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OVERVIEW

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It is a sign of troubled times when, in the search for solutions to the most pressing policy challenges of the day, it is considered necessary to look to earlier generations for guidance: a Marshall Plan – this time to fight global poverty – a Tobin tax to check financial volatility and a Keynesian spending package to combat deflationary dangers spring readily to mind. The source of the trouble is the gap between the rhetoric and the reality of a liberal international economic order. Nowhere is this gap more evident than in the international trading system. Even as Governments extol the virtues of free trade, they are only too willing to intervene to protect their domestic constituencies that feel threatened by the cold winds of international competition. Such remnants of neo-mercantilist thinking have done much to unbalance the bargain struck during the Uruguay Round.

Since the third session of the WTO Ministerial Conference, held in Seattle, a renewed effort has been made to address the concerns of developing countries, culminating in a different kind of bargain being struck at Doha. Developing countries, by agreeing to a comprehensive programme of work and negotiations, demonstrated their commitment to tackling global political and economic threats; in return, they expect that development concerns will be central to the negotiations. The challenge is now to translate an expanded negotiating agenda into a genuine development agenda.

One voice from the past stands out in the search for a more balanced trading system. In his statement to the first United Nations Conference on Trade and Development in March 1964, Raúl Prebisch, its then Secretary-General, called on the industrial countries not to underestimate the basic challenge facing developing countries in the existing system:

> *We believe that developing countries must not be forced to develop inwardly – which will happen if they are not helped to develop outwardly through an appropriate international policy. We also deem it undesirable to accept recommendations which tend to lower mass consumption in order to increase capitalization, either because of the lack of adequate foreign resources or because such resources are lost owing to adverse terms of trade.*

Prebisch understood that recommending "the free play of market forces" between unequal trading partners would only punish poorer commodity exporters at the same time as it brought advantages to the rich industrial core. His agenda to attack the persistent trade imbalance and create the essential external conditions for accelerating the rate of growth included new modalities of participation for developing countries in the trading system which would guarantee price stabilization and improved market access for primary exports, allow greater policy space to develop local industries and reduce barriers to their exports, establish more appropriate terms of accession to the multilateral system and reduce the burden of debt servicing. Although the participation of developing countries in the trading system has since gone through important changes, the minimum agenda put forward by Prebisch remains the basis for rebalancing that system in support of development.

Global trends and prospects

Growth in the world economy slowed sharply in 2001; performance was weak in all three leading economic regions in the developed world, and the spillover effects on developing countries were much stronger than in previous downturns in the 1990s. Several emerging-market economies in East Asia and Latin America entered into recession; only China and India, two large and relatively closed economies, were by and large immune from the downward pressure of world markets. Growth in Africa remained at a level similar to that of the previous year. For developing countries as a whole growth was only 2.1 per cent, down from 5.4 per cent in the previous year.

The United States economy entered into recession, and the belief that the Euro area would be unaffected proved unfounded. Faltering exports, lower profits of affiliates in the United States, and an overly cautious monetary and fiscal response all contributed to a decline in the growth rate for the Euro area in 2001 to about 1.5 per cent. Unemployment, which had been falling for three years, stabilized at the relatively high level of 8.5 per cent. Of the large EU economies, only the United Kingdom had a more favourable experience, thanks to strong consumer demand. The recovery in Japan, which began in 1999, dissipated in the second half of the following year, and since the second quarter of 2001 the economy has been in recession, with exports and private investment declining at double-digit rates. Despite the return of the Japanese central bank to its zero interest rate policy in March 2001, companies are reporting record losses, corporate bankruptcies have been rising, and unemployment has edged up to 5.5 per cent.

International trade played a major role in transmitting the slowdown in the industrial world to developing countries. After growing by 14 per cent in 2000, export volumes for developing countries grew by less than 1 per cent in 2001. All major developing regions were affected, but the impact was most marked in East and South Asia, where exports had grown particularly fast in 2000 thanks in large part to strong demand for electronic products and semiconductors in the United States; the decline in exports is estimated to have been more than 15 per cent for Taiwan Province of China, 10 per cent for the Republic of Korea and 5 per cent for Hong Kong (China), Malaysia, Singapore and Thailand. In some regions, slower growth in export volumes was compounded by falling prices, especially in Latin America, which suffered from substantial declines in the prices of its commodity exports. The sharp drop in petroleum prices from their peak in late 2000 also reduced revenues for oil exporters. By contrast, prices for some commodities exported by African countries held up well in 2001.

