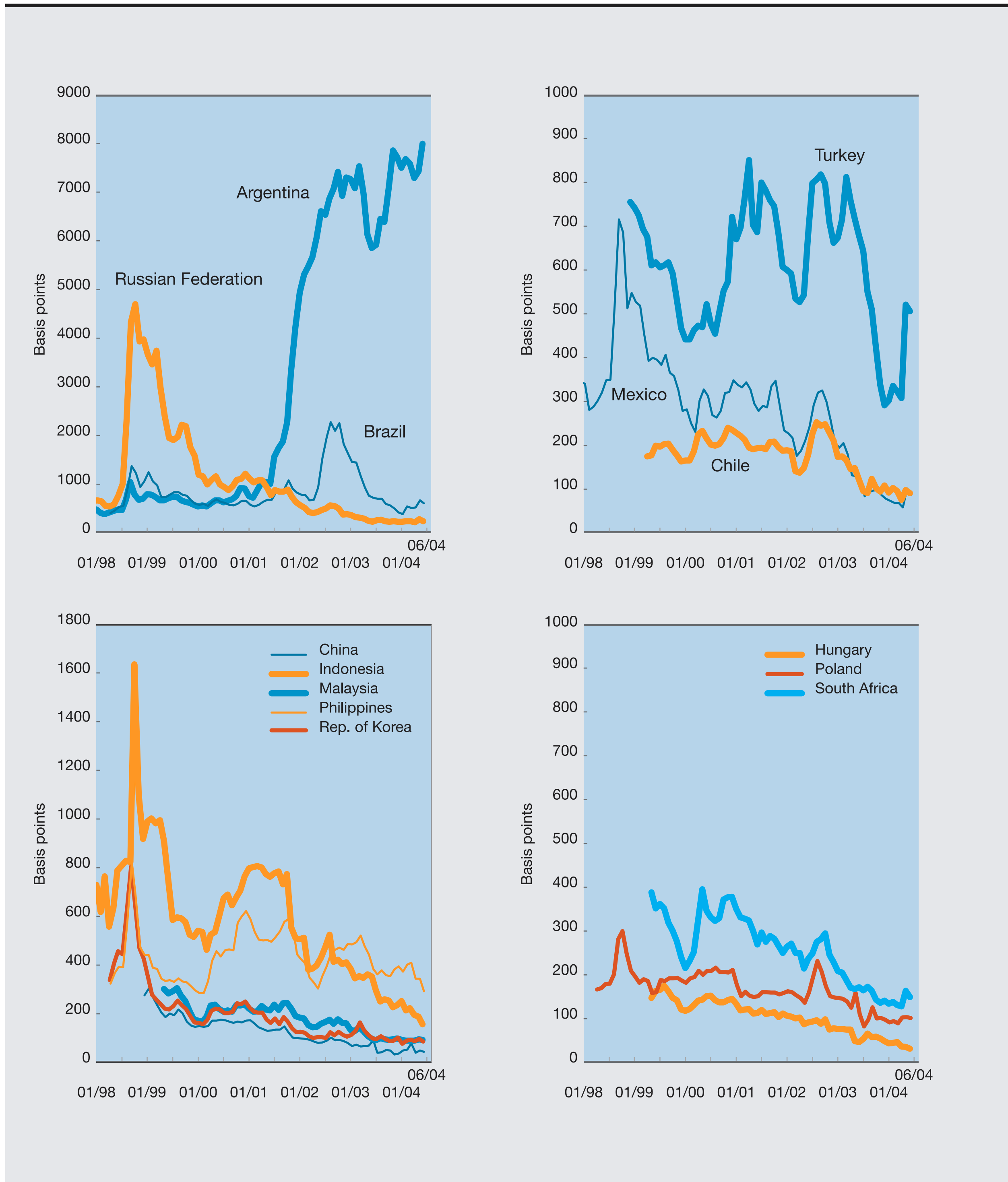
Among the internationally traded developing-country bonds, only Argentinean debt still carries a risk spread of several thousand basis points; this is not surprising, given that the restructuring of its sovereign debt is an issue that is yet to be resolved. However, as Argentina is not borrowing on the international market, the risk premium has little relevance for its domestic economy. Domestic financing conditions in local currency are favourable: short-term real interbank rates are slightly negative and 30-day nominal prime lending rates are at around 10 per cent.

However, the fall in international risk premiums needs to be viewed along with the prospect of increasing interest rates in the United States, as this might reverse Latin American countries ability to refinance their outstanding debt and reduce their interest burdens. In 2003, net interest payments made by Latin American countries fell by $0.5 billion, to $52.1 billion, the lowest level since 1997 (IMF, 2004c). However, the prospect of a tightening of international interest rates may reverse the fall in the risk premiums, as seems to have occurred in Brazil in the second quarter of 2004.

***Figure 2.8***

**YIELD SPREADS OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKET BONDS,[a] 1998–2004**

*(Basis points[b])*




***Source:*** Thomson Financial Datastream.

***a*** Differential between the yield on a representative bond issued by the borrowing country and those of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.

