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Chapter I

CURRENT ISSUES IN THE WORLD ECONOMY

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Chapter I

CURRENT ISSUES IN THE WORLD ECONOMY

A. Introduction

The world economy is still growing at a steady pace but the risk of a relapse hangs in the balance. The moderate slowdown registered in the first half of 2005 indicates that the world's main engine of growth, the United States economy, may not be able to drive forward global growth without the support from other parts of the world. Meanwhile, the euro area is stuck in stagnation, and Japan's growth shows a moderate deceleration.

Growth performance in the developing countries was generally good and the populous East and South Asian countries, in particular China and India, acted as the second engine of worldwide growth. As a result of their vigorous expansion and their strong demand for imports of raw materials, many other developing countries have experienced windfall revenues from rising commodity prices and surging demand for intermediate products. Even Africa posted a growth rate of about 4.5 per cent in 2004 and it is expected to expand by close to 5 per cent this year. Although these growth rates allow for an increase in per capita income, in sub-Saharan Africa they are still insufficient to attain the Millennium Development Goals (MDGs) by 2015. Section B of this chapter assesses the global growth record and regional performances.

The sustainability of the present growth path is facing several threats. Serious multilateral action to unwind global current-account imbalances without endangering the growth process has been missing. Instead, political pressure on some countries to take unilateral measures is mounting, as analysed in section C of this chapter. It is shown that the European Union, in its own interest, should do more to accelerate domestic demand growth and enhance absorption.

Section D of this chapter focuses on the effects of the oil price hike on the world economy from a historical perspective. It shows that the direct impact of quickly rising oil-import bills on the developed countries has been much less pronounced than in the period which followed the oil price shocks of the 1970s. Moreover, there are so far no signs of negative indirect effects on inflation and interest rates. On the other hand, the oil price hike has had, and continues to have, a significant impact on the economies of many oil-importing developing countries.

Section E examines some aspects of the present economic expansion in China and India, and compares it with the rapid growth episodes experienced by Japan and the Republic of Korea

in the period following the Second World War. It highlights the role played by profit-investment linkages, the sectors driving the economy, the need of establishing a balance between expanding domestic and foreign demand, and the importance of supportive macroeconomic policies.

B. The world economy: growth performance and prospects

The world economy grew by almost 4 per cent in 2004, recording its best performance since 2000. Global growth continued into 2005 – albeit at a slower pace – and is expected to fall to around 3 per cent. Most of this deceleration is attributable to the slowdown in developed economies, although some developing countries are also showing signs of losing momentum. Developing economies as a whole are expected to grow by 5 to 5.5 per cent, down from 6.4 per cent in 2004 (table 1.1).

1. Economic activity in developed countries

Domestic demand was the main driving force of growth in the *United States* in 2004, with private domestic investment growing at a two-digit rate and personal consumption maintaining a significant rate of growth, especially in durable goods. The volume and value of United States exports grew at a brisk pace in 2004 and the first months of 2005, in part because of the real depreciation of the dollar. However, imports grew even faster and, as a consequence, trade contribution to gross domestic product (GDP) growth continued to be negative. Trade and current-account deficits widened, with the latter rising to 6 per cent of GDP in the last quarter of 2004, raising the question of what supplementary policies would be needed if the United States current account is to be significantly reduced (see section C).

Annual growth in the United States is forecasted to be around 3.5 per cent in 2005 (Klein and Ozmucur, 2005). Indeed, personal consumption expenditures and fixed investment have slowed in the first quarter 2005.[1] It is an open question whether these are the first signs of a persistent deceleration of growth. On one hand, recent increases in labour income and corporate profits may support future private expenditure while, on the other hand, their positive effects may be offset by slower productivity gains, high energy costs, and the fading of temporary factors such as tax cuts and the depreciation of the dollar. Moreover, diminishing fiscal and monetary stimulus may eventually affect domestic demand. Fiscal policy is set to be less expansive than in previous years, as it aims to reduce the public deficit from 3.6 per cent of GDP in 2004 to 1.8 per cent by 2009. This may require some cutbacks in expenditure, especially if reforms involving fiscal costs, such as those associated with the social security system, are carried out while higher interest rates weigh on public debt services. Even if interest rates remain at historically low levels, rising rates may have a negative effect on the consumption of durable goods and on fixed investment. More generally, interest rate movements may have sizeable economic effects, as domestic debt levels in

Table 1.1

WORLD OUTPUT GROWTH, 1990–2005[a]

(Percentage change over previous year)

Region/country[b]	1990–2000[c]	1999	2000	2001	2002	2003	2004[d]	2005[e]
World	**2.7**	**2.9**	**4.0**	**1.3**	**1.8**	**2.5**	**3.8**	**3.0**
Developed countries	**2.4**	**2.7**	**3.5**	**1.0**	**1.3**	**1.7**	**3.0**	**2.3**
of which:								
Japan	1.4	0.1	2.8	0.4	-0.3	1.4	2.6	1.8
United States	3.4	4.1	3.8	0.3	2.4	3.0	4.4	3.5
European Union	2.1	2.9	3.6	1.7	1.1	0.9	2.1	1.5
of which:								
European Union-15	2.1	2.9	3.5	1.6	1.0	0.8	2.0	1.4
Euro area	2.0	2.8	3.5	1.6	0.9	0.5	1.8	1.2
France	1.7	3.2	3.8	2.1	1.2	0.5	2.1	1.5
Germany	1.6	2.0	2.9	0.9	0.2	-0.1	1.0	0.8
Italy	1.6	1.7	3.0	1.8	0.4	0.3	1.0	-0.4
United Kingdom	2.7	2.8	3.8	2.1	1.7	2.2	3.1	2.0
South-East Europe and CIS	**-4.3**	**3.4**	**8.1**	**5.6**	**4.9**	**6.9**	**7.5**	**6.0**
Developing countries	**4.8**	**3.5**	**5.4**	**2.4**	**3.5**	**4.7**	**6.4**	**5.4**
Developing countries, excluding China	**4.0**	**3.0**	**5.0**	**1.5**	**2.7**	**3.9**	**5.7**	**4.6**

Source: UNCTAD secretariat calculations, based on UNCTAD *Handbook of Statistics 2004*; United Nations, Department of Economic and Social Affairs (UN/DESA), Development Policy and Planning Office, Project Link estimates; national sources; IMF, *World Economic Outlook*, April 2005; JP Morgan, *Global Data Watch*, various issues; Economic Intelligence Unit (EIU), *Country Forecast*, various issues; and OECD, *Economic Outlook No. 77*.

a Calculations are based on GDP in constant market prices based on 1995 dollars.
b Region and country groups correspond to those defined in the UNCTAD *Handbook of Statistics 2004*.
c Average.
d Preliminary estimates.
e Forecast.

non-financial sectors reached $24.8 trillion at the end of the first quarter of 2005 – roughly twice the size of GDP.

Rising interest rates and/or a decline in housing prices may also affect other developed countries – such as Australia, Canada and the United Kingdom – where private consumption has been partly sustained by booming house prices and rising household indebtedness. This contribution to growth is most likely coming to an end as household saving ratios recover from their current low levels. Real appreciation has hampered export volumes and boosted imports in Australia and Canada, resulting in a negative contribution of net exports to GDP growth; however, these countries have benefited from significant gains in terms of trade, in large part due to their primary commodity exports. Australia, Canada and the United Kingdom are expected to experience a moderate decline in their GDP growth in 2005, to a rate close to 2.5 per cent.

Economic growth in the *euro area* has slowed since mid-2004. Most forecasters have reduced the 2005 growth expectations (set in the Autumn of 2004) from 2 per cent to 1.5 per cent or even slightly below. The economic slowdown was mainly attributed to a fall in the growth rate of exports (induced by the appreciation of the euro) in concert with sluggish domestic demand in many countries. As pointed out by UNCTAD over the

past three years, the biggest European countries have not been able to reach a higher and sustainable growth path despite receiving enormous stimulus from the world economy. This inability is attributed to depressed domestic demand as a result of a mixture of deflationary wage policies (i.e. in Germany, where a 0.8 per cent growth rate expected in 2005) and losses of market shares (i.e. in Italy, whose GDP is expected to fall in 2005). France, with a more moderate deflationary policy than Germany, remains in the middle of the group, with growth forecasted at around 1.5 per cent. Spain is estimated to grow at a rate of about 3 per cent in 2005 owing to sustained domestic demand. As no fundamental changes in economic policy within the euro area are foreseen, an acceleration of growth in the near future cannot be expected. The 2005 outlook for the ten new members of the European Union is more upbeat and growth rates are expected to exceed 4 per cent.

All in all, Europe is not positioned to help reduce global imbalances in the next two years. Its overall current-account deficit is rather low (0.3 per cent of GDP) but the imbalances of countries inside the European Monetary Union increased dramatically in the last three years. For example, Germany's surplus of $110 billion (3.8 per cent of GDP), forecasted for 2005 by IMF (2005a), is much larger than China's surplus.

In 2004, *Japan* recorded a growth rate of 2.6 per cent, which was driven by private and public consumption, non-residential investment and brisk export performance. Growth was strong in the first quarter of 2004, but faded in the second half of the year, as domestic and foreign demand weakened. In the first months of 2005, high corporate profits and the reversal of the long-lasting downward trend in employment and wages indicate that the sluggishness of domestic demand in the second half of 2004 may be over. Recent data on export performance are, however, less positive. They show a year-on-year deceleration of exports in late 2004, due to a slowdown in electronics exports. This is partly related to rising foreign direct investment (FDI) and production relocation to China (see chapter II). As a result, in 2005 trade is not expected to make a positive contribution to real GDP growth as it had in 2004. The forecast for 2005 points to a moderate deceleration in real growth to 1.8 per cent.

2. Economic activity in developing countries

In 2004, all developing regions posted significantly higher growth rates than in previous years (table 1.2). With a GDP growth of 4.6 per cent, *Africa* continued to grow at the same rate as in 2003 – the highest level reached in about a decade. However, the overall figures for the region mask considerable differences across countries, with growth rates ranging from an expansion of 31 per cent (Chad) to a contraction of over 8 per cent (Zimbabwe). The strong growth performance in Africa was fuelled mainly by higher prices of primary commodity exports, particularly petroleum, on the back of strong global demand. Economic growth was also supported by greater political stability and the improved agricultural performance resulting from favourable weather conditions. The continued growth in domestic demand is also credited to increased levels of external resource inflows via aid and debt relief, with the latter contributing to lower fiscal deficits. The general level of inflation went down from over 10 per cent to about 8 per cent.

Real GDP growth in 2004 was widespread in both sub-Saharan Africa and North Africa. High oil prices underscored output growth in Central Africa, which recorded the highest subregional growth rate at just over 7 per cent, and North Africa, with a growth rate of around 5 per cent. Economic performance in East and West Africa benefited from a combination of higher agricultural output and rising commodity prices. However, economic growth in West Africa was subdued, due to political instability in Côte d'Ivoire and a locust invasion in Mali, Niger and Senegal. Despite higher growth in South Africa, the Southern African region recorded the worst economic performance of all the African subregions, largely due to the continued economic contraction experienced by Zimbabwe as a consequence of drought and economic uncertainties.

Twelve African countries posted real output growth of 6 per cent or more in 2004, eight of which are either oil exporters (Chad, Equatorial Guinea, Angola, the Libyan Arab Jamahiriya and Sudan), or are recovering from a very low base (Ethiopia, Sierra Leone and the Democratic Re-

public of the Congo). Thus, once again, most countries have fallen short of the 7 per cent annual growth rate that is needed to attain the MDGs. A modest improvement is expected in the region's economic performance in 2005 on the back of continuing macroeconomic and political stability and high commodity prices; although domestic prices and external accounts in oil-importing countries will continue to suffer from high oil prices. However, even in oil-exporting countries that have been growing at two-digit rates over the past few years, poverty levels will not be significantly reduced unless governments manage to channel a significant part of the oil revenues into financing of non-oil economic sectors (including social and economic infrastructure), where the great majority of population is employed.

West Asia performed strongly in 2004, reaching 6.2 per cent growth in comparison to 5.3 per cent in the previous year. These performances are directly related to the massive injection of windfall revenues flowing into oil exporting countries, which also benefited indirectly most of the other countries in the region through increased demand for their exports, capital inflows and workers remittances.

Export revenues of the major oil exporters in the region (excluding Iraq) reached $292 billion in 2004,[2] 32 per cent more than in the previous year, owing mainly to higher international oil prices. The volume of oil production also increased (4.2 per cent for the group as a whole), contributing significantly to real GDP growth. These additional revenues, on average, represented 12 per cent of these countries' GDP, and boosted domestic expenditure. In particular, government revenues augmented significantly, allowing for an increase in public expenditures and, simultaneously, a significant fiscal surplus. Part of the surplus has been used to accumulate reserves, but another part was used to reduce indebtedness. As in some countries (notably Saudi Arabia) the bulk of public debt is held by nationals, debt repayments have further expanded private liquidity and demand. Expansionary trends have continued into 2005. Oil prices rose by 30 per cent in the first half of the year; if such price levels persist, oil revenues will increase in 2005 at a similar rate as in the previous year. Oil production is set to increase further in Saudi Arabia and Kuwait, and will probably be maintained at the current high levels in the Islamic Republic of Iran, Qatar and the United Arab Emirates. In addition, several investment projects are on line, covering the energy sector (oil, gas and refineries), infrastructure, telecommunications and real estate. At the same time, government expenditure is set to continue its upward trend; and it is aimed, in part, at addressing social problems related to high unemployment.

Other economies within the region, such as Jordan and Lebanon, also experienced accelerated growth in 2004, mainly driven by domestic demand that was stimulated by the expansion of regional tourism and higher workers remittances (ESCWA, 2005). Also, capital inflows into real estate investments boosted the construction sector. These countries managed to expand exports and profit from higher regional demand, including from Iraq. However, imports also expanded significantly and public debt remains high. These circumstances limited the room for manoeuvre of economic policies, making them highly dependent on continued inflows of capital, tourism and remittances.

Turkey posted a 8.9 per cent growth rate in 2004, propelled by strong domestic demand, in particular private consumption and fixed investment. An economic slowdown began in the second half of that year and extended into the first months of 2005.[3] However, GDP growth in 2005 is estimated to remain at around 5 per cent. Macroeconomic policy has to deal with the "twin" deficits problem. Overall fiscal balance remained negative in 2004, despite a primary surplus of 6.5 per cent of GDP, due to a public debt stock amounting to three quarters of GDP and high real interest rates. Moreover, although exports were growing significantly, the current-account deficit reached 5 per cent of GDP in 2004, as a result of booming imports and interest payments. These deficits remain a challenging issue for the Turkish economy. On the other hand, the continued reduction of interest rates by the central bank may play an important role in the sustainability of public debt and in preventing an excessive economic slowdown.