Capital flows to developing countries in 2001 remained at the low levels prevailing since the Asian financial crisis in 1997, and suffered a severe setback in the aftermath of 11 September. The economic slowdown and the loosening of monetary policy in the United States had been expected to encourage capital flows to emerging markets for reasons similar to those applying in the early 1990s. However, the lingering uncertainty surrounding these markets after a series of financial crises has

been compounded by increased vulnerability to the downturn in industrial countries. Since, in contrast to the situation in the early 1990s, growth in developing countries today is more directly linked to that of the United States, those countries provide less scope for diversification to investors seeking higher risk-adjusted rates of return. Loan repayments to foreign banks by East Asian borrowers have continued to exceed new loans elsewhere by a considerable margin, and securitized debt continues to flow to developing countries at a slower pace. Foreign direct investment (FDI) has held up better: flows to Latin America made that region the largest net recipient of capital flows. However, the resilience of FDI seems unlikely to persist into 2002. Only China, which saw net inflows rise in 2001, seems likely to continue attracting inflows on an even larger scale, now that it has acceded to the WTO.

Exchange rates in developing countries have been relatively stable. The major exceptions were Argentina and Turkey, which were forced to float their currencies, provoking in both cases considerable financial turmoil. In Argentina the abandonment of the currency peg was associated with a much broader economic crisis, the full consequences of which for both the country itself and its neighbours are not yet clear. However, there has been no widespread contagion of other emerging markets. Since the beginning of 2001 there has been further movement among developing countries towards the adoption of floating exchange-rate regimes, usually coupled with official willingness to intervene to prevent large movements in rates.

Despite the concerted response from the world's most important central banks following the events of 11 September, only in the United States has policy been consistently focused on limiting the impact of the slowdown on employment and real income. The Stability and Growth Pact of the Euro area has led to the pursuit of deficit targets with insufficient regard to the cyclical positions of different countries. While a weak euro has helped maintain foreign demand, from a global perspective monetary policy in the Euro area has also been restrictive. In Japan hopes seem to be pinned on a weak yen to ignite an export-led recovery. However, recovery also requires increased consumer expenditure, which monetary policy alone is unlikely to be capable of achieving.

Thus, much still hinges on the strength of the United States recovery. So far, despite the rise in unemployment and a slower growth of real wages, stronger-than-expected consumer spending has limited the drop in output. With private savings still extremely low, a sustained recovery will have to be compatible with a return of private households to normal spending habits. At the same time, corporate balance sheets are likely to require further restructuring and the potential of monetary expansion for achieving a revival of investment seems limited. There will be a sustained recovery only if consumer and business confidence is sufficiently buoyant to convince producers that they need to increase investment in new productive capacity. As yet, there are few indications that this is the case.

In the light of the above, a likely outcome is that the United States economy would stabilize at a low, but positive, rate of growth. Such an eventuality would have limited knock-on effects for Europe and Japan, both of which are still dependent on an export-led upturn. Moreover, if the dollar remains strong at the same time as growth in Europe and Japan remains sluggish, the current-account deficit of the United States may widen even further, with the danger of heightened protectionist pressures in that country and a risk that a large eventual dollar devaluation may usher in a period of more generalized currency instability.

As a result of active policies to stimulate domestic demand, most Asian economies returned to positive growth in the last quarter of 2001. Some Latin American and transition economies also managed to buck the global trend earlier in the year. However, growth in the industrial world is unlikely to return quickly to the 3 per cent that appears to be necessary to support a vigorous increase in employment and income in the developing world. Reaching such an objective would require substantial increases in demand for developing-country exports, a major recovery in commodity prices, and a strong increase in capital flows, for which there is little prospect at present.

Least affected by unfavourable external conditions will be the emerging markets in East and South Asia, which have recently been running current-account surpluses and generally have relatively high ratios of foreign exchange reserves to short-term external indebtedness. By contrast, most Latin American countries will require greater capital inflows in order to finance more vigorous growth. In several transition economies in Europe growth is also dependent on the dynamism of exports markets in the Euro area as well as on capital inflows.

In such a context of slow global growth, improved market access could provide a useful boost to activity in developing countries, and greater use of regional trade and financing mechanisms may provide relief from external constraints and protection against financial instability. Nevertheless, many developing countries will continue to require substantial official financial support if they are to be protected from the effects of the difficult external economic environment.