***b*** One basis point equals 0.01 per cent.

### 5. Calm year for financial markets, no major currency crises

Another positive side-effect of the extensive intervention of developing countries' central banks in foreign-exchange markets has been the calm in the global currency market. After Argentina's default and devaluation in late 2001 and early 2002, which also pulled neighbouring Uruguay into crisis, and the financial market scare in the run-up to the Brazilian presidential elections in 2002, 2003 was a remarkably calm year for international financial markets. This development was also reflected in a drop in net official lending to the developing countries. While in 2002 the IMF approved a record loan to Brazil to prevent the looming crisis getting out of control, countries sought less IMF support in 2003: its net credit and loans fell from $13.4 billion in 2002 to $1.8 billion. This explains the significant fall in net official capital flows to the developing economies, from $11.6 billion in 2002 to only $2.7 billion in 2003 (IMF, 2004c).

Even more encouraging is the fact that, worldwide, demand for emergency loans has abated. In all regions other than Latin America, net lending from the IMF has even been negative. The Russian Federation managed to pay back $1.9 billion in net terms thanks to its high oil revenues. In Latin America, the single IMF loan of $5.2 billion to Brazil accounted for almost all of the region's net capital receipts from the Fund.

However, even though the IMF's net lending has declined significantly, several countries rely on new IMF disbursements in order to pay for previous IMF loans. This is the case for Argentina, which is still struggling with international creditors to come to an agreement on how to restructure its defaulted debt. Uruguay managed to restructure its foreign debt, with strong IMF involvement, in May 2003, while Bolivia, Brazil and Ecuador are under close IMF supervision as they continue to have large outstanding positions with the Fund. Thus, the IMF continues to play a significant role in some countries, and the problems of debt crises remain unsolved, even in regions where, overall, economic conditions have recently improved.

### 6. FDI to developing and transition economies declines

Although FDI remains the major source of foreign financing in developing countries, their net FDI flows (inflows minus outflows) declined to $102.5 billion in 2003 from $112 billion in 2002 – the lowest level since 1996, and roughly $60 billion lower than the peak in 2001 (table 2.5). This development seems to be part of a more general trend linked to the reduction of cross-border merger and acquisition (M&A) operations since 2001.[4] Economic slowdown and financial constraints faced by transnational corporations (TNCs) – due to over indebtedness and declining stock values – are the main reasons for the fall in M&As.

In the developing and transition economies, the picture differs from region to region. In East and South Asia, net FDI flows remained roughly at their 2002 level: some $50 billion, and were highly concentrated in China (including Hong Kong, China). The region's continued success in attracting FDI is partly related to the reorganization of production processes through the development of regional production networks, and partly to its low labour costs and expanding domestic market, which attracted FDI from developed countries outside the region. Net FDI flows for Central and Eastern European countries (CEECs) declined. As in East Asia, a significant share of FDI to these countries is part of the geographical restructuring of production processes, but also the EU acceding countries are becoming attractive locations for FDI seeking access to the larger EU market.

In Latin America and the Caribbean, too, FDI continued to fall in 2003. Prolonged economic stagnation discouraged FDI targeting host-country markets. The termination of privatization processes in several countries was also a major reason for the decline in FDI inflows. Export-oriented FDI showed a mixed picture: the Andean countries (particularly Chile, Colombia, Ecuador, Peru and Venezuela) continued to attract FDI in natural resources (especially mining and hydrocarbons), but Mexico, where the assembly industry oriented to the United States market stagnated, saw a decline in FDI inflows. On the other hand, FDI outflows from the region rose.

A significant proportion of FDI flows to the CIS and West Asia also went to natural-resource extraction. These investments (essentially in oil and gas) seem to be relatively disconnected from local economic conditions, responding, instead, to the long-term strategies of TNCs. In Africa, FDI flows slumped from an exceptional peak of $24 billion in 2001 to about $12 billion in 2002, which appears to be a return to the normal trend considering the size of FDI flows during the period 1997–2000. Net FDI flows during 2003 are estimated to have amounted to about $14 billion. In all, FDI flows to the region are concentrated in a few countries, and in the extractive sectors of oil and minerals, with total flows in any particular year reflecting new investments in these sectors. ■

## Notes

1 In early June 2004, this index had fallen to 3,282 points, after reaching a peak of 5,681 points in February (Bloomberg, 2004).

2 The HWWA (Hamburg Institute of International Economics) Index, which tracks world prices of commodities from the perspective of industrialized countries, shows an increase of 14.3 per cent on a dollar basis and a decrease of 4.2 on a euro basis (http://www.hwwa.de/indikatoren/idsp_rohstoffindex.html, accessed June 2004).

3 See, for instance, a recent study of the International Energy Agency (IEA, 2004).

4 The continuing low value and number of cross-border M&As, which had been the main drivers of global FDI flows since the late 1980s, contributed significantly to this performance. For a discussion of FDI flows in 2003 see UNCTAD (2004).

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