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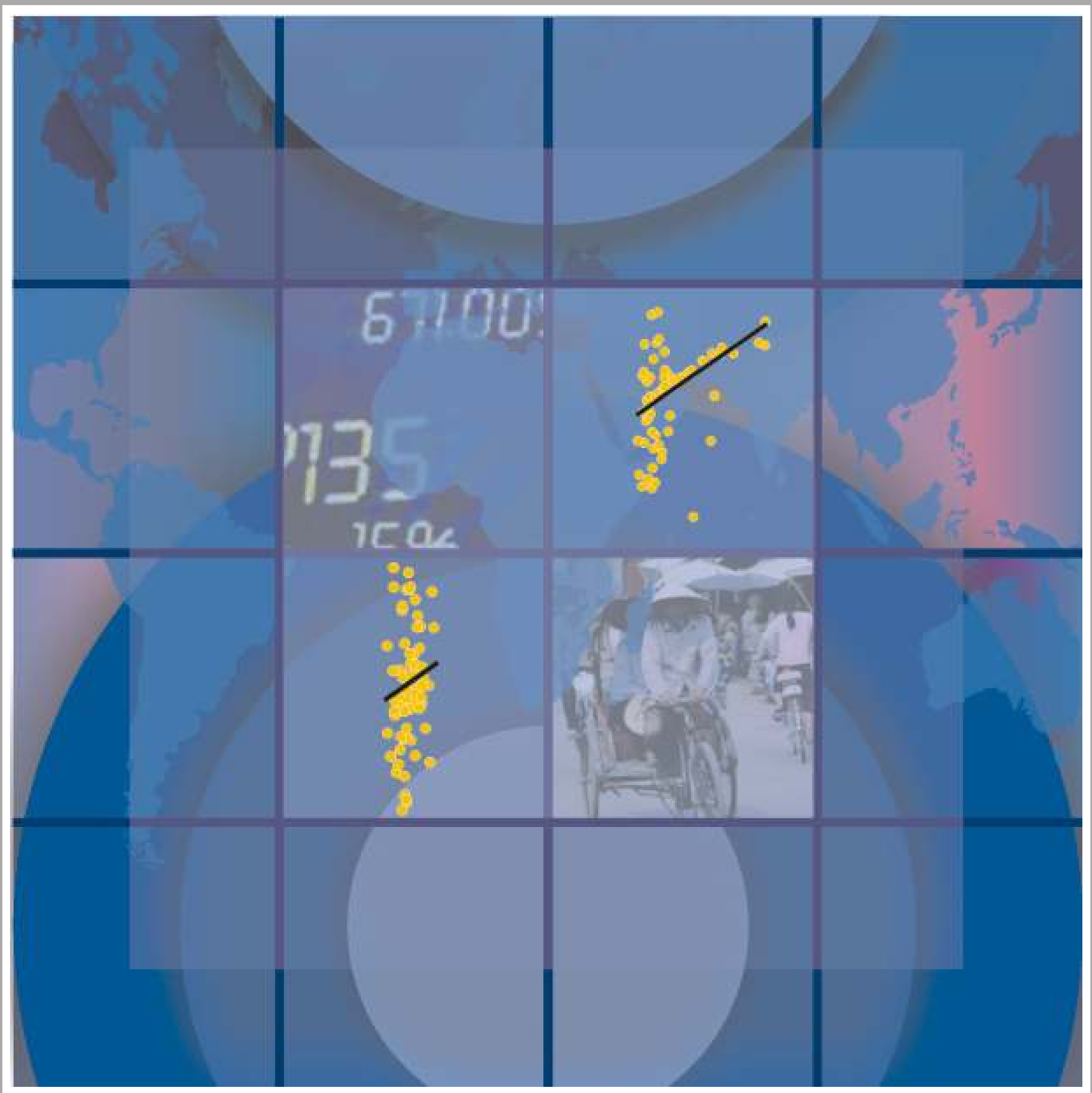
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 2004

OVERVIEW

UNITED NATIONS



UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 2004

Overview

UNITED NATIONS
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OVERVIEW

Global trends and prospects

The situation of the global economy is brighter than it was a year ago. Since growth in world output and trade recovered in 2003, there is now widespread optimism that the acceleration of growth in 2004 could lead to a return of the performance experienced at the end of the last decade and that the world economy may enter an extended period of growth.

In reality, however, the outlook for a sustained recovery is more clouded and uncertain than at the beginning of the 1990s. Large disparities in the strength of domestic demand persist among the major industrial countries, and increasing trade imbalances between the major economic blocks could lead to new protectionist pressures and increase instability in currency and financial markets, with adverse implications for developing countries. The sharp increase in oil prices and uncertainty about their future development, as well as their possible impact on inflation and interest rates, are an additional reason for concern.