With 7.1 per cent growth in 2004, *East and South Asia* recorded its strongest expansion since the 1997 financial crisis. China led the boom with output growing by 9.5 per cent, but growth was

Table 1.2

GDP GROWTH IN SELECTED DEVELOPING ECONOMIES, SOUTH-EAST EUROPE AND CIS, 1990–2005[a]

(Percentage change over previous year)

Region/economy[b]	1990–2000[c]	1999	2000	2001	2002	2003	2004[d]	2005[e]
Developing economies	**4.8**	**3.5**	**5.4**	**2.4**	**3.5**	**4.7**	**6.4**	**5.4**
Latin America	**3.3**	**0.2**	**3.8**	**0.4**	**-0.6**	**2.0**	**5.7**	**4.2**
of which:								
Argentina	4.1	-3.4	-0.8	-4.4	-10.9	8.7	9.0	7.5
Bolivia	4.0	0.4	2.3	1.5	2.8	2.9	3.6	3.5
Brazil	2.9	0.8	4.5	1.5	1.5	0.6	4.9	3.0
Chile	6.6	-0.8	4.2	3.1	2.1	3.3	6.1	6.0
Colombia	2.9	-4.2	2.9	1.4	2.5	2.0	4.0	3.5
Ecuador	2.2	-6.3	2.8	5.1	3.8	3.1	6.9	3.0
Mexico	3.1	3.6	6.6	-0.2	0.9	1.3	4.4	3.3
Paraguay	2.2	0.5	-0.4	2.7	-2.3	2.6	4.0	3.0
Peru	4.6	0.9	2.8	0.3	4.9	4.0	4.8	5.5
Uruguay	3.4	-2.4	-1.4	-3.4	-11.2	2.5	12.3	5.5
Venezuela	1.6	-6.1	3.2	2.8	-8.9	-7.5	17.9	8.0
Africa	**2.6**	**3.0**	**3.5**	**3.4**	**2.9**	**4.7**	**4.6**	**4.9**
of which:								
Algeria	1.9	3.2	2.4	2.1	4.1	6.7	5.8	7.5
Cameroon	1.8	4.2	5.3	4.6	4.0	4.0	4.8	4.5
Cape Verde	6.0	8.6	6.8	3.0	4.6	5.0	4.0	6.0
Côte d'Ivoire	3.3	1.9	-2.7	0.1	-1.2	1.8	-1.0	-1.0
Democratic Republic of the Congo	-4.9	-4.3	-6.9	-1.1	3.1	5.0	6.8	7.0
Egypt	4.2	5.4	3.5	3.2	3.1	2.8	3.2	5.0
Ethiopia	3.9	6.3	5.4	7.9	1.2	-3.8	11.6	6.0
Ghana	4.3	4.4	3.7	4.2	4.5	4.7	5.8	5.0
Kenya	2.1	1.3	-0.2	1.1	1.0	1.8	2.6	3.0
Morocco	2.3	-0.1	1.0	6.3	3.2	5.2	3.7	4.0
Nigeria	2.9	2.8	5.8	2.8	1.5	10.7	5.1	4.5
South Africa	2.1	2.0	3.5	2.7	3.6	2.8	3.7	4.0
Tunisia	4.7	6.1	4.7	4.9	1.7	5.6	5.7	5.0
Zimbabwe	2.5	-0.7	-4.9	-8.4	-5.6	-13.2	-8.2	-3.0
Sub-Saharan Africa	2.6	2.9	3.9	3.2	3.0	4.8	4.4	4.4
Asia	**6.0**	**5.3**	**6.6**	**3.2**	**5.5**	**5.9**	**6.9**	**6.0**
Asia, excluding China	**4.9**	**4.8**	**6.2**	**1.9**	**4.7**	**4.8**	**6.0**	**4.8**
West Asia	3.2	-0.6	4.6	-0.1	4.3	5.3	6.2	5.2
of which:								
Iran, Islamic Republic of	3.5	4.2	2.8	3.2	8.0	6.7	5.4	5.5
Jordan	4.6	1.5	2.7	3.5	4.9	3.0	6.2	5.0
Lebanon	6.3	4.0	2.0	1.4	2.0	3.0	4.0	2.0
Saudi Arabia	1.7	-0.8	4.9	1.2	0.1	7.2	5.3	5.5
Turkey	3.8	-4.7	7.4	-7.5	7.8	5.8	8.9	5.0
United Arab Emirates	2.6	2.5	5.4	5.0	1.6	6.3	5.9	6.0
Yemen	5.5	3.7	5.1	3.9	3.3	4.2	2.0	3.0
East and South Asia	6.6	6.5	7.0	3.9	5.7	6.0	7.1	6.1
of which:								
China	10.4	7.0	7.9	7.5	8.0	9.1	9.5	9.0
Hong Kong (China)	4.0	3.4	10.2	0.5	2.3	1.5	8.1	5.0
India	6.0	7.1	4.0	5.5	4.3	7.8	6.7	6.5
Indonesia	4.2	0.8	4.9	3.4	4.3	5.0	5.1	6.0
Malaysia	7.0	6.1	8.3	0.5	4.1	5.3	7.1	5.5
Pakistan	3.5	4.3	2.6	2.9	5.8	5.3	6.3	7.5
Philippines	3.3	3.4	6.0	3.0	4.4	4.7	6.1	4.0
Republic of Korea	5.8	10.9	9.3	3.1	6.4	3.1	4.6	3.5
Singapore	7.7	6.4	9.4	-2.4	3.2	1.4	8.4	2.5
Taiwan Province of China	6.3	5.3	5.8	-2.2	3.9	3.3	5.7	3.5
Thailand	4.2	4.4	4.6	1.8	5.4	6.7	6.1	4.0
Viet Nam	7.9	4.8	6.8	6.9	7.0	6.0	7.7	7.0

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Table 1.2 (concluded)

GDP GROWTH IN SELECTED DEVELOPING ECONOMIES, SOUTH-EAST EUROPE AND CIS, 1990–2005[a]

(Percentage change over previous year)

Region/economy[b]	1990–2000[c]	1999	2000	2001	2002	2003	2004[d]	2005[e]
South-East Europe and CIS	**-4.3**	**3.4**	**8.1**	**5.6**	**4.9**	**6.9**	**7.5**	**6.0**
CIS	**-5.0**	**5.6**	**9.3**	**5.8**	**5.0**	**7.6**	**7.8**	**6.3**
of which:								
Belarus	-1.7	3.5	5.8	4.7	5.0	6.8	11.0	7.0
Kazakhstan	-4.1	2.7	9.8	13.2	9.9	9.2	9.4	8.5
Russian Federation	-4.7	6.4	10.1	5.1	4.7	7.3	7.1	6.0
Ukraine	-9.5	-0.2	5.9	9.2	3.6	8.5	12.1	6.5
South-East Europe	**-1.6**	**-4.4**	**3.8**	**4.6**	**4.4**	**4.1**	**6.4**	**4.8**
of which:								
Bulgaria	-1.9	2.3	5.4	4.1	4.8	4.8	5.6	5.0
Croatia	0.6	-0.9	2.9	3.8	5.2	4.7	3.8	3.5
Romania	-0.6	-1.2	2.1	5.7	4.9	4.8	8.3	5.5

Source: UNCTAD secretariat calculations, based on UNCTAD *Handbook of Statistics 2004*; UN/DESA, Development Policy and Planning Office, Project Link estimates; ECLAC, *Economic Survey of Latin America and the Caribbean 2004–2005*; ESCAP, *Economic and Social Survey of Asia and the Pacific 2005*; ESCWA, *Survey of Economic and Social Developments in the ESCWA Region 2005*; national sources; IMF, *World Economic Outlook,* April 2005; JP Morgan, *Global Data Watch*, various issues; EIU, *Country Forecast*, various issues; and OECD, *Economic Outlook No. 77.*

a Calculations are based on GDP in constant market prices based on 1995 dollars.

b Region and country groups correspond to those defined in the UNCTAD *Handbook of Statistics 2004*.

c Average.

d Preliminary estimates.

e Forecast.

also strong in most other countries in the region (table 1.2). Economic growth was generally fuelled by a combination of strong foreign demand and robust domestic demand. Exports have been a major driving force: in 2004, exports of goods from the region grew by 22 per cent in volume terms (table 1.3). China's exports led the expansion, with export volume growing by 33 per cent, but several other countries that participate in regional production networks associated with China also benefited from its strong export performance. The region's exports continued to grow at double-digit rates in 2004, partly as a result of the dynamism in the global market for electronics. In general, exchange rate stability helped to maintain international competitiveness in most countries, although in Singapore, Taiwan Province of China and Thailand, and recently in China as well, managed floating led to a moderate appreciation vis-à-vis the dollar. This softened the impact of the rising price of primary imports, without leading to a significant appreciation of the real effective exchange rate. Other countries maintained a fixed exchange rate vis-à-vis the dollar, or even depreciated their currency as in Indonesia. Only the Republic of Korea underwent a significant real appreciation of its currency, but so far this has not restrained exports from growing briskly.

With the exception of the Republic of Korea where private demand was constrained by high indebtedness of households and small firms, domestic demand contributed considerably to the region's growth. Private consumption provided a strong stimulus to growth in China, India, Indonesia, Malaysia, Singapore, Thailand and Viet Nam, with fixed investment being the main driver of growth in China and Taiwan Province of China. Inflation, as measured by consumer prices, showed a moderate increase in some countries during 2004, but remained modest in most East and South Asian countries. Monetary policy maintained an accommodative stance and real interest rates have mostly been declining. On the whole, high income growth

Table 1.3

EXPORT AND IMPORT VOLUMES OF GOODS, BY REGION AND ECONOMIC GROUPING, 1996–2004

(Percentage change over previous year)

	Export volume					*Import volume*				
	1996–2000[a]	*2001*	*2002*	*2003*	*2004*	*1996–2000[a]*	*2001*	*2002*	*2003*	*2004*
World	7	-1	5	6	13	7	-1	4	7	13
Developed economies	7	-1	2	3	11	8	-1	3	5	11
of which:										
Japan	6	-8	8	9	13	4	1	1	6	6
United States	7	-6	-4	3	9	11	-3	4	5	11
Europe	7	2	4	3	12	8	1	2	5	11
Developing economies	8	-2	9	12	16	7	-3	7	10	19
of which:										
Africa	2	1	2	11	7	1	5	4	7	26
Latin America	10	1	2	3	10	9	-3	-4	0	13
West Asia	5	0	8	1	3	10	-4	7	-5	35
East and South Asia	10	-3	12	17	22	6	-3	11	15	18
of which:										
China	12	9	25	35	33	11	12	23	36	26
India	8	7	17	10	18	5	4	13	9	17
South-East Europe and CIS	1	7	5	9	13	-0	17	10	21	17

Source: UNCTAD secretariat calculations, based on UN COMTRADE; United Nations Statistics Division, United Nations Common Database (UNCDB); United States Bureau of Labor Statistics, Import/Export Price Indexes database; Japan Customs Trade Statistics database; UNCTAD, *Commodity Price Bulletin*, various issues; and other national sources.

a Average.

and good investment performance contributed to a balanced increase of domestic and foreign demand.

In 2005, economic expansion in East and South Asia is expected to slow to a growth rate of slightly above 6 per cent. In particular, the contribution of external trade to growth is diminishing in several countries in the region, although it remains significant. Global demand for electronics, especially personal computers and semiconductors, is growing much slower since the end of 2004, affecting exports from several Asian economies, such as Japan, Malaysia, Singapore, Taiwan Province of China and Thailand.

On the other hand, domestic demand has generally maintained its contribution to growth in the first months of 2005. Private consumption began to recover in the Republic of Korea in the last quarter of 2004, after contracting for almost two successive years. However, this does not fully compensate for slowing export growth. As a result, GDP growth is forecast to decline to 3.5 per cent (KDI, 2005). Investment has been increasing in Indonesia and Thailand in 2005, owing to reconstruction work after the December 2004 tsunami and the subsequent influx of public investment and incentives for infrastructure development. In Indonesia, the tsunami did not cause a significant impact on economic growth in the first quarter of 2005. On the other hand, economic activity was more severely affected in Thailand, where the reduction of tourism receipts and shrimp production after the tsunami added to other adverse factors,

such as high oil prices, drought and outbreaks of bird flu (NESDB, 2005). As a result, Thailand's growth will decelerate in 2005 to a rate of 4 per cent. In Malaysia, private consumption is expected to continue growing in 2005, and investment should increase within a context of low interest rates and easy credit availability. As Malaysian exports are highly concentrated in electronics and electrical machinery, export growth is likely to slow down. The overall result would be a moderate deceleration of growth to a still strong 5.5 per cent. Taiwan Province of China, is also experiencing slower export growth, while its overall domestic demand should be sustained by the increase in private consumption, owing to rising real disposable income and falling unemployment. These trends show a further rebalancing of growth in Asia as economies slowly shift their reliance on export-led growth to internally-generated demand growth (NIESR, 2005: 19). Such a rebalancing is particularly relevant in light of the huge global trade imbalances (see section B).

GDP growth in China remained very high in 2004 and the first quarter of 2005 (9.5 per cent). The tightening measures introduced in the course of the year have started to have some impact on investment expansion, even though it is still growing at a rapid pace.[4] Policy measures included the abandonment of the strict pegging regime with the dollar, higher bank reserve requirements, moderate increases in interest rates and direct measures aimed at limiting the financing of construction projects and industries, such as steel and cement, that may have been building excessive production capacities. These measures are likely to influence not only the amount that is invested, but also its direction. A reorientation of investment financing is under way towards areas where bottlenecks have appeared recently, in particular, energy and infrastructure. Inflationary pressures have abated during the first half of 2005, indicating that more severe monetary tightening is unlikely. Exports of goods continue to grow at a rapid pace, driven by the end of textile quotas in developed countries and the production of past investments in manufacturing coming on stream. As a result of these trends, even though it remains a major driving factor, investment may not be making such a large contribution to growth as in the past, while private consumption and net exports are playing an increasingly important role.

In South Asia, India and Pakistan are experiencing high and stable growth rates. India has undergone significant growth in manufacturing and exports of IT-related services and business-process outsourcing. This has helped to off-balance the adverse impact of a poor monsoon on agriculture. Inflation has been kept in check despite higher oil and other primary commodity prices. The fiscal measures taken by the Indian Government have so far not led to a substantial reduction of the fiscal deficit, which remains stable at 4.5 per cent of GDP. As a consequence, macroeconomic policy is likely to maintain a rather supportive stance. In Pakistan, strong GDP growth resulted from good performances in all sectors; however, it particularly benefited from an unusual expansion of agricultural output. A rich cotton crop has also contributed to stronger than expected growth in the textile sector. Real GDP growth may accelerate in 2005, driven by the continued expansion of manufacturing output and exports, supported by the phasing out of textile import quotas in January 2005. Domestic demand will sustain present growth rates, in particular private consumption, due to continued higher growth of personal disposable income.

Latin American economies showed a remarkable improvement in 2004, expanding at 5.7 per cent, following five years of stagnation and crisis. The engines driving this economic recovery were export expansion and the terms-of-trade improvement in most countries in the region (see chapter III). Gains from terms of trade were very significant for oil and mining exporters, and lower but still relevant for agriculture exporters. On the other hand, some Central American and Caribbean countries that export labour-intensive manufactures and import oil, suffered terms-of-trade losses. These countries managed to shoulder the external burden by increasing the volume of their exports (owing to expanding imports from the United States) and receiving substantial remittances from overseas workers. The external environment led to an overall surplus in the region's current account for the second consecutive year, despite a significant growth in imports. On the fiscal side, the last few years showed a moderate reduction in fiscal deficits and, in several cases, a considerable surplus in the primary balance (excluding interest payments). This has been partly the result of increasing public revenues originated in pri-

mary commodity exports, either directly – through State-owned exporting firms – or indirectly, through rising taxes and royalties. Fiscal expenditure has been allowed to increase in some cases, although in most countries fiscal policy was more oriented towards "debt sustainability" rather than towards the encouragement of economic activity and investment. For this economic reactivation to persist, it should rely less on temporary factors, such as the favourable external environment and more on a sustained recovery of domestic demand, including investment. Even though the latter has improved after reaching record lows in 2003, fixed investment was only 18.5 per cent of the region's GDP in 2004 (ECLAC, 2005).