Developing countries in world trade

Fundamentally, the basic policy challenge facing most developing countries remains how best to channel the elemental forces of trade and industry to wealth creation and the satisfaction of human wants. Shifting away from their dependence on the export of primary commodities towards greater production and exports of industrial products has often been viewed as a means of their participating more effectively in the international division of labour. Manufactures are expected to offer better prospects for export earnings not only because they allow for a more rapid productivity growth and expansion of production, but also because they hold out the promise of greater price stability even as volumes expand, thereby avoiding the declining terms of trade that have frustrated the long-term growth performance of many commodity-dependent economies.

Since the early 1980s, moves to rapidly liberalize trade and FDI have strongly influenced policy makers in many developing countries in their thinking about this challenge. Openness to international market forces and competition was expected to allow those countries to alter both the pace and the pattern of their participation in international trade, thereby overcoming balance-of-payments problems and accelerating growth, to catch up with industrial countries.

During this period, the exports of developing countries have, indeed, grown faster than the world average and now account for almost one third of world merchandise trade. Much of that growth has been in manufactures, which today account for 70 per cent of developing country exports; for some products developing country exports account for around half or more of world exports. More importantly, many developing countries appear to have succeeded in moving into technology-intensive manufactured exports, which have been among the most rapidly growing products in world trade over the past two decades, notably electronic and electrical goods.

However, on closer examination, the picture is much more nuanced. With the exception of a few East Asian first-tier newly industrializing economies (NIEs) with a significant industrial base, which

were already closely integrated into the global trading system, developing country exports are still concentrated on products derived essentially from the exploitation of natural resources and the use of unskilled labour, which have limited prospects for productivity growth and lack dynamism in world markets. Statistics showing a considerable expansion of technology-intensive, supply-dynamic, high-value-added exports from developing countries are misleading. Such products indeed appear to be exported by developing countries, but in reality those countries are often involved in the low-skill assembly stages of international production chains organized by transnational corporations (TNCs). Most of the technology and skills are embodied in imported parts and components, and much of the value added accrues to producers in more advanced countries where these parts and components are produced, and to the TNCs which organize such production networks.

Indeed, while the share of developing countries in world manufacturing exports, including those of rapidly growing high-tech products, has been expanding rapidly, the income earned from such activities by these countries does not appear to share in this dynamism. On this score, a comparison between the developed and developing countries over the past two decades raises some initial worries. Although developed countries now have a lower share in world manufacturing exports, they have actually increased their share in world manufacturing value added over this period. Developing countries, by contrast, have achieved a steeply rising ratio of manufactured exports to gross domestic product (GDP), but without a significant upward trend in the ratio of manufacturing value added to GDP. Accordingly, the increase in the shares of developing countries in world manufacturing exports has not been accompanied by concomitant increases in their shares in world manufacturing value added, and in several countries the two ratios have tended to move in opposite directions. Certainly, few of the countries which pursued rapid liberalization of trade and investment and experienced a rapid growth in manufacturing exports over the past two decades achieved a significant increase in their shares in world manufacturing income.

Clearly, for many developing countries, getting the most out of the international trading system is no longer just a matter of shifting away from commodity exports. At the same time, many of the same forces that adversely affected price and productivity dynamics in the primary sector, including the competitive structure of markets, income elasticities and technological weaknesses, need to be re-examined in the light of recent trends associated with the increased participation of developing countries in the international trading system.

Dynamic products in world trade

Over the past two decades the value of world merchandise exports has grown at an average rate of around 8 per cent per annum, compared to less than 6 per cent growth in global output and income (in current dollars). Among the 225 products examined in this *TDR*, exports of some have grown at rates three times as fast as the growth in global income, whereas for others export values have declined in absolute terms. It is mainly primary commodities, but also some manufactures, that have registered sluggish or negative growth rates. The growth of trade in about one third of all products, including both primary commodities and manufactures, has lagged behind the growth of global income.

While manufactures generally constitute the fastest-growing products in world trade, there are also some agricultural products in this group, such as non-alcoholic beverages and cereals. Many of the fastest-growing manufactures in world trade, such as electronic and electrical goods, which now account for around one sixth of world exports, tend to be technology-intensive, often with a high research and development (R&D) content. A common feature of these market-dynamic manufactures is that the sectors in which they are produced exhibit strong productivity growth. This is less so for

other market-dynamic products, such as textiles and clothing, and transport equipment, which have low- or medium-skill contents.

