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I. GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION

(Draft for comments only, please do not quote)

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The global setting

The global economy showed unexpected strength during 2003 despite the war in Iraq, the SARS outbreak in Asia and geopolitical tensions in West and East Asia. Indeed, preliminary indications are that the 2003 global GDP growth rate will either match, or modestly exceed, 2002 performance. Inflationary pressures have risen only slightly despite volatility in the energy markets; as a result, monetary authorities virtually across the world have been able to maintain an environment of low interest rates. Growth in world trade was unchanged in 2003 compared to 2002. Assuming no new negative shocks, prospects for the global economy in 2004 are broadly positive with the possibility of acceleration in the growth rate in the second half of 2004. In that event, GDP growth for the year as a whole could be around one percentage point more than in 2003. Selected indicators of global economic conditions and forecasts for 2004 are given in table 1.

At the same time, however, as current uncertainties fade and growth picks up steam new policy issues will inevitably arise in the months ahead. As explained in the concluding section of this chapter, short-term policy issues have to be placed within a longer-term continuum. Most countries in the ESCAP region have, for instance, to confront major development challenges, such as poverty eradication, in accordance with internationally agreed goals and commitments. Without more explicit policy interventions and the application of additional financial and non-financial resources these longer-term goals may not be reached.

Within the ESCAP region, despite the impact of domestic growth enhancing measures and the rise in intra-regional trade, reliance on the United States (US) economy continues to drive global growth; the US still accounts for over 20 per cent of the exports of ESCAP developing countries. While such reliance is a matter of concern for the region in that it intimately links the region to cyclical developments in the US economy, it is also contributing to the emergence of a serious macroeconomic imbalance in the United States economy in the form of a rising current account deficit. The US runs large balance of trade deficits with several ESCAP economies. In addition, in 2003, as a result of tax cuts and the cost of the war in Iraq, a sharply higher fiscal deficit has further complicated the macroeconomic situation in the US. The twin deficits and how they are funded have major implications for the global economy.

Concurrently, in many developed and developing economies while overall external positions remain favourable, domestic public debt is rising (see table 2). This widespread incidence of macroeconomic imbalances could presage significantly increased instability in global financial markets in the months ahead. Such instability could come in the form of higher risk aversion manifesting itself as higher borrowing costs, such as wider spreads on developing country debt, greater volatility in exchange rates disrupting global financial flows and, through lower business and consumer confidence, lower levels of activity in the real economy. Here, it should be emphasized that, from a domestic perspective, in many countries with interest rates already at historically low levels and public debts on a rising trend, the scope for further macroeconomic policy easing is limited should growth falter for any reason in the months ahead.

Over the short-term, Governments of all countries are thus faced with the policy challenges of sustaining the momentum of growth by preserving business and consumer confidence, maintaining their commitment to the agenda of trade liberalization in the face of setbacks and difficulties in negotiations, such as those in WTOs Fifth Ministerial Meeting in Cancun in September 2003, and coping with the rapid spread of globalization. While there are grounds for cautious optimism with respect to immediate prospects, it would be imprudent to assume that all countries will be able to negotiate the next 12-18 months smoothly and effortlessly. As stressed in previous issues of the *Bulletin* and *Survey* by the ESCAP secretariat, individual Governments need to remain committed to macroeconomic prudence, good governance and flexibility in day-to-day economic management. Simultaneously, Governments must facilitate structural change to enable their economies to maintain competitiveness in a globalizing world economy. For the long-term, the greatest challenges for the developing countries in particular emanate from meeting the Millennium Development Goals, especially those relating to the target of halving the number of people in poverty by 2015.

In the following pages developments in the global economy in 2003 are examined in greater detail. The differing roles of the developed and developing economies in terms of their participation in global trade and financial markets are analyzed, the likely impact of prevailing global trends on the economies of the ESCAP region and prospects for the various sub-regions and economic groupings among ESCAP member countries assessed. Finally, the near-term policy issues and long-term development challenges facing the ESCAP region are discussed.

Developed countries

Despite a combination of low interest rates and higher Government spending, output growth in the developed economies remained sluggish up to the middle of 2003. There were tentative signs of a pickup in the pace of growth in the second quarter in both the US and Japan but output growth in the EU (European Union) remained lacklustre in the first half of 2003. However, leading indicators in Germany, the largest EU economy, suggest that growth is likely to gain momentum later in the year or in early 2004. Taking the triad of the US, Japan and EU together there is now a degree of optimism that the next 12 months should see a steady improvement in GDP performance compared to the first half of 2003. While this assessment is the most probable scenario on the basis of currently available information it is nevertheless subject to a number of risks. These are more fully discussed in the following paragraphs.

In the US, household spending has been the principal driver of growth since the ending of the IT bubble in 2000. Corporate investment expenditures, despite improved balance sheets, have failed to pick up significantly, until recently at any rate. The signs are that this phase is coming to an end. Profitability is improving and this, combined with low borrowing costs, is expected to translate itself into higher investment expenditures in the months ahead. New capital equipment is also likely to be needed after two years of declining investment and on account of the rapid obsolescence of most ICT-related high-tech capital equipment.[1] Nevertheless, corporations still remain saddled with enormous debts – a legacy of the post-bubble economy – and any broad-based investment upturn in the near term is likely to be weak.

While there are encouraging signs with regard to corporate capital investment, question marks hang over both the sustainability of household spending in the face of weak employment data and the wider repercussions of the twin deficits, external and fiscal, on growth in the US economy over the next 12 months. Consumer and business confidence revived strongly following the formal ending of military action in Iraq but subsequent events in that country have served to undermine both to some extent. As a result, there are signs that spending on durable goods is tending to weaken. In particular, re-mortgages, a major factor in sustaining consumer spending over the past two or three years, appear to be tailing off with uncertainty on the jobs front. Growth in the US economy in both 2002 and 2003 has not been accompanied by higher employment. On the contrary, unemployment has risen from 5.8 to 6.1 per cent over the 12 months to August 2003 and job losses continue to occur in the manufacturing sector.