Preliminary evidence for 2005 points to a continuation of economic growth, but at a slower pace. One reason for this slowdown is monetary tightening in the two biggest Latin American economies: Brazil and Mexico. In these two countries, high priority is being placed on inflation targets, leading to a significant increase in policy interest rates, especially since the second half of 2004. In June 2005, the policy rate in Brazil reached a level close to 20 per cent with the inflation rate remaining at 6 to 7 per cent. As a result, fixed investment and private consumption slowed down in the last quarter of 2004 and the first quarter on 2005 (compared with the same period of the previous year), affecting manufacturing, construction, commerce and communications. Official forecasts for Brazil anticipate a recovery in domestic demand in the second part of the current year in expectation of lower interest rates and rising minimum wages. GDP is expected to grow at a rate close to 3 per cent in 2005, down from 4.9 per cent in 2004 (IPEA, 2005). In Mexico, persistent monetary tightening has pushed the interbank rate up from 5.3 per cent in January 2004 to 10.1 per cent in May 2005. Economic activity decelerated in the first months of 2005, particularly in manufacturing, agriculture and construction, pointing to an annual growth rate of about 3.3 per cent (compared to 4.4 per cent in 2004).[5]

Economic activity in Latin America is also set to slow in 2005 because Argentina, Uruguay and Venezuela will grow at a less brisk pace. According to some observers the recent rapid growth just reflects a return to the pre-crisis GDP levels. However, the driving sectors and the characteristics of this economic growth are radically different from those prevailing before the crisis. Argentina and Uruguay are drawing the benefits of restored competitiveness after shifting relative prices in favour of tradable goods and services. Moreover, they have managed to restructure their foreign debt, particularly Argentina, with a sizeable reduction in capital and interest rates. Domestic demand is providing new stimulus through higher domestic consumption and fixed investment. These countries have also benefited from improving terms of trade, with a sizeable impact on domestic income and fiscal receipts, especially in Venezuela, where ambitious social and development programmes have been launched.

The Andean countries that have gained strongly from oil and mining exports, both in volume and value terms, such as Bolivia, Chile, Ecuador and Peru, will continue to grow in 2005. However, there will not be the same amount of investment in natural resources and of new production capacities coming on stream in 2005 as in 2004. High prices for their exports will continue to provide a considerable level of revenues for both the private and the public sector, maintaining a healthy domestic demand. Central American countries will keep a moderate growth pace in 2005, with some export price increases, higher public investment linked to debt-relief programmes and private consumption sustained by workers' remittances. Finally, Caribbean countries, some of which were hit by natural disasters in the second half of 2004, should benefit from the recovery of tourism in 2005.

3. Recent developments in world trade and finance

The strong performance of the global economy in 2004 brought about an acceleration in world trade. Total merchandise exports grew by 22.5 per cent in current dollars. As in 2003, this expansion was the result of both increasing volume (13 per cent) and rising dollar prices (9.5 per cent).[6] The latter was partly caused by the depreciation of the dollar, which increased the value of international trade in dollar terms within the euro area.

The expansion in export volume was associated with some changes in its geographical composition (table 1.3). In comparison with the situation which prevailed in 2003, the major change was the strong recovery of export volumes from developed countries, which grew by 11 per cent in 2004, compared to 3 per cent in the previous year. There was a widespread acceleration of export volume growth in Europe, largely due to the speeding up of intraregional trade with the new EU acceding member countries, and to expanding sales to East Asia and to oil-exporters in West Asia and the CIS. Exports from the United States also recovered, as a result of a more competitive currency level, while Japan continued to benefit from dynamic Asian intraregional trade.

Exports from developing countries continued their expansion at a very rapid pace in 2004, and registered a growth rate of 16 per cent in volume terms. As in previous years, East and South Asia led this expansion, but Latin America and Africa also experienced significant increases in export volumes. As has been usually the case since 1990, exports increased at higher rates in developing countries than in the developed world. However, the revival of exports of developed countries reduced the relative contribution of developing countries to global export growth from two thirds in 2003 to an estimated 40–45 per cent in 2004.

Increasing export volume, together with higher commodity prices provided a boost to the value of merchandise exports from developing countries, which grew by 26 per cent in current dollars. In particular, regions with a large share of primary commodities in their total exports – Africa, CIS, South America and West Asia – recorded above-average export growth in 2004. Terms-of-trade gains from in these regions explain the very rapid growth in import volume, clearly exceeding that of exports (table 1.3). Among the manufacturing exporters, East and South Asia also performed above average, mainly due to strong export growth from China and India. As a whole, the share of developing countries in world exports rose to 33.4 per cent in 2004, compared to 27.7 per cent ten years earlier. Among developed countries, the United States have been constantly reducing their share in world exports from 12 per cent in the mid-1990s to 9 per cent in 2004, while at the same time slightly rising their share in world imports, as the economy has increasingly relied on outsourcing in foreign markets.

World trade in services (transport, travel and other commercial services) grew by 16 per cent in dollar terms in 2004 (WTO, 2005a). The expansion of transport services was naturally stimulated by the strong recovery in trade volume. In particular, world seaborne trade volume grew by 4.3 per cent in 2004 (after a 5.8 per cent expansion in 2003), mainly as a result of increased shipments of primary commodities directed to China and other countries in East Asia (UNCTAD, 2005a). Strong demand for transport services has maintained freight rates at very high levels, after soaring in 2003 (see box 4.1 in chapter IV). By the end of 2004 the level of freight rates in the main containerized routes – trans-Pacific, trans-Atlantic and Asia-Europe – were mostly above the levels that prevailed at the end of 2003.

Travel services recovered markedly from the 2001 downturn. 2004 was an excellent year for tourism, with international tourist arrivals increasing by 10.7 per cent. Growth in tourism services rebounded by 28 per cent in Asia and the Pacific, following the lows of the first half of 2003, which had been due to SARS. It was also very fast in the Middle East (21 per cent), while Europe performed below the world average (with 5 per cent growth in 2004) as a result of the continued strength of the euro. International tourism kept growing in the first four months of 2005, albeit at a slower pace (7.7 per cent compared to the same period of 2004). Growth rates showed wide disparities, with very positive results in South America (with a 19 per cent expansion), Middle East (17 per cent) and sub-Saharan Africa (15 per cent), and slow growth rates in Western and Southern Europe (below 3 per cent). South-East Asia and South Asia experienced a sudden deceleration in tourist arrivals due to the tsunami in December 2004 (World Tourism Organization, 2005: 6–7).[7]

Given these developments in goods and services trade and the growing inflow of workers' remittances in several countries, all developing regions posted current-account surpluses in 2004. Naturally, these regional totals concealed some deficits at the country level, especially in sub-Saharan Africa, South-East Europe, Central America and the Caribbean. But, in general, the need for fi-

nancing the current account was less stringent in the developing world than in previous years. The single most important source of external financing for developing countries was FDI, which recovered to its 2001 level.[8] A large part of the current-account deficit in several sub-Saharan and Central American countries is explained by the expansion of FDI in recent years, which was accompanied by an increase in imports of capital goods and an outflow profit remittances. In other cases, current-account deficits were financed through grants or official borrowing. On the other hand, in several middle-income countries in Asia (including West Asia) and Latin America current accounts were in balance or in surplus.

This overall situation had two consequences for the international financial markets. First, as the more comfortable balance-of-payments situation of the "emerging markets" coincided with high liquidity in developed countries, the spreads on emerging markets bonds have declined significantly. Yet external debt problems have persisted in some middle-income countries; many of them have issued new bonds in order to repay those coming to maturity, and have remained in a vulnerable situation. But market conditions were favourable for a restructuring of external debt at lower interest rates. They also facilitated the end of the Argentine debt default through a debt restructuring, which included debt stock reduction, extended maturity and/or lower interest rates. Second, there has been a continued accumulation of international reserves in a number of developing countries, mainly in East and West Asia. In 2004, foreign exchange reserves of developing countries increased by an unprecedented $450 billion (IMF, 2005a). As increasing reserves mainly consist of financial assets issued by developed countries (and particularly those of the United States), they represent a significant export of capital from developing to developed countries, and a key element in the current phenomenon of global economic imbalances. This issue is further examined in the next section.

C. The global imbalances and the United States current-account deficit

The United States current account recorded a deficit of $666 billion in 2004, which makes it the counterpart of almost 70 per cent of the aggregated surpluses in the world economy (table 1.4). This unprecedented size of a deficit and the dim perspectives of its correction in the foreseeable future have raised questions about the stability of the global financial system and the sustainability of global growth. Warnings abound, as to date no other major economic power has been prepared to shoulder part of the adjustment burden. Much of the world economy continues to depend on the United States economy, both as the consumer and the debtor of last resort. Serious policy initiatives to tackle the problem are missing, and the debate is now focused on whether dramatic exchange rate changes are the only way out or whether policies to stimulate growth in surplus regions, combined with measures to limit growth in the United States, could be an alternative.

Table 1.4

CURRENT-ACCOUNT BALANCE, SELECTED ECONOMIES, 2000–2004

	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
	($ billion)					(As a percentage of total surplus or deficit)				
Surplus economies										
Japan	119.6	87.8	112.6	136.2	171.8	23.8	21.6	21.9	20.4	19.3
Germany	-25.7	1.6	43.1	51.8	96.4	3.9	0.4	8.4	7.8	10.9
China	20.5	17.4	35.4	45.9	70.0	4.1	4.3	6.9	6.9	7.9
Russian Federation	44.6	33.4	30.9	35.4	59.6	8.9	8.2	6.0	5.3	6.7
Saudi Arabia	14.3	9.4	11.9	29.7	49.3	2.9	2.3	2.3	4.4	5.5
Switzerland	30.7	20.0	23.3	42.4	42.9	6.1	4.9	4.5	6.4	4.8
Norway	26.1	26.2	24.4	28.3	34.4	5.2	6.4	4.8	4.2	3.9
Sweden	9.9	9.7	12.1	23.0	28.0	2.0	2.4	2.4	3.4	3.2
Singapore	11.9	14.4	15.7	27.0	27.9	2.4	3.5	3.1	4.0	3.1
Republic of Korea	12.3	8.0	5.4	12.1	26.8	2.4	2.0	1.0	1.8	3.0
Canada	19.7	16.1	14.4	17.0	26.0	3.9	4.0	2.8	2.6	2.9
Netherlands	7.2	9.8	12.8	15.1	19.4	1.4	2.4	2.5	2.3	2.2
Taiwan Province of China	8.9	18.2	25.6	29.3	19.0	1.8	4.5	5.0	4.4	2.1
United Arab Emirates	12.2	6.5	3.5	6.9	16.1	2.4	1.6	0.7	1.0	1.8
Hong Kong (China)	7.1	9.9	12.6	16.2	15.9	1.4	2.4	2.5	2.4	1.8
Malaysia	8.5	7.3	8.0	13.4	15.7	1.7	1.8	1.6	2.0	1.8
Kuwait	14.7	8.3	4.3	7.3	15.1	2.9	2.0	0.8	1.1	1.7
Belgium	9.0	8.9	14.1	13.3	14.9	1.8	2.2	2.8	2.0	1.7
Venezuela	11.9	2.0	7.6	11.4	14.5	2.4	0.5	1.5	1.7	1.6
Qatar	3.2	3.5	3.3	6.8	12.0	0.6	0.9	0.6	1.0	1.3
Total surplus	501.7	406.6	513.7	667.6	888.0					
Deficit economies										
United States	-413.5	-385.7	-473.9	-530.7	-665.9	62.2	67.7	72.5	71.1	69.0
Spain	-19.4	-16.4	-15.9	-23.6	-49.2	2.9	2.9	2.4	3.2	5.1
United Kingdom	-36.5	-32.2	-26.4	-30.6	-47.0	5.5	5.7	4.0	4.1	4.9
Australia	-15.3	-8.2	-16.6	-30.2	-39.4	2.3	1.4	2.5	4.1	4.1
Italy	-5.8	-0.7	-6.7	-21.9	-24.8	0.9	0.1	1.0	2.9	2.6
Turkey	-9.8	3.4	-1.5	-8.0	-15.6	1.5	0.8	0.2	1.1	1.6
Portugal	-11.1	-10.4	-8.9	-8.0	-13.3	1.7	1.8	1.4	1.1	1.4
Hungary	-4.0	-3.2	-4.7	-7.5	-8.9	0.6	0.6	0.7	1.0	0.9
Mexico	-18.2	-18.2	-13.7	-8.6	-8.7	2.7	3.2	2.1	1.1	0.9
Greece	-7.8	-7.7	-9.7	-10.8	-8.4	1.2	1.4	1.5	1.4	0.9
New Zealand	-2.5	-1.2	-2.2	-3.3	-6.0	0.4	0.2	0.3	0.4	0.6
Czech Republic	-2.7	-3.3	-4.2	-5.6	-5.6	0.4	0.6	0.6	0.7	0.6
France	18.0	21.5	14.5	5.0	-5.4	3.6	5.3	2.8	0.7	0.6
Romania	-1.7	-2.6	-2.0	-3.9	-5.4	0.3	0.5	0.3	0.5	0.6
South Africa	-0.2	-0.0	0.7	-1.5	-5.3	0.0	0.0	0.1	0.2	0.6
Poland	-10.0	-5.4	-5.0	-4.1	-3.6	1.5	0.9	0.8	0.5	0.4
Serbia and Montenegro	-0.3	-0.5	-1.4	-1.6	-3.2	0.1	0.1	0.2	0.2	0.3
Lebanon	-3.1	-3.8	-2.6	-2.5	-3.1	0.5	0.7	0.4	0.3	0.3
Ireland	-0.1	-0.6	-1.5	-2.1	-2.7	0.0	0.1	0.2	0.3	0.3
Azerbaijan	-0.2	-0.1	-0.8	-2.0	-2.3	0.0	0.0	0.1	0.3	0.2
Total deficit	-664.9	-569.4	-653.7	-746.0	-965.2					

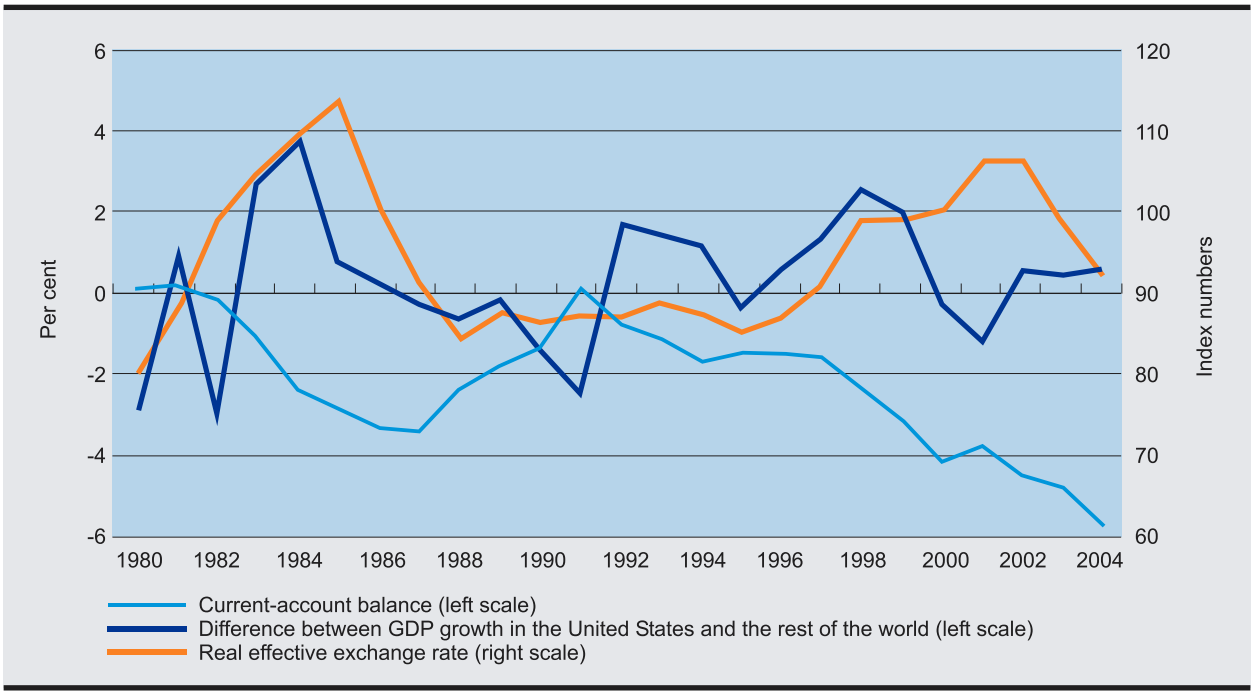
Source: IMF, *World Economic Outlook*, April 2005.