Moreover, income growth is unequally distributed both among developed countries, where the euro area continues to lag behind, and among developing countries, where fast and sustained growth continues to be concentrated in East and South Asia. At the same time, per capita income in most of sub-Saharan Africa is stagnating, and the basis for sustained growth in Latin America is still very fragile. Indeed, the improvement in the global economy has been the result of exceptionally good performance in a small number of countries, with great variations in the spillover effects on other economies.

The recovery of the world economy has been driven largely by the United States economy and continued fast expansion in East and South Asia. Through its increasing fiscal and trade deficits, the United States economy has provided a strong demand stimulus to the rest of the world. On the other hand, several developing economies in Asia, in particular China, have been able to increase not only their imports – with strong spillover effects in economies in the Asia and Pacific region – but also their exports at double-digit rates.

The dependence of the global economy on the performance of the United States economy is not a new phenomenon, but United States deficits are much larger today than they were in the late 1990s. This is a matter for concern, since the high budget deficit of the United States will require fiscal adjustments and the unusually expansionary monetary policy stance may also need to be revised in light of inflationary pressures stemming from a surge in import prices and in particular from oil prices.

Geopolitical tensions and speculative forces explain much of the sharp rise in oil prices, which during the first half of 2004 reached their highest level since the early 1990s, but the rise has also been driven by the global recovery and rapidly rising demand from China. Substantially higher oil prices carry the risk of compromising growth in oil-importing countries, especially those in the developing world that are facing serious balance-of-payments and external financing constraints while benefiting to a relatively small extent from potentially higher exports to oil-exporting countries. Moreover, as in past episodes of rapidly rising oil prices, the oil-exporting countries may not be able immediately to translate additional oil revenues into higher demand for goods produced in oil-importing countries. Although higher oil prices have not had an immediate impact on inflation in the industrialized countries, such an effect cannot be ruled out should prices remain at current levels in the medium term. This in turn might lead to increases in interest rates.

Greater financial and exchange-rate instability may also result from the fact that the United States is increasingly immersed in trade-financial dynamics with East Asia. Expansionary fiscal and monetary policies in the United States have been providing a significant boost to exports from East Asia, including Japan, and are contributing to the large current account surpluses in the region. On the other hand, the East Asian developing countries have been following a policy of keeping their exchange rates at a competitive level following the currency depreciations in the late 1990s. This has required heavy intervention in the foreign exchange market, leading to fast reserve accumulation. As a result, East Asia has been recycling its current-account surpluses directly to the United States, thereby financing a large part of the United States current-account and budget deficits through the investment of increasing foreign exchange reserves in United States Treasury securities. In 2003, East Asian developing countries, including China, bought more than $210 billion of foreign currency, compared to a United States budget deficit of $455 billion and a trade deficit of $490 billion. This pattern is unlikely to be sustainable in the long run, especially if pressure on the dollar to depreciate mounts as a result of further rising United States deficits, which, in turn, could induce Asian central banks to minimize risks by diversifying their foreign exchange holdings into assets denominated in other currencies, in particular the euro.

Because of the recycling of balance-of-payments surpluses of the East Asian and a number of other developing and transition economies through an unprecedented increase in reserve accumulation in 2003, there has been a continued net capital outflow, in the order of $230 billion, from developing and transition economies to the developed countries. This has occurred despite a substantial rise in the net inflow of private capital to the developing and transition economies, which has reached its highest level since 1997. On the other hand, although foreign direct investment (FDI) remains the most important type of private capital inflows to developing countries, it fell to its lowest level since 1996 as the wave of privatization, which had been a driving force behind FDI during the 1990s, levelled off. Conversely, credits and short-term capital flows rose considerably, but the bulk of these flows were directed to a small number of emerging-market economies, attracted by high interest rates or the expectation of currency appreciation. Indeed, a substantial proportion of private external financing did not flow to economies with external financing needs or low investment rates. Instead these flows were mainly directed to economies with often sizeable current account surpluses resulting from fast export expansion, adding to their foreign exchange reserves. This is another indication that capital markets cannot be counted on as a stable source of development finance. Moreover, the obvious fear of many developing countries with regard to floating their currencies in the presence of sharply fluctuating expectations on the international financial markets should give rise to increased efforts to strengthen the coherence between the international trading system, on the one hand, and the international monetary and financial system, on the other, an issue that is taken up below.

