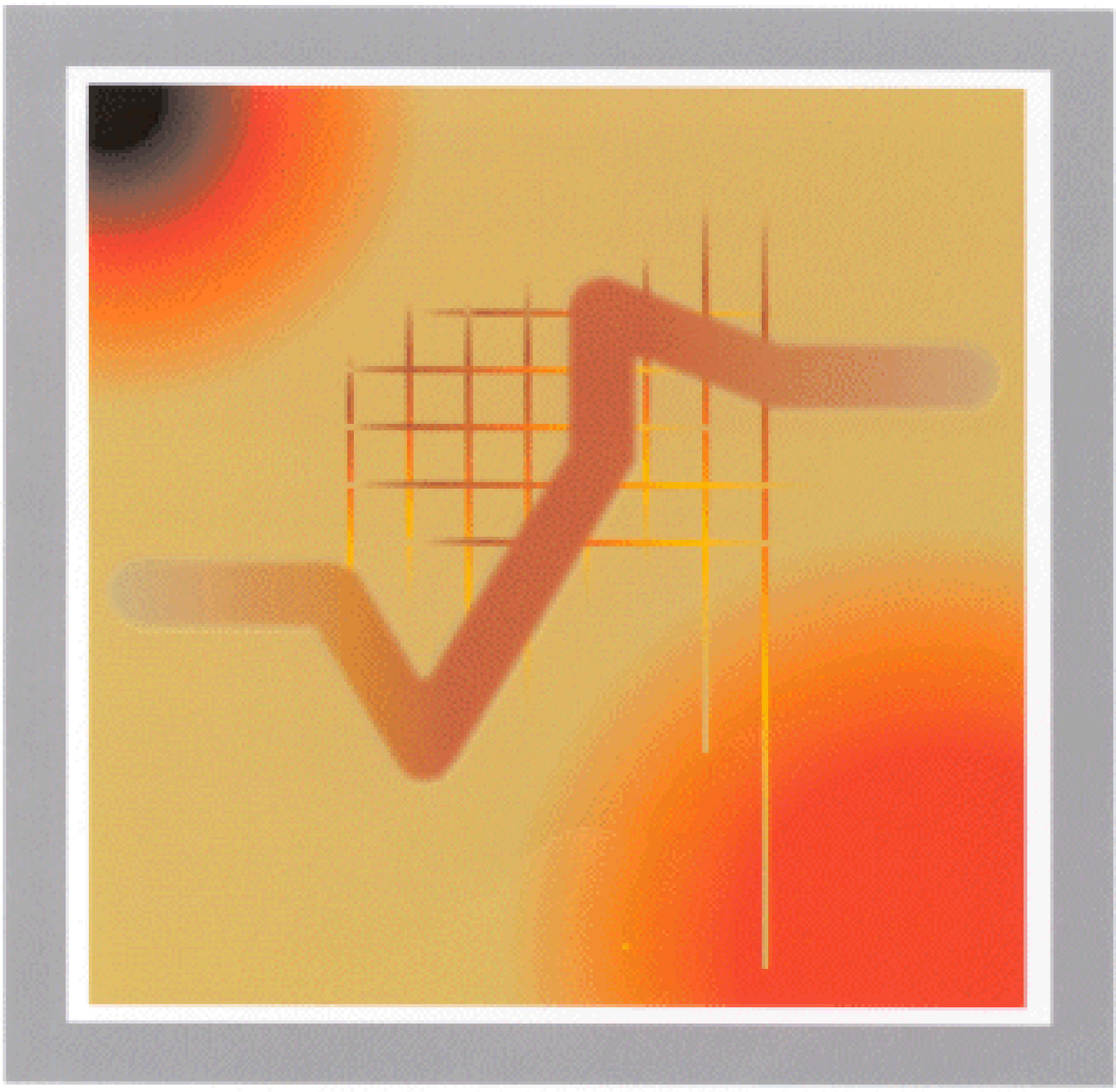
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 2000

OVERVIEW

UNITED NATIONS



OVERVIEW

Two big global economic forces are competing for the world's attention. On the one hand, the promise of a "new economy" underpinned by information and communication technologies is exciting policy makers, including those from the world's poorest countries. On the other hand, growing instability and uncertainty linked to globalization has left them deeply worried about the impact of financial shocks on growth prospects; the experience of some of the most successful developing countries has shown just how virulent those forces can be.