Note: Calculations are based on a total of 180 countries; the sum of total surpluses and deficits is different from zero because of errors and omissions. Countries are listed according to the levels of their surplus/deficit in 2004.

Figure 1.1

UNITED STATES CURRENT-ACCOUNT BALANCE,[a] RELATIVE GDP GROWTH AND REAL EFFECTIVE EXCHANGE RATE, 1980–2004

(Per cent and index numbers, 2000 = 100)



Source: UNCTAD secretariat calculations, based on United States Bureau of Economic Analysis, International Economic Accounts database; World Bank, World Development Indicators database; and JP Morgan, Effective Exchange Rate Indices database.

a As a percentage of GDP.

1. *Twenty-five years of deficits in the United States*

The deficit in the United States current account is not a new phenomenon. In 1982 the United States current account fell into a deficit, which continued to grow until 1987 (fig. 1.1). Following the Plaza Agreement in 1985 and the Louvre Accord in 1987, it returned to balance in 1991. However, the current account went into deficit again, and it has since continued to widen in the context of the long-lasting and strong recovery in the United States. Since 1998, the share of the deficit in GDP increased from around 2 per cent to almost 6 per cent in 2004.

These developments are explained by two major factors. First, the real exchange rate, which mainly determines the international competitiveness of United States producers, rose markedly during the first half of the 1980s. An overvalued dollar played a central role in the widening current-account deficit. The subsequent reduction of the deficit was accompanied by a depreciation of the dollar in the second half of the 1980s. The second factor is the gap between real GDP growth in the United States and in the rest of the world. Relatively fast growth in the United States tends to exacerbate the current-account deficit via strong import demand, whereas outright recessions (such as the one which occurred in 1991) lead to the opposite result. More recently, however, these factors seemed to have a weaker influence on the current account; since 1998 the deficit continued to increase as a percentage of GDP, even though the growth gap between the United States and the rest of the world has almost disappeared since

2000, and the dollar substantially depreciated in 2003 and 2004. While exports increased in 2004 and in the first few months of 2005, the expansion of imports has continued to outpace them.

Some of the explanations given for the lack of a rapid response of imports to exchange rate changes point to temporary factors; for instance, the unit value of imports rises immediately after a devaluation, increasing the import value, while import volume takes more time to adjust downward (the so-called J-curve effect). It has also been suggested that firms exporting to the United States would be willing to squeeze their profit margin for some time in order to keep their market shares. Other interpretations indicate more durable factors, such as a loss of competitiveness and market shares of some United States industries and redeployment of industrial production to Asia (Aglietta, 2004: 31). It has also been argued that income elasticity for United States imports is structurally larger than foreign income elasticity for United States exports, leading to a tendency towards a trade deficit, even in the absence of a growth gap.[9]

These arguments suggest that only a huge depreciation of the dollar – with all its potential repercussions on the global financial system – could reduce the United States trade imbalances and bring them down to a sustainable level. On the other hand, an adjustment brought about by a much lower growth in the United States involves obvious risks for the world economy. As the value of the United States imports currently represents roughly 180 per cent of its exports, the latter will have to grow much faster than imports for a considerable time for the trade deficit to follow a downward trend. Box 1.1 presents UNCTAD secretariat's calculations of the order of magnitude of the currency depreciation or the growth adjustment required for reducing the current-account deficit.

These considerations raise a string of questions about the currencies the dollar should depreciate against and which countries should either enhance or dampen economic growth. The increase in the Unites States deficit in recent years is most pronounced with the EU and Asia (fig. 1.2); however, the intraregional structure of current-account surpluses and deficits has also to be taken into account. While China accounts for most of the rise in the United States current-account deficit in recent years, it has considerable deficits with many Asian countries as a result of its rapid growth and its presence at the end of many production chains. On the other hand, the moderate increase in the current-account surplus of the EU as a whole hides the much bigger increases in the surpluses of some individual countries in the euro area, in particular Germany.

In addition to such trade balance considerations, a number of authors and organizations have recently examined how a devaluation of the dollar may modify the terms of the global imbalance problem if the effects of financial globalization are taken into account. They have introduced the "valuation effect", that is, the role of the actual valuation of the stock of assets and liabilities and the changes in their valuation due to asset price changes and exchange rate changes.

In the United States liabilities are almost exclusively denominated in domestic currency. As two thirds of United States assets are denominated in foreign currencies, a depreciation of the dollar increases the domestic currency value of assets, while leaving the value of liabilities more or less unchanged. As a result, the depreciation had a positive effect on the "net international investment position" (NIIP) of the United States – i.e. the difference between the value of the accumulated stock of assets (domestic claims on foreigners) and the accumulated stock of liabilities (foreign claims on residents). This effect did not stop the deterioration of the NIIP in dollar terms (i.e. liabilities to increase more than assets) due to the persistence of the current-account deficit, but it limited that deterioration.

Obviously, the opposite valuation effect occurs in those countries, mainly in Europe, that are facing a currency appreciation vis-à-vis the dollar. This process is interpreted as a burden sharing among countries and as a facilitation of the global adjustment process.

However, the sharp appreciation of the dollar from 1996 to 2002 led to similar valuation losses for the United States and gains for Europe. Accordingly, the appreciation of the dollar at that time had accelerated the deterioration of the investment position of the United States that is

Box 1.1

PRIMARY TRADE BALANCE EFFECTS OF CHANGES IN THE UNITED STATES GDP GROWTH AND IN EXCHANGE RATES

UNCTAD secretariat calculated long-term trade elasticities for the estimation of: (i) the impact of changes in domestic GDP on the United States merchandise trade balance; and (ii) the effect of a dollar depreciation on the same trade balance. However, it must be kept in mind that, given the trade deficit at the "initial situation", exports must grow at least 1.8 times faster than imports to reduce the merchandise trade deficit.

The table in this box presents the main results. The first exercise supposes that the rest of the word (ROW) grows at 3.2 per cent, and considers three situations characterized by different GDP growth in the United States, with the exchange rate remaining unchanged. In *scenario 1*, the United States growth rate is the same than in the ROW. In this case, imports continue to grow faster than exports, and the United States trade deficit would grow by 0.3 per cent of GDP, on top of the existing 5.7 per cent of GDP in 2004. In *scenario 2* it is assumed that the trade deficit remains at its 2004 level. In order to achieve that (and assuming that ROW grows at 3.2 per cent), the United States economy would need to reduce its GDP growth to 1.5 per cent. In this case, import growth would be lower than in *scenario 1*, at 3.1 per cent. In *scenario 3* the trade deficit is reduced to 5 per cent of GDP. At constant exchange rate and ROW growth, this would require a negative GDP growth of 1.8 per cent in the United States, which would lead to a contraction in imports of 3.6 per cent.

The table also shows that a 10 per cent appreciation of the currency of one of the main trading partners of the United States would not improve the imbalance visibly. The highest impact would come from an appreciation of the Canadian dollar, followed by the euro and the Mexican peso. Appreciations of the Chinese renminbi and the Japanese yen would have lower impacts, because of the lower shares of these economies in the United States merchandise exports. According to the simulation, a 10 per cent general depreciation of the dollar would reduce the trade deficit to 4.5 per cent of GDP.

Additionally, the table shows the rates to which the main trading partners should appreciate their currencies to reduce the United States trade deficit to 5 per cent of GDP. In the case of China, given its low weight in the composition of United States exports, the renminbi would need to appreciate by 67 per cent, whereas, for the Canadian dollar an appreciation of 26.5 per cent would be sufficient.

decelerated by the depreciation now. Thus, the current change in favour of the United States simply compensates the adverse effect that occurred before.

Hence, the argument that the sustainable level of that deficit would increase through the valuation effect because it is easier to finance the deficit thanks to a higher net value held in the United States is not convincing. The appreciation of the dollar that had accelerated the deterioration of the NIIP of the United States since the mid-1990s did not prevent the rapid increase of the current-account deficit. Did the deterioration in the NIIP due to the negative valuation effect make the access to external financing more difficult for the United States at that time? If not, it is difficult to argue that the positive valuation now makes access of the United States to financial markets much easier. If market participants in the financial markets

Box 1.1 (concluded)

EFFECT OF CHANGES IN GDP GROWTH AND IN EXCHANGE RATES ON THE UNITED STATES TRADE BALANCE

	Hypothetical change		Outcome		
	United States GDP	Exchange rate	Exports	Imports	Merchandise trade balance
	(Per cent)		(Per cent)		(Per cent of GDP)
			GDP growth changes in the United States[a]		
Scenario 1	3.2	-	4.4	6.6	-6.0
Scenario 2	1.5	-	4.4	3.1	-5.7[b]
Scenario 3	-1.8	-	4.4	-3.6	-5.0
			Exchange rate changes		
Euro	-	10.0	1.5	-0.6	-5.5
Canadian dollar	-	10.0	2.3	-0.7	-5.4
Chinese renminbi	-	10.0	0.4	-0.6	-5.6
Japanese yen	-	10.0	0.6	-0.4	-5.6
Mexican peso	-	10.0	1.4	-0.4	-5.5
United States dollar	-	-10.0	9.9	-4.2	-4.5
			Exchange rate changes required for a reduction of the United States trade deficit to 5 per cent of GDP		
Euro	-	37.2	5.7	-2.2	-5.0
Canadian dollar	-	26.5	6.2	-2.0	-5.0
Chinese renminbi	-	67.4	2.9	-3.8	-5.0
Japanese yen	-	74.1	4.8	-2.7	-5.0
Mexican peso	-	44.9	6.1	-2.0	-5.0
United States dollar	-	-5.6	5.5	-2.3	-5.0

Source: UNCTAD secretariat calculations, based on United States Bureau of Economic Analysis, International Economic Accounts database.

a GDP growth in the rest of the world is assumed at 3.2 per cent in all scenarios.

b The deficit of the United States merchandise trade balance as a percentage of GDP in the base year (2004) is 5.67 per cent.

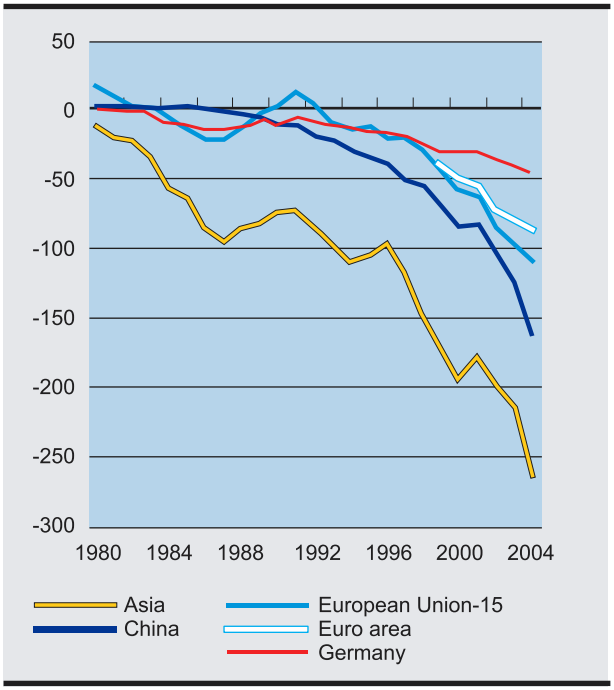
expect appreciations and depreciations to be equally distributed over the long term, the short-term valuation does not change their perception of a long-lasting current-account deficit.

For most of the developing countries the valuation effect is felt on both sides of the balance sheet. The liabilities of developing countries are normally denominated in foreign currencies. For these countries, exchange rate movements affect both the domestic value of assets and the domestic value of liabilities. Appreciation of the national currency of a developing country reduces the burden of liabilities (denominated in foreign currencies) and also reduces the value of assets (denominated in foreign currencies). On the other side, depreciation increases the burden of liabilities and increases the value of assets. In the past, in many developing countries with huge stocks of net foreign debt, depreciation shocks after finan-

Figure 1.2

MERCHANDISE TRADE BALANCE OF THE UNITED STATES, BY COUNTRY/REGION, 1980–2004

(Billions of dollars)



Source: UNCTAD secretariat calculations, based on UN COMTRADE; and United States Bureau of Economic Analysis, International Economic Accounts database.
Note: Asia includes: China, Hong Kong (China), Japan, the Republic of Korea, Singapore and Taiwan Province of China.

cial crises have led to big negative valuation effects on their liabilities that could not be compensated by the positive effects on their assets. Argentina was the most prominent case recently.

Although there is no strict and general ceiling for sustainable external deficits, recent studies analysing current-account dynamics in industrial economies conclude that reversals usually take place as deficits reach about 5 per cent of GDP.[10] However, the mechanisms towards such an adjustment may be different for the United States. So far, the biggest economy in the world has been able to finance its current-account deficit at relatively low interest rates. An examination of the economic situation in the surplus regions is necessary to understand this continued easy financing of the deficit and to assess the chances for a smooth resolution of global imbalances.

2. The surplus regions

The fact that the current account essentially corresponds to net foreign investment in financial assets, reflecting the simple logic that whoever extends demand beyond means has to raise debt, has been taken as proof for the willingness of the rest of the world to provide the United States consumers with "savings" that could not be used elsewhere. This static logic overlooks the fact that without the stimulus provided by United States growth, income and savings in the rest of the world (and in particular, in surplus countries) would have been lower. Thus, part of the savings that were used to finance the current-account deficit of the United States were generated by the process of rising demand from the United States. If the surplus regions were to reduce their financing to the United States, they would not be re-allocating their "savings" elsewhere, but the process of generating these savings would itself be at stake. In other words, the attempt to repatriate funds may have negative consequences not only in the deficit but also in the surplus economies. This poses a dilemma to surplus regions, in Asia and in particular in some parts of Europe.

In the aftermath of the currency crises at the end of the 1990s, Asian economies implicitly or explicitly pegged their currencies to the dollar at rather low values. The currency peg has encouraged rising exports and has had a positive effect on growth, profits and jobs in these countries. Moreover, in Asia imports have been rising rapidly, spilling the effects of the Asian boom over many developing countries. From the point of view of these countries and their beneficiaries, a sharp currency appreciation that would markedly reduce the current-account surplus might jeopardize these positive outcomes on a broad scale.

The members of the euro area as well as those economies whose currencies are tied to the euro constitute the third major block in the current imbalances constellation. As in the case of Asia, this block has registered external surpluses that rely

on the United States market, even if their contribution to the United States trade deficit has not risen as dramatically in recent years. Yet, like Asia, European authorities have been focusing on export-led growth strategies, although the European Central Bank has not pursued an explicit exchange rate policy. A major reason for the good trade performance has been wage restraint, which has resulted in stronger international competitiveness, but also in anaemic growth of private consumption. Thus, in some large member countries, domestic demand remains weak due to overly moderate wage increases. The dependency on foreign demand explains the uneasiness at the beginning of 2005, when the euro rose to 1.35 against the dollar. In a way, Europe will have the most to lose if it does not move quickly. If Asian central banks stick to managing dollar rates while at the same time diversifying their portfolio by moving towards the euro, Europe is doomed to bear the brunt of dollar depreciation.