With East and South Asia forming a de facto dollar block, adjustments of global imbalances may require more pronounced exchange-rate changes in the rest of the world. In order to maintain the growth momentum in the world economy without constantly growing United States deficits and mounting pressure on the dollar, demand growth would need to be strengthened in the other major industrial countries. However, growth in most European economies continues to be itself dependent on exports. The euro area has benefited from the recent United States recovery, despite the appreciation of the euro vis-à-vis the dollar, confirming the competitiveness of its industries, but domestic demand remains sluggish, mainly due to the inability of economic policy to lift the income expectations of consumers in the three largest economies. Without a reorientation in the euro area away from fiscal and monetary orthodoxy, the rising imbalances in world trade will force further and even more dramatic changes in real exchange rates.

Regional trends and the new geography of trade

An exceptionally strong fiscal stimulus and a reduction of interest rates to their lowest level in 50 years have helped the United States economy overcome the phase of weakness that began in 2000. Rising government expenditure due mainly to a surge in defence spending, higher company profits that finally led to the long-awaited rise in business investment, and a recovery in household consumption all converged to produce a substantial rise in domestic demand. By contrast, despite the weakening of the dollar vis-à-vis the euro and the yen in 2003, external demand grew at a much slower rate than imports. The large and rising trade deficit thus remains a major concern, as it is likely to exert further downward pressure on the dollar.

Moreover, given the size of the United States budget deficit, fiscal policy will need to adopt a more restrictive stance, and a switch towards a more restrictive monetary policy would aggravate the high indebtedness of households, which could prove to be a major obstacle to sustained expansion. There are thus serious doubts that United States growth and its positive impact on the world economy will continue with the same strength as has been the case during 2003 and the first half of 2004.

In the euro area, domestic demand has remained flat. The European Central Bank was reluctant to follow a more aggressive expansionary policy. Despite slower growth, real short-term interest rates in Europe have been consistently higher than in the United States, while the space for expansionary fiscal policies is restricted by the Stability and Growth Pact. This is in contrast to the United Kingdom, where countercyclical fiscal policy in response to the global slowdown after 2000 contributed to considerably higher growth rates than those in continental Europe. The current attempt of many European companies to improve their international competitiveness by cutting wages will aggravate the weakness of domestic demand. Eventually, as the financial markets realize that the world economy is not receiving the stimulus needed to overcome the existing imbalances, the probability of a strong overvaluation of the European currency will rise significantly. In this case, the euro area and its major trading partners will run the risk of being trapped in a low-growth, high-unemployment scenario.

After a decade of stagnation, the Japanese economy finally achieved considerable recovery of output growth in 2003. Although there has been a rebound of corporate investment, the recovery was largely based on higher external demand. While exports to the United States fell in 2003, the export drive was mainly due to continued strong demand from China, suggesting a change in trade patterns within Asia and between Asia and the United States. However, given the strong reliance on foreign demand, the Japanese export-led recovery is vulnerable to changes in external conditions, particularly currency fluctuations.

GDP growth in the developing countries rose in 2003 and is likely to do so again in 2004. While growth has accelerated in a large number of developing countries, its level differs considerably across and within regions. Growth has been the strongest in East and South Asia, as a result of further expansion of domestic and external demand, and it is set to accelerate further in 2004. Economic policy in most countries of the region has maintained an expansionary stance through public investment in infrastructure development and the creation of favourable monetary conditions. The stability of exchange rates within the region, together with significant growth of investment and GDP, has favoured the trend towards specialization in the context of rapidly growing intraregional trade and investment.

China is playing a central role in this process. Indeed, in 2003 and the beginning of 2004, it was a major engine of growth for most countries in the region. A large proportion of its imports, which have been growing even faster than its exports, are coming from the rest of Asia. In 2004 rapid growth is likely to continue in East and South Asia, and particularly in the two largest economies, China and India. However, in China there is now overheating in certain sectors of the economy, and the policy stance is becoming more restrictive, with attendant effects on other countries in the region, including Japan.

Although exports to the United States continue to be an important component of total output growth in East and South Asia, this region has generated an intraregional pattern of demand and specialization that should allow it to maintain a relatively stable growth path independent of cyclical and structural problems in the rest of the world.

After two years of negative per capita growth, economic activity in Latin America began to improve in the second half of 2003. Several countries have regained international competitiveness and have increased their room for manoeuvre in macroeconomic management by shifting away from rigid exchange rate regimes and overvalued currencies. While improved trade balances in 2002 were largely the result of import compression, further improvement of trade performance in 2003 was mainly due