So far the big winner has been the United States. On some accounts the spread of new technologies has already uplifted its growth potential. But financial crises in emerging markets have also helped to sustain rapid growth in the United States as capital was attracted to this safe haven and cheap imports helped keep the lid on inflation. By contrast, the impact of new technologies has been much less evident in Europe and Japan. As regards developing countries, most of their firms have had little or no benefit so far, and this digital divide is of growing concern to policy makers.

Disparities in growth rates within the industrial world and a strong dollar have resulted in growing trade imbalances as the United States has become "buyer of last resort" to the world economy. At the same time, the combination of technological and financial innovations has aggravated the underlying fragility of current financial and trade flows. The mania for cross-border mergers and acquisitions has contributed to a larger worldwide financial bubble in technology stocks, whose prices have been rising much faster than productivity, even in the United States.

The task of adjustment to global economic imbalances is falling on monetary policy alone. This is a cause for concern. Current global macroeconomic imbalances bear some disturbing resemblances to those of the 1970s and 1980s, when the absence of cooperation and coordination among the major economic powers led to systemic breakdown and hard landings. And what we have learnt about the global economy over the past few decades tells us that failure to resolve such imbalances in an orderly manner will be most damaging to growth in the developing countries.

Global economic growth and imbalances

The world economy made a welcome turnaround in 1999, confounding fears that it would drop into recession. Robust growth was also accompanied by an improvement in world trade and the return of some degree of normalcy to currency and financial markets, after the chaotic conditions of the previous two years. This was greatly helped by a combination of unexpected and one-off events.

The expected chaos from the Y2K computer bug and the associated economic costs proved grossly exaggerated; in the event, the business expenditure undertaken worldwide to avoid any potential disruption provided a massive shot in the arm for the world economy, estimated at some 1–2 per cent of global GDP. The reversal of policies of austerity in East Asia in the second half of 1998 helped to repair much of the earlier damage to output from the financial collapse, and pushed growth in the developing world ahead of that in the industrial countries after the shortfall in 1998. Sharply increased oil prices gave an unexpected boost to the Russian economy, allowing it to register a moderate growth against widespread expectations of deepened recession.

But above all, the United States economy continued to surge ahead, belying forecasts and growing well above what was customarily believed to be the longer-term potential. With economic growth exceeding 4 per cent, unemployment dipping below 4 per cent, and imports rising by 12 per cent, the United States economy continued its role as white knight to the global economy.

All in all, the immediate prospects for the world economy have improved, with growth this year expected to exceed 3 per cent. Considerable encouragement can also be taken from the way the world has shrugged off the sharp rise in oil prices since mid-1999. The impact on inflation has so far been negligible, and simulations undertaken by various organizations suggest that the effect of continued high oil prices on global growth will be limited and confined mostly to oil-importing developing countries.

It is also possible that the world economy will become even more robust over the coming years, with a consolidation of global growth accompanied by increased stability. The United States economy may become neither too hot nor too cold, engineering an orderly slowdown to a sustainable growth rate compatible with the greater potential arising from new technologies. Stronger growth in Europe and Japan, propelled by adaptation to the new economy, would relieve the United States of its role as the sole engine of global growth. In this ideal scenario oil prices and interest rates will level off and the dollar will gradually be realigned so as to consolidate price and financial stability. And renewed private capital flows, together with continued domestic reforms and the spread of new technologies, will begin to deliver the promised fruits of globalization to developing countries.