Overall, none of the three regions analysed above has an interest in prolonging the current situation as long-term risks exceed short-term advantages. As the issuer of the world's predominant reserve currency, the United States bears a special responsibility for financial market stability. A further lowering of the dollar exchange rate, if eventually needed, should take place in an orderly adjustment process, in which both, the deficit and the surplus regions, would act transparently and effectively.

3. Tailoring policy measures

There can be little doubt that a smooth correction of global imbalances will have to be achieved through adjustments in both relative prices and absorption levels. Obviously, the main difficulty is the identification of policy measures tailored to the specific economic circumstances of certain countries and regions. The examination of the internal and external performance of the euro area and the United States leads to relatively clear policy conclusions.

The United States starts from relatively low unemployment and high growth. It could use the currency depreciation already in place, combined with careful measures to dampen domestic demand. Monetary policy has already shifted to a more restrictive path and some fiscal adjustment is underway. However, in light of the dominance of the United States economy on a global scale, authorities should refrain from excessively curtailing absorption in order to avoid recessionary tendencies that could feed back into a worldwide slowdown.

In contrast, the euro area has no reason to worry about its external balance, but growth is stalling and in many countries unemployment is very high or even rising. Consequently, the whole region would greatly benefit from higher demand and rising absorption. Thus, the optimal combination of macroeconomic policies to correct global imbalances would certainly include a massive expansion of domestic demand in the euro area. A coordinated effort of macroeconomic policies is needed to foster economic growth and to approach internal and external equilibrium at the same time. In an environment of negligible inflation rates, monetary and fiscal policy can actively contribute to economic recovery by lowering interest rates and stimulating domestic demand. Finally, the excessively moderate stance of wage policy in some member countries should be abandoned to avoid deflationary spillovers.

Identifying an appropriate approach for surplus countries in Asia is much more complicated as most countries in the region are already reporting rapid and sometimes "neck breaking" growth rates. Despite the fact that the often-mentioned danger of overheating – most pronounced in the non-tradable sectors – does not represent a major threat to price stability yet, the argument whereby more growth is needed to increase absorption in this region is unconvincing. The recommendation given by many observers to use currency appreciation for creating leeway for monetary authorities to fight overheating by raising interest rates, would reduce absorption and imports, and trade surpluses might thus persist despite currency appreciation. Consequently, global imbalances would continue but at a slower rate of GDP growth for the world, and they would be accompanied by lower demand for other developing countries primary commodity exports. Additionally, countries such as China need to integrate a vast pool of rural workers – unaccounted for by official unemployment statistics –

if political and economic stability is to be maintained.

As shown before, any bilateral exchange rate realignment with the dollar will fall short of a significant re-equilibrating effect; this could even have a disruptive effect on the revaluing country and on the region it is mainly trading with. If exchange rate reforms are undertaken in surplus regions, they will have to involve all regional protagonists within a multilateral agreement. China's move to abandon the peg with the dollar in July 2005 without allowing for a major revaluation could be a step in the right direction if it forms part of a concerted action among the global players.

History offers examples of correcting global imbalances, some of which ended in regional crises and in an upsurge in protectionism harming trade, growth and welfare, as was the case for the Asian episode of 1997–1998. But there are other examples where crises have been avoided by early and controlled adjustments of exchange rates, for example the regional arrangements in Europe that preceded the European Monetary Union. But even on a global scale, the current-account reversal that followed joint political efforts by the major powers in the late 1980s suggests that an orchestrated attempt might have a greater chance of succeeding than isolated measures. This may well be the right time for a global exchange rate agreement.

D. Oil price hikes in perspective

After the relatively low prices seen in the first half of the 1990s, when the price of crude petroleum rarely exceeded $20 per barrel,[11] the price of oil began to rise in 1999 and culminated at $60 per barrel in mid-2005. This surge in oil prices worries governments in many oil-importing countries, who fear the detrimental effects of a substantial and long-lasting rise in energy prices on output growth. This is a special concern for many developing countries which have become increasingly dependent on oil imports as industrialization has progressed.

Oil price shocks have repeatedly had a negative aggregate impact on global economic activity. The reason for this has to be mainly sought in the response of economic policy in countries affected by an oil price shock. Inappropriate reactions, particularly from those responsible for wage and monetary policies, can aggravate the situation and lead to losses in economic activity that could otherwise have been avoided.

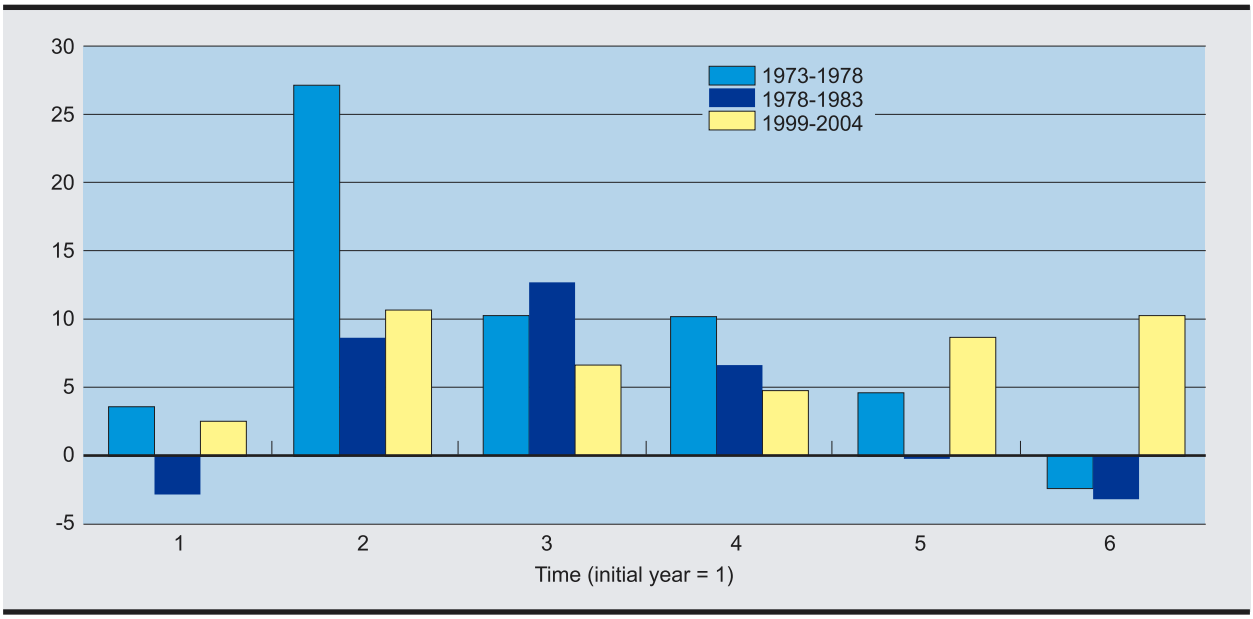
1. The impact of an oil price shock on prices and economic activity

The consequences of a rise in oil prices are usually separated into first- and second-round effects. Under any normal circumstances, consumer prices rise (or stop falling) immediately after petroleum products, such as gasoline and heating oil, become more expensive because the elasticity of demand is rather low at most stages of the production chain. On the other hand, second-round effects occur if workers try to compensate their real income loss by bargaining for higher nominal wages. The occurrence of second-round effects becomes more likely the larger the impact of first-round effects of a rise in oil prices – or energy prices more generally – on the overall price level. A higher rate of inflation implies a loss of real income unless nominal wages rise alongside consumer prices. If, however, workers successfully bargain for higher wages in order to compensate

Figure 1.3

CURRENT-ACCOUNT BALANCES OF 10 OPEC COUNTRIES[a]

(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on UNCTAD *Handbook of Statistics 2004*; IMF, Balance-of-Payment Statistics database and International Financial Statistics database; Economist Intelligence Unit, *Country Reports*; and national sources.

a Algeria, Ecuador, Gabon, Indonesia, the Islamic Republic of Iran, Kuwait, the Libyan Arab Jamahiriya, Nigeria, Saudi Arabia and Venezuela.

for real income losses, the result is an additional upward pressure on the price level as firms will seek to pass rising labour costs on to consumer prices. Workers may thus find that their recently negotiated wages do not keep up with the rising price level, and consequently enter the next round of wage bargaining with yet augmented aspirations. In the worst case, such a scenario may lead to a wage-price spiral resulting in accelerating inflation. At best, it will still cause inflationary expectations to become embedded in the economy's wage bargaining processes, involving a permanently higher inflation rate compared to the initial situation.

Apart from the consequences on inflation, the effects of an oil price shock on the overall economic activity in importing countries are more difficult to disentangle. The most obvious impact stems from the deterioration in the terms of trade. An oil price increase shifts the terms of trade between net-importing and net-exporting economies in favour of the latter. Essentially, this implies a real income transfer from consuming to producing countries. Shrinking real incomes in countries facing larger oil bills, in turn, mean less income to spend on other products, which translates into lower domestic demand unless matched by reduced domestic savings and/or higher export demand. To date, the evidence suggests that the propensities of oil-producing countries to consume from current income are low relative to consuming economies. Oil price increases have historically been accompanied by swelling current-account surpluses in oil-exporting countries, implying that the windfall revenue accruing to producers is typically not immediately spent to its full extent – a pattern that can also be observed in the current situation (fig. 1.3).

In this case, cutbacks in output and employment are the consequence of falling demand in consuming countries. While macroeconomic

Figure 1.4

CRUDE PETROLEUM PRICES,[a] NOMINAL AND REAL,[b] 1970–2005[c]

(Dollars per barrel)

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

a Average of Dubai/Brent/Texas equally weighted.

b Deflated by United States Consumer Price Index (CPI) (2000 = 100).

c 2005 data are estimates.

studies usually confirm the general effect on the aggregate level, empirical studies using disaggregated data suggest that demand disturbances of oil price shocks vary substantially between sectors, with producers of consumer durables being hit especially hard during oil-price related recessions (Bresnahan and Ramey, 1992). To the degree that firms are able to pass higher costs to market prices without a subsequent reaction of nominal wages, the burden of adjustment shifts from producers to consumers, while the net negative impact remains identical.

A further effect operates through nominal interest rates, which may be higher if second-round effects on inflation are triggered by an oil price increase. While central banks will find it difficult to prevent an initial rise in the general price level due to the change in relative prices induced by higher energy prices, they will be alerted by second-round effects and curb persistent inflation through restrictive monetary policy. With such a move they would add to the restrictive first-round effects on the real economy to prevent inflationary expectations from becoming embedded in the system.

2. *The 1973–1974 and 1979–1980 oil price shocks: putting current events in perspective*

By the early 1970s, the price of crude oil had been declining persistently for about two decades to reach a level of $2–3 per barrel. This situation changed dramatically after 1973. Between November 1973 and the first quarter of 1974, the price increased from $3.3 to $13. Prices remained relatively unchanged for the next four years. In late 1978, OPEC cutbacks triggered the second oil price shock and oil prices peaked at $39 in November 1980.

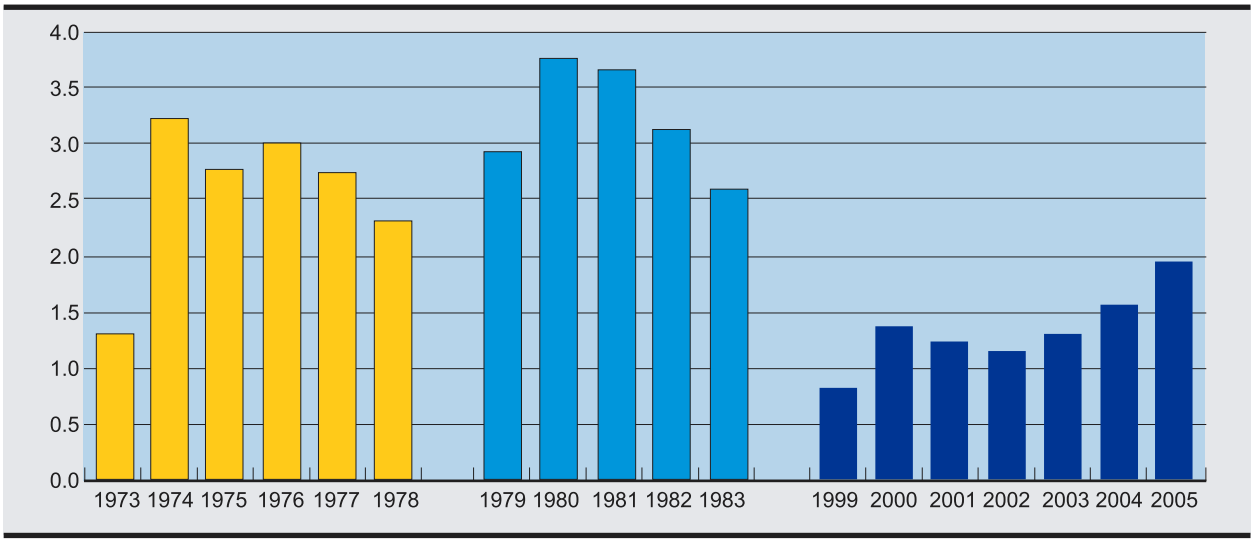
Compared with the two oil price shocks in the 1970s, the substantial oil price rise between 1998 and mid-2005 presents several features rendering it less dramatic than it seems to be at first glance. Firstly, the starting point for oil prices ($11 in the beginning of 1999) was an abnormally low one, following the plummeting of oil prices that resulted from the Asian financial crisis in 1997–1998. Among informed market participants, the expectation prevailed that the oil price would not remain depressed for much longer, but would soon rise again to previous levels of around $20. Secondly, recent price increases have been stretched over five years, and have thus taken the form of a gradual evolution instead of an explosion. Thus, the surprise effect of the oil price increase was milder this time. Thirdly, in real terms, the recent oil price increase was significantly smaller than that of the 1970s (fig. 1.4). Measured in today's prices, the oil price increases of the 1970s were considerably more substantial than implied by the nominal figures.

One obvious reason for current developments on the oil market being steadier compared to 30 years

Figure 1.5

OIL IMPORT BILL, OECD MAJOR OIL-CONSUMING COUNTRIES,[a] 1973–1978,1979–1983, 1999–2005[b]

(Per cent of GDP)



Source: UNCTAD secretariat calculations, based on UN COMTRADE; UN National Accounts Main Aggregates database; EIU, *Country Forecast*, various issues; and OECD, International Trade by Commodity Statistics database.

a Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States.

b 2005 data are estimates.

ago is that they were primarily demand-driven, rather than motivated by supply decisions in oil-exporting countries. Despite the fact that there have been several OPEC interventions on oil supply in recent years, there is little doubt that the growing demand for oil imports, primarily coming from the United States and the rapidly growing developing countries in East and South Asia, in particular China and India, is at the origin of the oil price hike. On the supply side, OPEC spare supply capacity almost disappeared in 2004. OPEC countries had dramatically reduced their supply in the first half of the 1980s, but their production was replaced by new entrants with higher production costs (such as North Sea producers). In recent years, however, non-OPEC supply grew at lower rates, and OPEC countries recovered their 1979 production level. At present, OPEC countries are not in a position to respond rapidly to a surge in demand or a disruption in supply in a major producer. Oil supply is expected to increase in the coming years, but at a pace that will probably not exceed that of demand (Kaufmann, 2004).