Differences in income elasticities, product innovation and changing consumption patterns, and shifts in competitiveness of industries across countries, can explain why some products are more dynamic in world markets than others. However, differences in the speed of liberalization of markets have also played a significant role. A particularly important influence in recent years has been the commercial policies of many developed countries, which limit access to their markets. Trade liberalization has been limited and slow in textiles and clothing along with other labour-intensive manufactures, compared to the pace of liberalization in other sectors. High tariffs and tariff escalation have been compounded by other overt forms of protection such as tariff rate quotas, as well as by the adverse impact of anti-dumping actions and product standards. The growing number of non-tariff barriers, especially against unsophisticated manufactures, has reinforced the prevailing patterns of market access, which favour high-tech products over low- and middle-range products that tend to gain importance in the early stages of industrialization.

Perhaps a more decisive influence on product dynamism has been the strategy of TNCs. The three product groups with the fastest growth rates over the past two decades, namely components and parts for electrical and electronic goods, labour-intensive products such as clothing, and goods with a high R&D content, have been most affected by the globalization of production processes through international production-sharing arrangements. The increased mobility of capital, together with continued restrictions over labour movements, has extended the reach of international production networks, thereby accelerating the growth of trade in a number of sectors where production chains can be split up and located in different countries. Favourable tariff provisions, often through regional arrangements, and fiscal and other incentives have encouraged this process, promoting a new pattern of trade whereby goods are processed in several locations before reaching final consumers, and the total value of trade recorded in such products exceeds their value added by a considerable margin. Trade based on specialization within such networks is estimated to account for up to 30 per cent of world exports.

Trade and industry: new linkages, old challenges

While developing countries as a whole appear to have become more active and dynamic participants in world trade over the past two decades, closer examination shows a great deal of diversity in the modalities of their participation in the international division of labour:

- First, many countries have not been able to move away from primary commodities, the markets for which are relatively stagnant or declining. However, growth in trade in several primary commodities has been as rapid as in some manufactures, and countries which have successfully entered such sectors have experienced a significant expansion in their exports and incomes;

- Second, most developing countries that have been able to shift from primary commodities to manufactures have done so by focusing on resource-based, labour-intensive products, which generally lack dynamism in world markets;

- Third, a number of developing countries have seen their exports rise rapidly in skill- and technology-intensive products which have enjoyed a rapid expansion in world trade in the past two decades. However, with some notable exceptions, the involvement of developing countries in such products is confined to labour-intensive, assembly-type processes with little value added. Consequently,

the share of some of these countries in world manufacturing income actually fell. For others, increases in manufacturing value added lagged considerably behind their recorded shares in world manufacturing trade;

- Finally, a few countries have seen sharp increases in their shares in world manufacturing value added which matched or exceeded increases in their shares in world manufacturing trade. This group includes some East Asian NIEs which had already achieved considerable progress in industrialization before the recent shift to export drive in the developing world. None of the countries which have rapidly liberalized trade and investment in the past two decades is in this group.

Thus, most developing countries are still exporting resource- and labour-intensive products, effectively relying on their supplies of cheap, low-skilled, labour to compete. With the exception of the last group, they do not appear to have been able to establish a dynamic nexus between exports and income growth that would allow them to rapidly close the income gap with industrial countries. Although they as a whole appear to have become major players in world markets for dynamic products, they still account for only 10 per cent of world exports of products which score high in R&D content, technological complexity and/or economies of scale.

Making sense of a system in which many developing countries are vigorously expanding their foreign trade but are not rewarded by a comparable rise in income requires some hard thinking. A first step is to break with a casual style of empiricism, which takes the classification of manufactured traded goods at face value. Generally, developing countries participating in high-technology sectors are not involved in the skill- and technology-intensive parts of the overall production process. Consequently, their contribution to value added is determined by the cost of the least scarce and weakest factor, namely unskilled labour, whereas the rewards to scarce but internationally mobile factors such as capital, management and know-how are reaped by their foreign owners. It is thus the labour itself, rather than the product of labour, that is exported. Indeed, even in countries such as China and Malaysia, which have been highly successful in raising their shares in world manufacturing exports and value added through participation in international production chains, an important part of domestic value added is captured by profits earned on FDI.

Clearly, participation in the labour-intensive segments of international production networks can yield considerable benefits for countries in the early stages of industrialization and with a great deal of surplus labour. It can enable them to increase employment and per capita income even when value added generated is low. Furthermore, increased employment of low-skilled labour in activities linked to international production networks – whether organized by large TNCs producing a standardized set of goods in several locations, or through groups of smaller enterprises located in different countries and linked through international subcontracting – has certainly widened the possible range of sectors

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