However, there is also a recognition that the wreckage from the Asian crisis will not be cleared away by simple incantations to the new economy, and that making good on the promises of globalization will call for considerable policy effort. Not only are the root causes that led to the fear of recession during 1998–1999 still present, but also further fault lines have emerged, along which any unexpected movements could have damaging consequences not only for industrial economies but also, and of greater concern, for developing countries. Prospects for the latter could deteriorate rapidly if the major industrial countries continue to set their policies without regard to their global repercussions on trade and capital flows.

The factors that have helped the United States economy to surge ahead have also increased financial fragility and global imbalances. The flight of capital to quality that started after the Asian crisis, and accelerated rapidly in autumn 1998 following that of the Russian Federation, provided an important stimulus to the United States economy by accentuating the bubble in asset prices and thereby encouraging private spending based on capital gains. The combination of rapid growth in domestic demand and a strong dollar has also resulted in mounting external deficits, reaching 4 per cent of GDP. The recovery in emerging markets has added to demand for dollar assets as reserves are piled up as a safeguard against future crises. Japan, like other surplus countries, is also willing to hold its trade surpluses with the United States in the form of dollar assets. The coincidence of a budget deficit and rising supply of government bonds in that country with a budget surplus and falling supply of government bonds in the United States has held out the prospects of gains on United States government bond holdings, triggering a flow of funds from Japan. European and Japanese TNCs have joined in the process of buying into the technological gains already made by United States firms. Headline-grabbing mergers and acquisitions in the high-tech sector have spilled over into a financial bubble in technology stocks, where self-fulfilling expectations rather than solid earning prospects have been moving the market.

A combination of dwindling private savings, rising private debt, mounting current-account deficits and the bubble in technology stocks, whilst providing a Keynesian fillip to the United States economy, has been sustained by the continuing attractiveness of dollar-denominated assets to non-residents. But this situation cannot continue indefinitely. The factors accelerating growth in the United States have also reduced the effectiveness of monetary policy in engineering a soft landing; higher interest rates have so far served to attract more capital from abroad, thereby fuelling asset prices and adding to effective demand, the strength of the dollar, and the trade deficit.

By contrast, in 1999 growth in EU failed to match that of 1998, but is generally expected to reach or exceed 3 per cent this year, harbouring hopes that EU will soon replace the United States as the global growth engine. However, even under a scenario of accelerated growth, Europe is unlikely to provide a comparable demand stimulus to the rest of the world. Its growth spurts have been dependent on exports, helped last year by a weak euro and the strength of the United States economy. The tensions inside Euroland between fast- and slow-growth economies complicate considerably the search for a common monetary stance at a time when the policy autonomy of the European Central Bank (ECB) has been compromised as a result of closer integration of global financial markets, the increased responsiveness of capital flows to interest rates in the United States and, contrary to original expectations, the consolidation of the dollar’s status as a reserve currency. Any hike in United States rates could check investment spending and derail growth in Europe. None of this points to an accommodating macroeconomic stance that could underpin a high-tech Keynesian recovery of the kind enjoyed in the world’s richest economy in the past few years. Nor is the situation helped by the hypnotic hold which the notion of a non-accelerating-inflation rate of unemployment (NAIRU) still has over European macroeconomic policy, even though the theory that high unemployment rates are structural and cannot be brought down without accelerating inflation is now discredited by the experience of the United States, where expansionary policies fuelled productivity growth.

The economy of Japan picked up last year after contracting by over 2 per cent in 1998. However, strong first-half growth figures in 1999 owed much to extra government spending, and the annual growth rate was dragged back down to a mere 0.3 per cent as this injection of funds petered out. The East Asian recovery did help thanks largely to the presence of Japanese producers in the region, and now that private expenditure appears to be picking up, prospects are more encouraging, pointing to a growth rate perhaps in excess of 2 per cent for the year as a whole. Still, private spending remains structurally constrained by the financial legacy of overinvestment during the boom years of the late 1980s and by the creeping rise in unemployment, which is now close to 5 per cent. The confidence of Japanese households and firms remains brittle, and finding the right course is complicated by mounting public debt, now standing at over 100 per cent of GDP. Japanese policy makers would do well to recall that the United States deficit was tackled in the context of accelerated growth. Recovery in Japan is also vulnerable to a premature tightening of monetary policy and a strengthening of the yen.