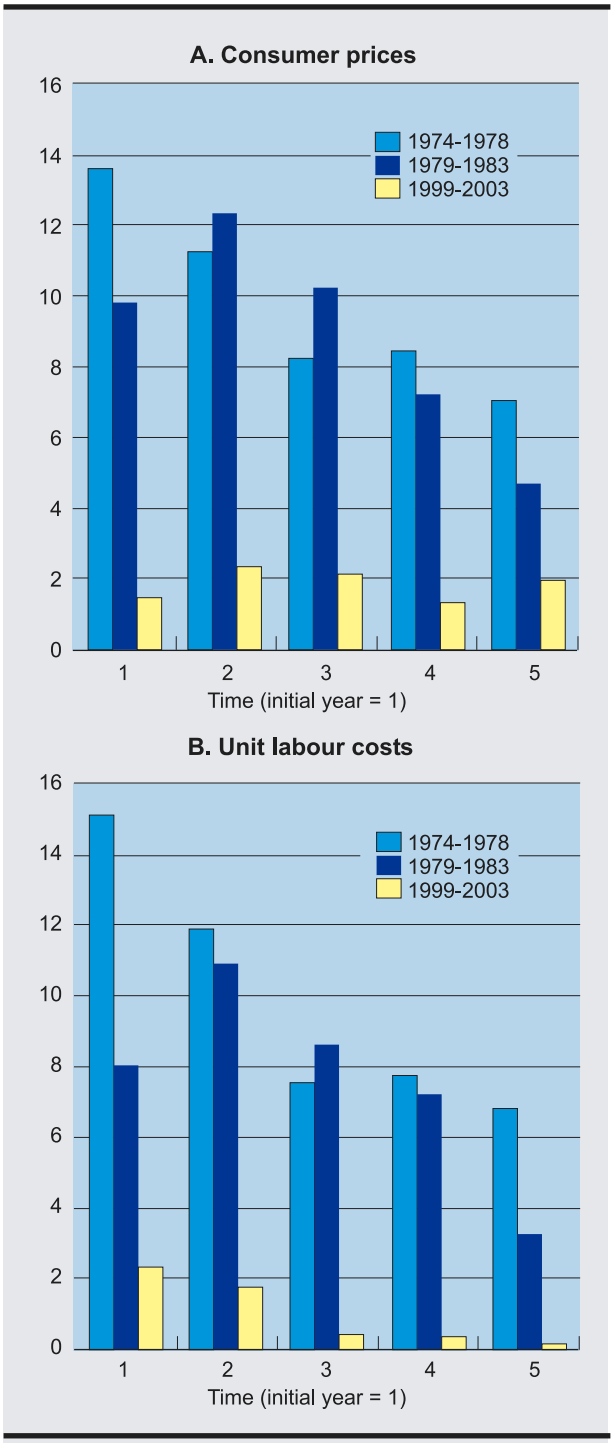
In the same way as the size of the oil price increase, its impact has also been much smaller in this recent episode than in earlier ones. Between 1973 and 1974, oil imports as a percentage of GDP in eight major industrialized countries increased from 1.3 to 3.2 per cent, and remained between 2 and 3 per cent for the rest of the decade, before rising again in 1980–1981 to reach 3.7 per cent of GDP. The 1999–2000 oil price increase resulted in a rise of the oil import bill from 0.8 per cent of GDP in 1999 to 1.4 per cent in 2000, and it went down again over the subsequent two years. In 2005, assuming that the renewed hike will maintain oil prices at an annual average of $50 per barrel, it may reach 1.9 per cent but even then it would fall short of the levels attained in 1974 and the following years (fig. 1.5).

On average, consumer prices in the major industrialized countries increased by about 10 per cent in the course of the first and second years of both oil price crises in the 1970s, and by only marginally less in the following years. By con-

Figure 1.6

CHANGES IN CONSUMER PRICES AND UNIT LABOUR COSTS, OECD MAJOR OIL-CONSUMING COUNTRIES,[a] SEVERAL PERIODS

(Per cent)



Source: OECD, Main Economic Indicators database and *Economic Outlook No. 77*.

a GDP weighted average of Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States.

trast, the impact of recent price increases on the consumer price index is rather negligible (fig. 1.6A). The evolution of unit labour costs in the industrialized countries during the 1970s and early 1980s demonstrates the role and weight of second-round effects. The rise in unit labour costs is especially marked in the wake of the first shock. Trade unions were firmly determined to compensate for real income losses, as unit labour costs grew by 15 per cent in the first year and 12 per cent in the second year, and subsequently remained in the neighbourhood of 7 per cent. Increases were less pronounced during the second crisis, although they were still quite considerable (fig. 1.6B).

The development of unit labour costs in the major oil-consuming countries since 2000 indicates that second-round effects have been practically absent. Unit labour costs rose by just over 2 per cent in 2000 and have been growing more slowly ever since, a fact that is also reflected in the consumer prices shown in figure 1.6A. Except for the immediate impact of higher energy prices, there is no sign of inflationary tendencies taking hold as trade unions have refrained from seeking compensation for real income losses due to energy prices during wage negotiations.

Nevertheless, central banks in the industrialized countries have continued to vehemently warn against the occurrence of second-round effects, to which they would react by raising interest rates in a bid to defend price stability. However, given the absence of inflationary second-round effects, central banks have refrained from responding immediately to slightly higher inflation rates, focusing instead on "core inflation" indices that exclude energy prices. Volatility in energy costs and the concomitant variation of real incomes have, arguably, come to be seen in the developed world as something that is outside the control of consumers, manufacturers and monetary authorities and thus can only be accepted.

The policy responses during the major oil crisis followed a quite different pattern. That the two oil price shocks had markedly different repercussions in individual countries is quite instructive with a view to lessons to be learned by those countries in the developing world faced by a similar oil price increase. By the time of the second oil price shock, all major central banks adopted a re-

strictive stance, led by the Federal Reserve. The federal funds rate reached 19 per cent in 1981 and remained above the 10 per cent mark through late 1982. Even in those countries whose central banks had pursued a largely accommodative monetary policy stance throughout the 1970s, such as France, short-term rates scaled new heights in the early 1980s. Interest rates increased sharply despite the fact that oil-exporting countries recycled their windfall oil revenues through the international capital markets, rather than to spend them directly on higher imports. The potentially decreasing impact on interest rates of these capital flows reaching the international capital markets was overlaid by the concerted action to curb inflation carried out by central banks of the industrialized countries after 1979.

Many developing countries, in particular in Latin America, were caught in this high interest rate trap with disastrous results for their overall economic development and their foreign indebtedness. Servicing the existing debt became more difficult in an environment of climbing international interest rates and, eventually, plunged many developing economies into severe economic crises during the 1980s.

The repercussions from current price developments in the oil market will much less likely produce the kind of dramatic impact seen during the 1970s, particularly in the absence of comparable interest rate reactions in developed countries.

Moreover, the impact on consumer prices is much weaker as increased efficiency in energy use over the past few decades has contributed to a decline in the share of energy products in the consumer price index. The effect is further mitigated by the presence of higher indirect taxes on energy consumption, particularly on gasoline. In the euro area, about two thirds of the price for transport fuels and lubricants are made up by taxes, meaning that a price increase only works on one-third of the overall price. The respective tax burden is smaller in the United States and slightly larger in Japan. Moreover, the use of other energy sources has also contributed to the reduction in the share of oil in total energy consumption.[12]

Furthermore, in addition to greater efficiency in the use of energy for final consumption, there has also been a decline in energy intensity of production.[13] The overall economic structure of developed economies has changed over the past 30 years. It has become more service-oriented and less reliant on industrial production, which further reduces the likely role of an oil price rise as an impending disturbance. The combination of these various factors explains why the average oil bill of the major economies (as depicted in figure 1.5) has declined to about 0.8 per cent of GDP in 1999, and why present inflation did not pick up in the same way it did during the 1970s.

3. The impact on oil-importing developing economies

Exposure of oil-importing developing countries to oil price hikes frequently differs from that of the developed world. First-round effects on prices and balance of payments tend to be more severe, as the energy and oil intensities are generally higher in these countries. Taking the OECD countries level as 100, oil intensity (e.g. primary oil consumption per unit of GDP) in 2002 was 142 in Brazil, 232 in China, 237 in Thailand and 288 in India (IEA, 2004b: 11). Moreover, the share of taxes in the final price of fuels is usually much lower in developing than in most developed countries, and in a number of them, these prices are subsidized. As a consequence, the cost of crude has a more direct impact in developing countries, either on the final consumer price or on fiscal accounts. If these impacts are seen as a threat to the control of inflation or to fiscal consolidation, they would call for policy adjustments with all the attendant effects these have on growth. Finally, developing countries could also feel another indirect effect, stemming from policy reactions in the developed countries, in the form of lower exports and tighter conditions in international financial markets.

In contrast to the substantial reduction of oil dependency in developed countries, reliance on oil imports has increased in the developing word, as a result of industrialization and urbanization. In 1972, the oil import bill in developing countries (excluding OPEC) represented 0.8 per cent

of current GDP, and it climbed to 2.3 per cent in 1975–1976 and 3.4 per cent in 1980. In 1998–1999 this share was 1.7 per cent of GDP, and it rose to 2.7 per cent in 2000–2003. In 2004–2005 it has probably exceeded 3.5 per cent, roughly twice the oil import bill paid in the main OECD countries.[14] As a result, the increased cost in oil imports in developing countries clearly exceeds those faced by developed regions and more closely resembles the experience of the oil shocks of the 1970s.

Latin America (excluding the oil-exporting countries of Ecuador and Venezuela) shows the lowest exposure among developing regions, with the share of oil imports rising from 0.8 per cent of GDP in 1998 to 1.3 per cent in 2003. This has been, in particular, the result of active Brazilian policies aimed at substituting oil with national energy sources (hydroelectricity and alcohol) and at increasing the domestic production of hydrocarbons. However, oil imports account for a significant proportion of GDP in Chile (4.7 per cent in 2003), Central America (4.9 per cent on average for Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama) and the Caribbean, with particularly high shares in Guyana, Jamaica, Belize and Barbados.

Asia (excluding OPEC) accounts for roughly 80 per cent of oil imports from developing countries, and is also the region where the ratio of oil imports to GDP remains the highest. The main reason for this is the deepening of industrialization in East and South Asian countries. In 2003, the share of oil imports in GDP was 5 per cent or more in Singapore, the Republic of Korea, Thailand, Taiwan Province of China and the Philippines, and more than 4 per cent in Pakistan and Sri Lanka; in India, which is relatively less advanced in industrialization than other countries in the region, this share amounted to 3.8 per cent.

In Africa, the situation is very heterogeneous as the region comprises several major oil exporters, but also a number of countries that are heavily dependent on oil imports, particularly among sub-Saharan countries. This subregion as a whole (excluding Nigeria and South Africa) presents levels of oil dependency close to those found in East and South Asian countries (3.5 per cent of GDP in 2000–2003), despite the much lower level of industrialization.

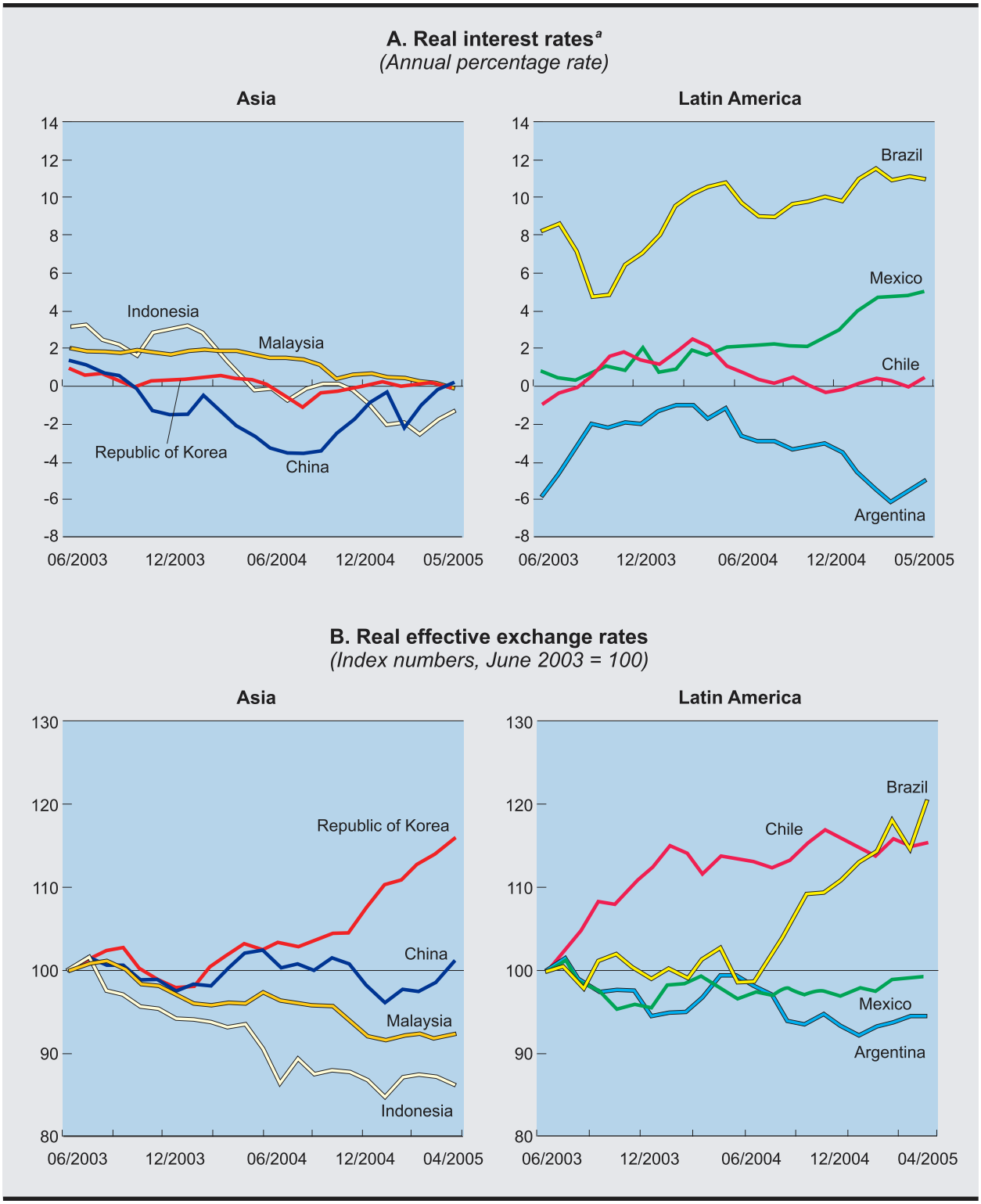
Summing up, oil prices have had, and continue to have, an impact on the import expenditure of a significant number of developing countries which is comparable to the one subsequent to the 1970s oil shocks. However, in many cases their negative impact on the trade balance has been compensated, either by a parallel increase in the price of other exported primary commodities or by expanding volumes of manufactured exports; the first case was especially relevant in several South-American and sub-Saharan countries, while the second explains the solid trade performance in East and South Asia, despite high oil prices. Other oil-importing countries, however, face severe financial strain.

In some developing countries, high commodity prices (including oil) have caused concern about inflationary pressures, and prompted a tightening of monetary policies in order to prevent second-round effects on prices. This is in stark contrast to the reaction in developed economies. There the lesson has been learned that monetary policy instruments, which almost exclusively operate through the impact on aggregate demand and the absolute price level, should not be used to abate price increases originating in changes of relative prices.