With regard to the simultaneous emergence of the twin deficits, too, the situation has significant worrisome elements. The current account deficit of US of - 5.2 per cent of GDP is the worst in the country's history and there is a likelihood of a further deterioration in 2004. The principal concern is that the appetite of foreigners to invest in

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[1] The Semiconductor Industry Association is predicting growth of semiconductor sales by 10.1 per cent in 2003 and 16.8 per cent in 2004, *Bangkok Post*, 6 August 2003.

US assets could be flagging. In the last two years the composition of capital flows has changed significantly. FDI into the US has become negative and private portfolio flows financed only about a quarter of the deficit in early 2003; the remainder being funded by short-term speculative capital flows and official purchases of bonds by foreign central banks. This lack of enthusiasm for US assets has already revealed itself in the decline of the dollar trade-weighted exchange rate by more than 15 per cent between September 2002 and September 2003. A weakening dollar will further dampen capital inflows into the US unless compensated by higher returns.[2]

On the fiscal side, the deficit has risen above 4.5 per cent of GDP and, until growth revives in a more robust fashion, is unlikely to come down significantly. All things considered, the fiscal deficit is unlikely to boost long-term growth.[3] Recent empirical evidence from the US and, indeed, elsewhere lends support to the view that budget deficits, over time, push up interest rates. In the US there has already been a steepening of the yield curve for bonds in recent months with a rise in long-term interest rates. Furthermore, there is a view, based upon macroeconomic simulations for a variety of differing scenarios, that deficits induced by tax cuts do boost activity in the short-term. However, the rise in long-term rates eventually negates the boost owing to the slower capital accumulation caused by higher interest rates. It should also be noted here that, given the increased integration of capital markets, trends in US interest rates are likely to have a direct bearing on interest rates in other countries, possibly leading to higher global interest rates with negative spillovers on global growth.

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[2] The US Federal Reserve stated in August 2003 that interest rates would remain low "for a considerable time." *Bangkok Post*, 14 August 2003.
[3] IMF, *United States: 2003 Article IV Consultation* (Washington, DC, August 2003).

Nevertheless, taking together the growing evidence of an upturn with the overall balance of forces operating in the US economy, the consensus is that, while there is significant uncertainty in making an accurate assessment of prospects for 2004, the risks to growth at this stage are not immediate. It is likely, therefore, that with a resumption in capital spending, output growth could be at, or very close to, the long-term trend rate of growth of the US economy of around 3.5 per cent a year in the second half of 2004.

Although Japan has been stuck in a low growth syndrome for the better part of a decade (1.2 per cent per annum over the past eight years) its economy has been showing signs of revival in recent months. By the second quarter of 2003 Japan had enjoyed six consecutive quarters of growth. This unexpected change in the fortunes of the Japanese economy is best exemplified by the resurgence of profits of Japanese companies, the rise in the stock market of nearly 30 per cent in dollar terms since end-2002 and improved business confidence. In fact, there is patchy evidence that consumer demand, too, after several years of decline or flat growth is reviving. By July 2003, wages and earnings had registered a year-on-year growth of 2.3 per cent and unemployment had fallen marginally from 5.4 to 5.3 per cent. Observers are of the view that many Japanese consumers now feel that the worst is over and that unemployment has stabilized. As a result, they could become less reluctant consumers in the months ahead.

While the recent performance of the Japanese economy gives grounds for optimism for the near term a number of important caveats need to be stated. First and foremost, despite the improvement in consumer confidence, it is the case that the recent revival of growth has been driven primarily by exports. In this process the yen exchange rate appears to have played a major part. On a trade-weighted basis the yen exchange rate has appreciated by less than 1.5 per cent over the last 12 months, unlike, say, the euro, and the current account surplus has begun to increase. In fact, the Bank of Japan has intervened on a massive scale in order to prevent the yen from appreciating but in doing so it has added to the already huge foreign exchange reserves, paradoxically adding to the upward pressure on the yen exchange rate.

Companies have begun to invest but these expenditures are viewed as being primarily in anticipation of higher export demand. Given this background, there are obvious doubts whether the contribution of net exports based upon a weak yen can be sustained for long. Second, the problem of deflation continues essentially unabated. Indeed, should current forecasts be borne out Japan will, in 2004, complete six years of falling price levels. The apparent revival of consumer confidence should be viewed in that context. Third, problems in the banking and corporate sectors, notwithstanding recent progress, remain daunting. The improved profitability of Japanese companies has not been reflected in any meaningful reduction in the non-performing loan problem although the present Government has committed itself to a target of halving bad loans by March 2005. Provisioning against bad debts in the banking system is still low, the banking system is still minimally capitalized and most banks' capital is subject to a large measure of vulnerability emanating from fluctuating sentiment in the equity markets.

For these reasons the overall judgment is that Japan will not be able to sustain growth at its present pace into 2004. Further, given the poor performance of the Japanese economy over a number of years its potential growth rate may now be significantly below the generally assumed 4 per cent per annum that Japan achieved in the 1980s. In other words, an upturn in Japanese GDP growth will only be an improvement on its recent performance and not a return to the robust growth of the 1980s. [4]

In late 2002 there were signs that growth in the EU would become stronger in 2003. In the event, the most probable outcome is likely to be a slight deceleration with Germany, France, Netherlands and Italy slowing down perceptibly in mid 2003, registering