The experience of the 1960s and 1980s shows that large imbalances in external payments and capital flows between the United States and other major industrial countries can pose serious threats to global growth and stability, since the willingness of investors in surplus countries to hold dollar-denominated assets can come to an abrupt end. That these imbalances are now associated with deficits of the private, rather than of the public, sector makes the situation all the more fragile in view of the greater risk involved in holding private liabilities.

While a rise in United States interest rates relative to the rest of the world does little to reduce global imbalances in growth and trade, it is in any event unlikely to occur, since ECB tends to track United States interest rates in an effort to defend the new currency, while emerging markets are obliged to follow suit in order to retain capital inflows. A generalized rise in interest rates in the industrial world, including Japan, which now looks set to abandon its policy of zero rates, would do little to alter the current pattern of exchange rates and trade balances, but would create problems for debtor developing countries. Since fiscal tools are no longer in the armoury of macroeconomic management and policy coordination comes, if at all, with crisis management rather than crisis prevention, an orderly adjustment of imbalances without sacrificing growth may be too much to expect.

Thus, as in previous episodes, the danger is that a policy impasse will end with much more abrupt changes than are either needed or desirable. Such an outcome would be of grave concern to developing countries, since their economic fundamentals are hyper-sensitive to movements in foreign interest rates and capital flows, and their exports would be seriously affected by the slowdown in growth.

The vulnerability of developing countries to policy shifts in the major industrial countries will, of course, depend on their current state of health. Conditions in Latin America deteriorated further in 1999, with a contraction in GDP per capita for the first time since 1990. Growing trade deficits and falling capital inflows throughout the region were signs of a continent in trouble. However, there were some sharp differences among countries. Mexico posted a relatively strong performance, thanks to its increasingly close ties to the United States, as did some smaller countries in Central America and the Caribbean. Elsewhere, weak commodity prices and the collapse of intraregional trade meant that policy-making was carried out in an unfavourable environment. But the heavy-handed policy response to the threat of financial contagion, including fiscal tightening and high interest rates, tipped some countries into recession. Things could have been much worse for the region if Brazil had not weathered its financial storm surprisingly well. By contrast, Argentina's defence of its dollar peg took a much heavier toll on its real economy last year, with output dropping by over 3 per cent. For the region as a whole the basic policy challenge remains how to break free from an excessive dependence on external resources.

The economies of developing Asia turned strongly upwards in 1999, growing on average by more than 5 per cent. The big economies of India and China continued to sustain their above-average performance, but it was the sharp recovery in East Asia which attracted most attention. The rebound in the Republic of Korea has been spectacular, and Malaysian growth reached double-digit figures in the first months of 2000. The revival became evident in the first half of 1999 and owed much to expansionary monetary and fiscal policies, and a further fillip was provided by exports, which began to reap the advantages of currency devaluations. The high degree of regional integration was a critical ingredient: the collapse of intraregional trade was a major conduit of contagion, and recovery has been amplified through the same channels. While balanced growth is expected in 2000, there remain downside risks for some countries, such as Indonesia.

China also benefited from the regional recovery in 1999, but its 7 per cent growth was still the slowest in a decade. Short-term easing of monetary and fiscal policies to boost demand failed to stimulate private consumption, leaving exports and government expenditure to underpin growth. With rising fears of unemployment, consumer confidence seems unlikely to improve, and policy makers are looking for a new growth path which could break the forces of deflation, over-production and excess capacity. Accession to WTO is expected to contribute, but greater emphasis is also being placed on developing the internal regions. On the other hand, if accession to WTO necessitates a devaluation of its currency to protect some of the country's less competitive industrial enterprises (particularly those still under state ownership) against an unexpected surge in imports, other countries of the region are likely to be affected in consequence. Indian growth was based on the dynamism of industry and services. Even with a sharp slowdown in agriculture, the economy expanded by close to 7 per cent in 1999, and the growth momentum is expected to continue this year.