Indeed developing countries have taken different approaches. For example, monetary policy was tightened in Brazil and Mexico in 2004 in order to prevent second-round effects, even though it was recognized that higher-than-expected inflation was mainly related to supply-side factors, including energy prices (IPEA, 2005: 7–9; Banco de México, 2005: 2). The policy response in other Latin American and most East Asian countries was more flexible. In order to avoid negative effects on growth, monetary policy was not used to curb inflation forced by higher oil prices (fig. 1.7). For instance, economic policy in Argentina tried to avoid high real interest rates and currency appreciation as ways to fight against accelerating inflation in early 2005. The latter was considered to be largely due to temporary factors, and the current levels of real exchange and interest rates are central policy instruments for maintaining economic growth and competitiveness. Similarly, in most East and South-East Asian countries, supply-side driven inflation pressures have not led to sharp interest rates increases, which could have

Figure 1.7

REAL INTEREST RATES AND REAL EFFECTIVE EXCHANGE RATES, SELECTED ASIAN AND LATIN AMERICAN COUNTRIES, 2003–2005



Source: UNCTAD secretariat calculations, based on Thomson Financial Datastream; national sources; and JP Morgan, Effective Exchange Rate Indices database.

a Interbank rates deflated by CPI changes.

undermined economic growth and the recovery of their financial systems from the 1997–1998 crisis. For the Malaysian monetary authorities, for instance, price pressures have been contained by improvements in labour productivity and capacity expansion, enabling monetary policy to remain supportive to growth (Bank Negara Malaysia, 2005).

Several countries have also tried to isolate domestic from international oil prices. In Latin America, this has been the traditional approach in Venezuela (see also annex to chapter III), but also in a number of Asian countries, including oil-producing countries, such as Viet Nam and Malaysia, and countries dependent on oil imports. In India, for example, the government resorts to subsidies in the order of 0.5 per cent of GDP for specific petroleum products largely used by the rural poor. In Thailand, such subsidies reached 1.3 per cent of GDP in 2004, and in Indonesia they amounted to 2.5 per cent of GDP in the same year. In the latter countries, these policies have recently been revised, leading to an increase in oil prices (Channel News Asia, 2005).

In conclusion, the chances of an oil price hike plunging the global economy into a recession comparable to the ones of the 1970s and 1980s appear to be small. In the major developed countries, oil prices have considerably lost significance for the evolution of GDP. First- and second-round effects have not led to inflationary pressures that would have prompted a restrictive stance in monetary policy. Naturally, the higher cost for energy had an impact on price indices, but the monetary authorities have learned from the previous oil price hikes that monetary tightening is not a proper response to this challenge. However, oil dependency remains high in many developing countries and the prospect of permanently higher oil prices is especially disturbing for those countries that are not benefiting from higher prices for their exports.

E. Rapid growth in China and India and the profit-investment nexus

Asia has been a remarkably dynamic region over the past four decades, with different economies in the region experiencing rapid growth and catching up. Following Japan's economic catching up episode between the 1950s and the 1980s, the fast pace of economic growth, industrialization and growth of manufactured exports in the Republic of Korea, as well as in other Asian newly industrializing economies (NIEs) – Hong Kong (China), Singapore and Taiwan Province of China – awarded these countries, and by extension the region, with the distinction of forming the "East Asian miracle". China and India have entered this process most recently.

In spite of their rapid growth over a number of years, both China and India still have relatively low levels of per capita income (table 1.5). However, due to the two countries' size and the fact that, together, they account for about two fifths of the world population and one fifth of global income (measured in terms of purchasing power parity, PPP), their economic performance has already a sizeable impact on international trade patterns, global output growth, and the economic prospects of other developing countries, including their progress towards achieving the MDGs. In 2003, China ranked second and India fourth in the world in terms of absolute purchasing power,

Table 1.5

REAL GDP PER CAPITA AND GDP GROWTH IN CHINA, INDIA, JAPAN AND THE REPUBLIC OF KOREA DURING THEIR RAPID GROWTH PERIODS

	Real GDP per capita (dollars)								Average growth rate (per cent)				
	Market prices[a]				PPP[b]								
	Year 1	Year 10	Year 20	2003	Year 1	Year 10	Year 20	2000	1st decade	2nd decade	3rd decade	4th decade	1st 20 years
China (1979)	163	347	752	1 067	1 023	1 752	3 276	3 747	8.6	8.1	.	.	8.3
India (1980)	222	304	440	511	1 159	1 634	2 414	2 479	3.7	3.8	.	.	3.7
Japan (1957)	5 481	11 575	20 763	38 222	3 605	7 515	13 544	24 675	8.4	6.1	2.9	2.9	7.2
Rep. of Korea (1965)	1 297	2 397	4 149	12 232	1 803	3 501	6 237	15 876	6.7	5.7	7.5	4.2[c]	6.2
United States	.	.	.	35 566	.	.	.	33 293	.	.	.	.	.

Source: UNCTAD secretariat calculations, based on UNCDB; Japanese Ministry of Internal Affairs and Communications, Historical Statistics of Japan database; World Bank, World Development Indicators database; and Penn World Table 6.1, 2002.

a In constant 2000 dollars.

b In constant 1996 dollars.

c The Republic of Korea's average growth rate in the 4th decade covers only 9 years due to data constraints.

their respective ranks being sixth and twelfth in terms of real GDP. Moreover, as the third largest importer and exporter in the world in 2004, China's growth dynamics significantly influence commodity prices and the prices of some traded manufactures such as textiles, as discussed in subsequent chapters of this *Report*.

This section addresses selected issues that are of crucial importance for the sustainability of rapid economic growth in China and India in the medium and long term. In particular, investment plays a key role in the expansion of productive capacity and productivity growth (*TDR 2003*). UNCTAD's analysis has shown that the catching up process in the NIEs was based on the so-called profit-investment nexus (*TDR 1996*, chap. II, *TDR 2003*, chap. IV), in which savings created by profits in a process of rapid capital accumulation, technological progress and structural change constitute the basis for sustained productivity growth, rising living standards and successful integration into the international economy. Investment plays the crucial role due to its ability to simultaneously create income, develop productive capacities, and transmit technological progress; moreover, investment supports the upgrading of skills as well as institutional deepening.

A macroeconomic environment which both supports and encourages investors is required for domestic and foreign investment to become a source of growth and development. The profit-investment nexus emphasizes that profits, the savings accrued at companies, are the dominant source of financing. Rising profits can create a virtuous circle whereby the profits stemming from investment increase the incentives for companies to invest, thereby raising the capacity for financing new and additional investment.[15] For this to happen on an economy-wide scale, access to reliable, adequate and cheap sources of financing is an important precondition. The stance of domestic monetary policy is of crucial importance to initiate a process that will become self-supporting once profits have started to create the savings necessary to finance additional investments. Overly restrictive monetary policy may lead investors to prefer investing in financial assets over extending productive capacity.

Together with the interest rate, the exchange rate level is the other crucial macroeconomic price.

Without a competitive and rather stable exchange rate it is even more difficult for developing countries to successfully integrate into the world market. Hence, the monetary conditions of an open market economy (i.e. the interest rate and the real exchange rate) are of utmost importance for domestic and foreign investors and for the sustainability of the growth process.

Finally, the experience of the successful Asian economies shows that growing profits and positive profit expectations do not exclude the full participation of labour in the functional distribution of income. By contrast, only if overall demand grows in line with the production potential of an economy, can investors expect a stable and lasting source of profit income. But domestic demand can only follow such a growth path if real wages increase in line with productivity. This, more than the perceived ability and willingness to "save", has been one of the characteristic features of the Asian economies during their catching up episodes. High *ex-post* savings are the result of the investment process, rather than its source.

Thus, three conditions for sustainable growth emerge from Asia's growth experiences. First, economies need productivity drivers. These drivers may be individual companies, or a critical mass of companies located in specific sectors or branches, that push productivity growth beyond formerly reached limits and create the kind of incentive needed for maintaining the overall profit-based dynamics of the economy. In the past, manufacturing has been the most important driver, as the potential to expand productivity growth has been closely related to the opportunities of intensifying the process of capital deepening.

Second, growth dynamics need to be supported by both domestic demand and exports. An appropriate balance between domestic and foreign demand is required mainly to cushion the shocks that frequently emerge from the vagaries of world financial markets and their impact on exports. In particular, steady and rapid growth of private consumption, which is quantitatively the most important component of overall demand, is needed to sustain growth processes. Finally, pro-growth macroeconomic conditions are required to set and keep the economy on a sustainable and steep growth path.

1. The sectors driving economic growth

A breakpoint analysis on labour productivity trends[16] for the post-Second World War catching up process in selected Asian countries indicates rapid growth episodes for Japan between 1957 and 1973, the Republic of Korea since 1965, China since 1979, and India since 1980. At the beginning of their economic take-off, the level of Japan's per capita income (in constant 2000 dollars) was $5,481 and that of the Republic of Korea $1,297. Compared to these levels, economic take-off in China and India started from a much lower base – $163 for China and $222 for India. Table 1.5 shows the four countries' per capita GDP in market prices, as well as in constant PPP terms, which gives less divergent results among countries, as poor countries generally have lower price levels and higher purchasing power per dollar.

Assuming labour to be immobile internationally and wages to be set at the level of the national economy, the sectors where profits rise or prices fall will be those that are best positioned to exploit the potential for productivity growth through the increasing use of sophisticated equipment and technologies. Whereas, in principle, any sector can take the lead and become a driver, the manufacturing sector has most often assumed this role, because it is apparently the best placed to exploit all the specific advantages of machinery and technology for large-scale production. The pattern of manufacturing productivity growth dominating overall productivity growth can be found in most of the successful catching up episodes.

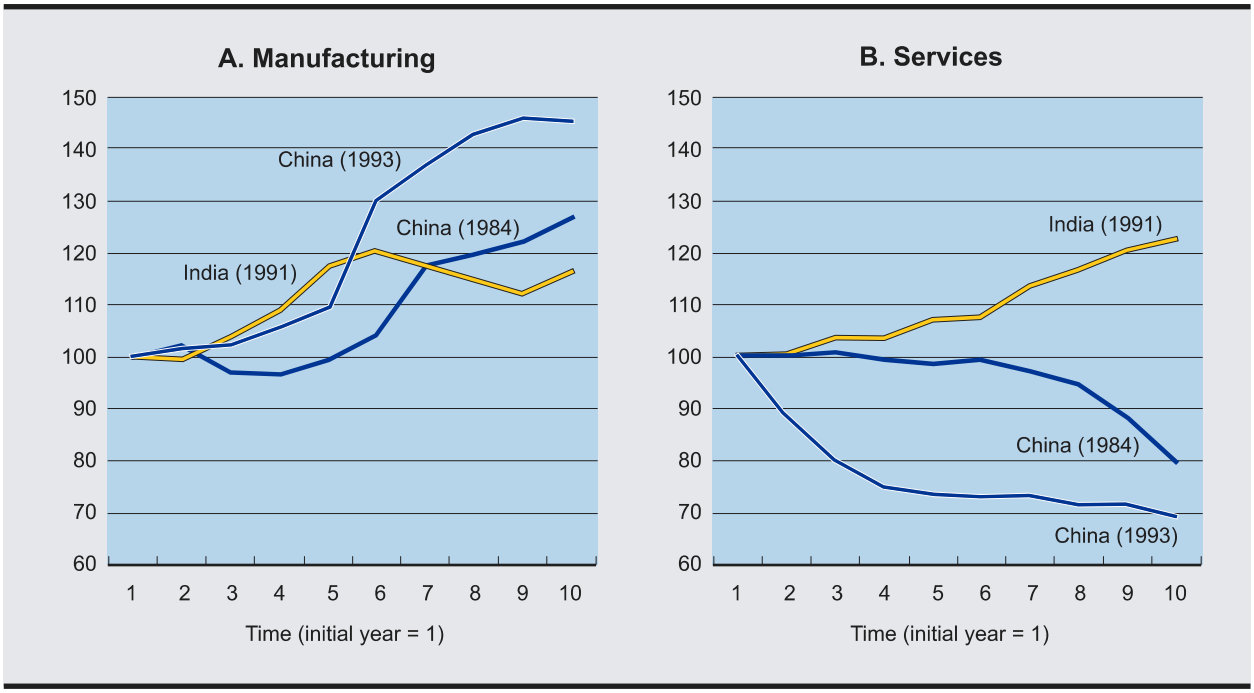
In the Republic of Korea, manufacturing productivity was expanding at about 2.5 per cent above the productivity of the overall economy between 1963 and 1983.[17] Where this is the case, and where wages in manufacturing rise broadly in line with productivity of the overall economy, manufacturing producers have a huge advantage above all other sectors. They can either increase the volume of production by lowering prices or realize consistently higher profits than other parts of the economy.

The same pattern of development can be observed in China's rapid growth phase starting in the early 1980s. Between 1981 and 2000, its manu-

Figure 1.8

PRODUCTIVITY IN THE MANUFACTURING AND SERVICES SECTORS COMPARED TO OVERALL PRODUCTIVITY IN CHINA (1984–1993, 1993–2002) AND INDIA (1991–2000)

(Index numbers, initial year = 100)



Source: UNCTAD secretariat calculations, based on UNCDB; China State Information Center (SIC) Database; Ghoshal, 2003; and World Bank, World Development Indicators database.

Note: Numbers over 100 mean that manufacturing and services sectors productivities exceed overall productivity.

facturing productivity growth averaged 9.4 per cent, an extremely high rate by historical standards, exceeding all the other sectors of the economy by 2.5 per cent per year on average. In China, manufacturing productivity growth accelerated in the mid-1990s and expanded at an unprecedented rate of 14.7 per cent annually between 1997 and 2000 (fig. 1.8). This productivity surge in the Chinese manufacturing is closely related to rapidly increasing inflows of FDI and their concentration in industry. Inflows of FDI in industry increased from $11 billion in 1992 to $45 billion in 1997 and to $53 billion in 2003. Indeed, since the mid-1990s, 60 per cent of China's total FDI inflows have been oriented to the manufacturing sector (UNCTAD, 2004a: 55).