Africa was again unable in 1999 to match the growth peak of 1996. Indeed, with growth dipping even below the 3 per cent achieved in the previous two years, per capita income actually stagnated. There were nonetheless some bright spots. The CFA countries benefited from the depreciation of the euro in 1999, which boosted their competitiveness and a combination of political stability, agricultural growth and increased capital inflows in North and East Africa produced some encouraging performances. After a number of lean years, the economies of Nigeria and South Africa appear to have bottomed out. But on the whole, neither the domestic nor the external conditions are yet right for an African growth revival. In many countries, political conflicts and the weather left economic policy makers with few options. Elsewhere, the vagaries of global commodity markets took their toll. Weak prices for beverages and a sharp downturn in cocoa and coffee prices were particularly damaging, and oil-importing countries have been badly hit by the hike in prices. Growth may accelerate moderately in 2000 if commodity prices strengthen, albeit with gains heavily concentrated in North Africa. But for sub-Saharan Africa the basic policy challenge remains how to overcome savings and foreign-exchange constraints and to raise investment to hit at least 6 per cent growth per annum. This will need increased official financing and debt relief along with a more pragmatic approach to domestic reforms.

The transition economies posted their highest growth in a decade, some 2.4 per cent. But volatility and variation are endemic to the region. Contagion from the Russian crisis dominated developments in the first half of the year. However, marked improvements in exports to EU allowed many countries in Central Europe to grow faster than the regional average. More surprising still was the recovery in the Russian Federation, where growth in 1999 ended up at over 3 per cent thanks to the sharp rise in oil prices and the devaluation of the rouble. The momentum is expected to be sustained this year. Nevertheless, weak export performance and lingering fears of inflation in the transition economies continue in many cases to create difficulties in obtaining international finance. Despite the ending of open conflict in South-East Europe, the macroeconomic situation there remains fragile and economic prospects bleak. The challenges for these countries are not unlike those in much of the developing world, and again the response of the developed countries has so far been insufficient.

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Despite a rapid recovery from the depressed conditions of 1998, external vulnerability is still a looming menace to growth prospects in the developing world. Concerted efforts by developing countries to become full participants in an increasingly interdependent global economy continue to be stymied by biases and asymmetries in the trading and financial system. There are too many exporters struggling to gain access to the markets of the rich countries, and the kind of extreme price movements previously suffered by commodity producers have also begun to upset the plans of manufacturers. A reluctance to move towards a new round of multilateral trade negotiations that took into consideration the development needs of poorer countries, including the problems they confront in implementing commitments in the Uruguay Round, was apparent in Seattle, and the trade imbalances among major industrial countries simply adds to the anxieties of the developing world. Even after years of hard-won domestic reforms, developing countries are still dependent on highly volatile capital flows to support growth.

Growth prospects of developing countries will depend on how these concerns are addressed. In an increasingly interdependent global financial and trading system, it is clear that trust in market forces and monetary policy alone will not carry the day. Increased international cooperation and dialogue will be needed if the full potential of new technologies to bridge the growing gap between the rich and poor is to be realized. This calls for much bolder leadership, of the kind which heralded in the last Golden Age.

Crisis and recovery in East Asia

The potential damage to developing countries from the combined influence of global imbalances and speculative pressures was brutally exposed by the financial crisis in East Asia. The speed of recovery in the region over the past year has been encouraging. However, the fact that neither the depth of crisis nor the speed of recovery was anticipated even by those responsible for policy should caution against excessive exuberance.

Although the crisis in each country had its own characteristics, there is little doubt that the extremes of collapse and recovery have, in large part, been due to misguided policies. The initial policy response was unnecessarily severe and the expectation that tight monetary policies would quickly stabilize the currency, resulting in an investment-led recovery, was misplaced. Monetary tightening aggravated the crisis by deepening the debt deflation process set off by speculative attacks, and served to depress output and employment. Nor were currencies stabilized as a result of the hike in interest rates; that outcome came rather from the build-up of reserves due to massive cuts in imports, and from reductions in foreign claims due to debt rescheduling or to more unorthodox measures, such as capital controls. Indeed, the hike in interest rates proved to be much more damaging than currency depreciations, causing serious dislocations in the corporate and financial sectors.

The economies only bounced back when policies of austerity were reversed and governments were allowed to play a more positive role. The policy reversal was brought about by the depth of the crisis and by widespread criticisms rather than as part of a carefully sequenced policy package; in this respect, the positive influence on the entire region of the example of Malaysia in pursuing policies based on autonomously set objectives and priorities cannot be emphasized strongly enough. In retrospect, provision of adequate international liquidity to replenish reserves, accompanied by temporary exchange controls and a debt standstill and roll-over (measures recommended by the UNCTAD secretariat early in the crisis) would have been a much more effective response than the policy of high interest rates actually followed.

With the exception of Indonesia, per capita incomes have returned to or exceeded pre-crisis levels; exchange rates have strengthened; interest-rate spreads in international borrowing have narrowed significantly; and foreign capital has begun to return. However, there are reasons for concern. In the first place, recovery has been accompanied by only limited corporate restructuring, and the health of the financial system continues to rely on public intervention in the credit mechanism.

Second, exports are unlikely to continue at their recent pace, and public deficits and debt have been on the rise in most countries seriously hit by the crisis. Since premature fiscal tightening could stifle growth, fiscal consolidation needs to wait until private demand takes the lead in growth. But this process may be delayed because of persistent unemployment and the existence of excess capacity in many branches of industry.

Finally, the recovery has so far been supported by highly favourable conditions in the world economy which are susceptible to change. A sharp slowdown in the United States and a deterioration in global financial conditions could be particularly damaging, since already external payments in the region are moving towards deficits, enhancing the need for external financing. Hikes in foreign interest rates could pose a dilemma: attracting foreign capital would call for a reversal of the easy monetary stance, but that could stifle growth by blocking the domestic forces of recovery and aggravating the difficulties of the banking system.

As in other episodes of financial crisis in emerging markets, shifts in macroeconomic aggregates, notably the decline in the domestic resource gap and the improvement in the current-account balance, as well as sharp currency devaluations, have been associated with significant adverse changes in income distribution in East Asia. Employment and wages have generally lagged behind aggregate income in the recovery, and poverty has remained considerably above pre-crisis levels. This is consistent with a troubling pattern in the developing world, where the poverty-alleviating impact of a recovery in growth is significantly weaker than the poverty-augmenting impact of a comparable decline.

The longer-term implications of all this for the East Asian economies are far from clear. If growth in the region is adversely affected by unfavourable global conditions, then the malign social legacies of the crisis will persist for some time. Only with a more inclusive growth pattern, at rates closer to the longer-term average, can the fight against poverty be effectively resumed. How governments manage to withdraw from the business of crisis management and get back into the business of managing integration into the world economy will be crucial.

A fundamental lesson of the financial crisis is surely that excessive reliance on foreign resources and markets leaves growth prospects vulnerable to external shocks. Policy makers have rightly rejected a retreat into protectionism, but it would be just as wrong to allow global market forces to dictate future growth and development. With domestic savings likely to remain high, dependence on foreign capital to close the income gap with the leading industrial nations will be that much less. Greater attention also needs to be given to domestic sources of growth, such as rising wage shares and higher social spending. There is a major role for public investment and the involvement of a developmental State, with new policy agendas. Regional economic ties are likely to remain important and should be strengthened, *inter alia*, through collective defence mechanisms against systemic financial instability and contagion.

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