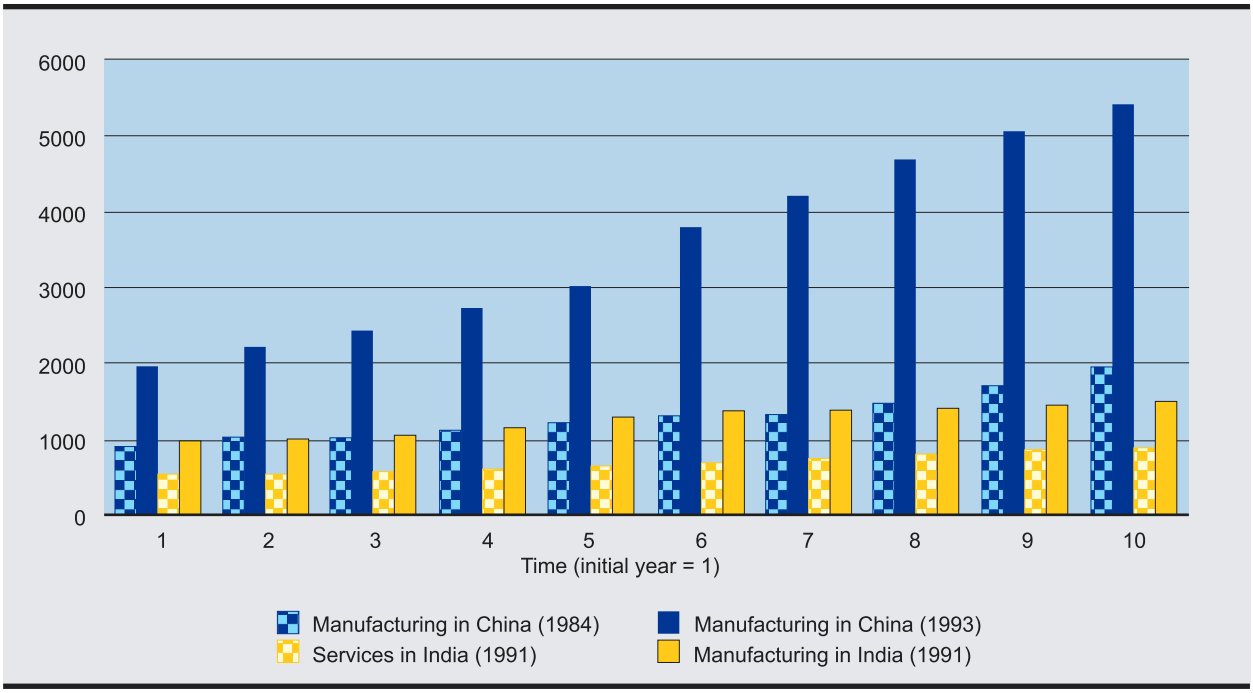
Producers in high-cost industrialized countries have found in China an attractive outsourcing platform not only because of its cheap and relatively well-educated workforce, but also because of the incentives offered by its Government. For more than two decades, foreign funded enterprises (FFEs)[18] have benefited from tax breaks which gave them a competitive advantage over local State-owned and private companies. For corporate income tax, local companies are charged a tax rate of 33 per cent as soon as they start making profits, while foreign firms pay 7.5 per cent two years after they start earning profits, followed by 15 per cent starting from the sixth year they continue to earn profits.

India is still far from such a regime of manufacturing-driven growth. Comparing China's and India's manufacturing productivity growth and their total economy productivity growth,[19] reveals the dominating role of China's manufacturing sector (fig. 1.8). Although India also experienced vigorous growth of manufacturing productivity in

Figure 1.9

PRODUCTIVITY IN THE MANUFACTURING SECTOR IN CHINA (1984–1993, 1993–2002) AND IN THE MANUFACTURING AND SERVICES SECTORS IN INDIA (1991–2000)

(Constant 2000 dollars)



Source: UNCTAD secretariat calculations, based on UNCDB; China State Information Center (SIC) Database; Ghoshal, 2003; and World Bank, World Development Indicators database.

the first half of the 1990s, the dominance of manufacturing was much less pronounced in India than it was in China throughout the 1980s and 1990s. This is reflected in the fact that China almost tripled its manufacturing productivity between 1993 and 2002 (fig. 1.9).

In India, the services sector seems to be assuming the role as an engine of income growth and driver of change, albeit in a less pronounced fashion, that manufacturing has played in other countries. Moreover, productivity growth in India's services sector is only slightly higher and more stable than in manufacturing. Average annual growth rates of 5.6 per cent in the services sector in the 1990s were outstanding, especially considering that this very heterogeneous sector includes a large part of informal activities and activities with a very low productivity potential. In China the growth rate of services between 1993 and 2002 averaged only 3.7 per cent, and it has lagged considerably behind overall productivity increases.

In absolute terms, productivity in India's services sector is still much lower than in China's manufacturing sector (fig. 1.9). For instance, productivity in Chinese manufacturing increased from $900 in 1984 to $5,400 in 2002. Productivity in India's services sector reached $530 in 1991 but rose to only $870 in 2000. Moreover, productivity in Indian manufacturing stood at about $960 in 1991, a level roughly comparable to China's $900 in 1984. But over a period of 10 years India's manufacturing productivity increased to only $1,500 while China had already reached $1,950 in 1993. Thus, while the initial productivity level of Indian manufacturing was higher, the growth dynamics were insufficient to keep the position.

With extraordinary productivity growth in the last decade, Chinese manufacturers, domestic and foreign alike, had a wide margin to improve their market position. While labour productivity in manufacturing increased at an average annual rate of 12.2 per cent from 1991 to 2002, real wages grew by only 6.8 per cent in that sector. The huge gap between productivity growth and wage growth could be strategically used to reduce prices of their products and to gain market shares against foreign competitors and domestic producers in less favoured sectors. Depending on the degree of competition in their specific markets, manufacturing producers could also use the gap to increase their profit margins and to strengthen their ability to invest.

2. Stable and balanced demand growth as a condition for sustained rapid growth

An analysis of the contribution of the different components of GDP growth in Asia suggests that an effective policy should not only focus on exports and imports but try to balance foreign and domestic stimuli (table 1.6). In fact, the contribution of exports to GDP growth has increased over time in all the countries considered but domestic demand, comprising investment and private consumption, plays a much more important role in quantitative terms. While India lags behind in its investment dynamics, China and the other Asian drivers have used an approach where both, external and domestic demand had a significant impact on the sustainability of GDP growth. Obviously, large and populous countries such as China and India cannot rely on exports as the only engine of growth; domestic demand, investment and consumption, is at least as important.

Real household demand, the main contribution to GDP growth, grew at an average annual rate of 8.9 per cent in China, 7.7 per cent in Japan, 7 per cent in the Republic of Korea and 4.7 per cent in India (fig. 1.10). Private consumption registered a remarkably steady and strong growth rate in China. Given the sustainability of the past performance in Asia, it seems that the steadiness of households demand growth can act as an endogenous stabilizer to economic development. Even more, if it is true that revenues from a flourishing domestic demand flow back to the business sector in form of steadily rising profits, the participation of workers in the proceeds of an economy-wide expansion may be indispensable for a sustainable growth process.

If the increase in labour productivity of the total economy is fully reflected in real wage and salary increases, disposable income and real consumption grow consistently at a rate close to the growth rate of GDP. Indeed, in a world where the distribution of income between labour and capital and the household savings rate are constant, the growth rates of GDP and private consumption are identical.

In China, as well as in the other successful Asian countries, the full participation of labour in the proceeds of total economy productivity increases was never in question. Apart from the growing inequality of the personal distribution of income between different types of labour, the functional distribution between labour and capital has been reflecting equality of powers rather than the dominance of one side. For instance, for the period between 1990 to 2000, available statistics indicate that, on average, real wage in the total economy grew by around 8 per cent annually, while overall economy productivity grew at a rate of some 9 per cent (Flassbeck et al., 2005).[20]

Recently, real wage growth seems to have been even more rapid than overall productivity growth. This is in line with reports warning about labour shortages in the manufacturing sector, which would be leading to an upward pressure on wages. For example, the province of Guangdong in the Pearl River delta is short of two million migrant workers; a shortage evident throughout the manufacturing sector along China's eastern shoreline, from the Pearl River Delta up to Shanghai (*The Economist*, 9 October 2004). Other observers also warn of an impending labour shortage (Yang, 2005).

These developments have led to a significant reduction in poverty, but as rapid wage increases are unevenly distributed among sectors and regions, they have also led to a more unequal income distribution (box 1.2).

Table 1.6

CONTRIBUTION OF CONSUMPTION, INVESTMENT AND TRADE TO GDP GROWTH IN CHINA, INDIA, JAPAN AND THE REPUBLIC OF KOREA

(Per cent)

	Consumption		Gross fixed capital formation	Trade		Average annual GDP growth[a]
	Private consumption	Public expenditure		Exports	Imports	
1st decade[b]						
China	4.88	1.39	3.05	0.61	-1.06	10.10
India	3.25	0.75	1.33	0.32	-0.57	5.89
Japan	4.89	0.58	4.40	1.34	-1.27	9.41
Republic of Korea	6.08	0.65	4.27	3.80	-5.25	9.01
2nd decade						
China	3.88	1.10	3.62	2.03	-1.96	9.41
India	3.11	0.70	1.51	1.16	-1.38	5.70
Japan	3.45	0.64	3.10	1.38	-0.97	7.41
Republic of Korea	3.96	0.43	3.43	4.33	-3.67	7.35

Source: UNCTAD secretariat calculations, based on UNCDB; Japanese Ministry of Internal Affairs and Communications, Historical Statistics of Japan database; and World Bank, World Development Indicators database.

a Differences between the sum of the contributions and GDP growth are due to variations in stocks and/or statistical discrepancies.

b Starting years as in table 1.5.

All in all, consumption may not have been the main engine of growth, but the stable growth rate of consumption must have been a huge stimulus for investors. The profit-investment nexus has not materialized through a redistribution of income from labour to capital, but by equally rapidly rising profits and wages in the overall economy associated with surging manufacturing productivity. In other words, investment that pushed the economy towards new frontiers has created sources of new investment through consumption (Eatwell et al., 2002).

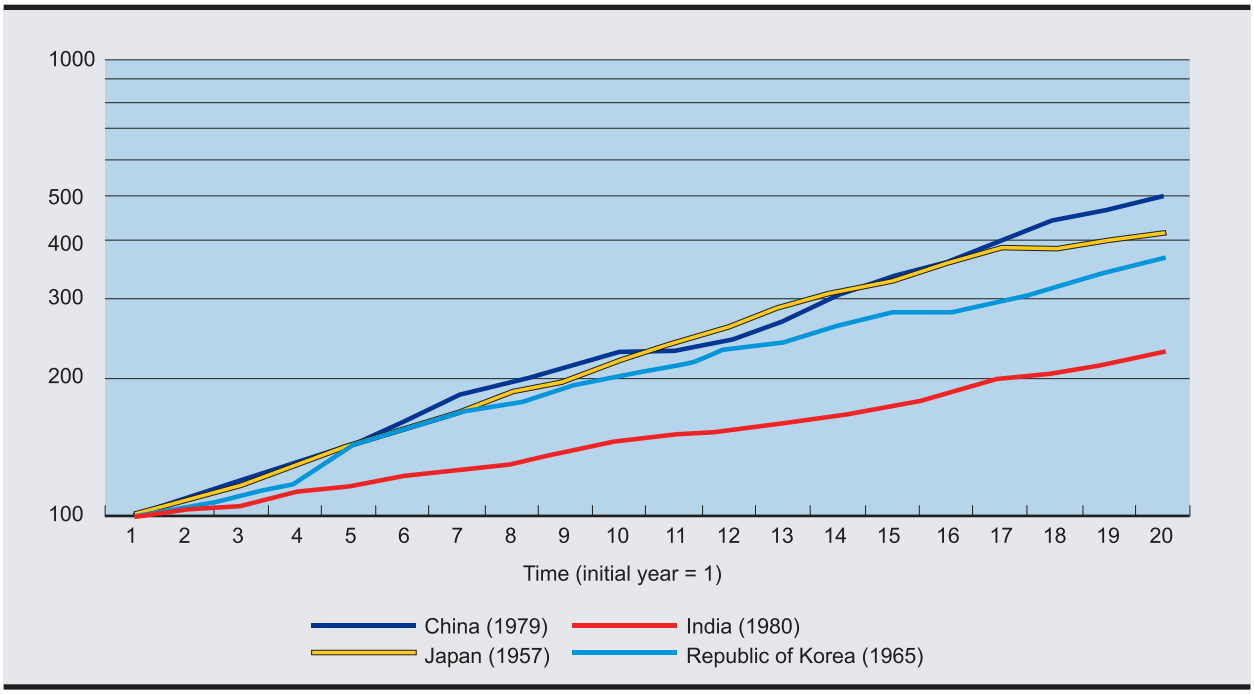
Compared to private consumption, investment growth rates are much more volatile in all the countries under consideration. The magnitude of investment in the Republic of Korea and Japan in the first 20 years of the economic take-off dwarfs the much-quoted spectacular growth of Chinese investment. Overall, the Republic of Korea recorded an average annual growth rate of gross fixed capital formation (GFCF) of 17.2 per cent over a 20-year time span, whereas investment in Japan expanded by 12.5 per cent and in China by 11 per cent annually. India's average performance lags far behind, at 6.8 per cent, but India's and China's investment growth has accelerated markedly in the past five years at 7.6 per cent and 14.1 per cent respectively.

Investment shares of GDP were high in the Asian countries, at levels hovering around 30 per cent in the first and second decades of their rapid growth periods. While Japan's investment share levelled off to just below 30 per cent in the third and fourth decades following the initial take-off, the Republic of Korea's share has remained at over 30 per cent up to the present. In India, investment shares in the first and second decades have again lagged around 10 per cent behind the respective Chinese and Japanese investment shares, and the investment gap between China and India widened further between 2000 and 2004. On average, China's investment share reached 41.1 per cent per

Figure 1.10

EVOLUTION OF PRIVATE CONSUMPTION IN CHINA, INDIA, JAPAN AND THE REPUBLIC OF KOREA

(Index numbers on a logarithmic scale, initial year = 100)



Source: UNCTAD secretariat calculations, based on UNCDB; Japanese Ministry of Internal Affairs and Communications, Historical Statistics of Japan database; and World Bank, World Development Indicators database.

annum in this period, compared with India's 22.5 per cent. In 2004, India's GDP share of GFCF stood at 23.4 per cent, half of China's 46.6 per cent.

3. Policy conditions underlying the Asian catching up processes

Asia's catching up episode has also been a period of consistent monetary stability. Despite extremely fast real income growth, rising employment opportunities and falling unemployment rates, long periods of very high investment have coincided with very low inflation rates. None of the countries under consideration experienced inflation rates above 30 per cent during their respective growth periods. The inflation rate, on average, was 7.4 per cent for Japan between 1960 and 1979, and 12.7 per cent for the Republic of Korea in the 20 years from 1967 to 1986. In China and India it was 5.6 per cent and 8 per cent, respectively, between 1990 and 2003. Moreover, China's growth and investment have recently experienced an extraordinary acceleration but there are still no hints of an impending inflationary acceleration that could force the government and the central bank to sacrifice real growth in order to stabilize prices in an overheating economy. Despite the rise in commodity prices, and oil in particular, monthly headline inflation did not exceed 5.3 per cent at annual rate in 2004.

It is important to note that the achievement of price stability is not rooted in a restrictive monetary policy. For example, the policy interest rate (in real terms) set by the Peoples' Bank of China throughout the boom years, i.e. from the mid-1990s to the present, has remained at an average level of 3 per cent. In Japan's 20-year period from 1957 to 1976, the average real interest rate (again

Box 1.2

INCOME DISPARITIES IN CHINA AND INDIA

In China, the number of people living in absolute poverty has been reduced considerably over the past 25 years. However, both relative poverty and the gap between the rich and the poor are growing. China's Gini-coefficient increased from 0.18 to 0.33 in urban areas and from 0.25 to 0.36 in the rural areas between 1981 and 2002 (United Nations, 2004a). In 2001, the Gini-coefficient for the country as a whole was 0.44. In India, it was significantly lower than in China at 0.32 in 2000, down from 0.37 for the period 1993–1998. In comparison, in 2000, the Gini-coefficients in Sweden, Germany and the United States were 0.25, 0.28 and 0.41, respectively.

The high value of the Gini-index in China in general, compared to the lower values for rural and urban areas, reflects the rising disparities between regions within the country. As the rural population is an important factor for the expansion of domestic demand, in China, the policy to raise welfare of the rural population will be a crucial factor for economic growth in the future. In this regard, the Chinese Government recently reduced agricultural taxes in order to increase the incomes of China's 800 million rural residents.

For India, widening disparity is less of an issue. However, with more than 350 million poor people (UN Statistical Division, Millennium Indicator Database) not fully participating in overall economic growth, social stability could be threatened. Only if India can significantly increase income levels nation-wide, can overall pro-growth balanced demand be created to help move the economy forward.

based on the policy rate) was negative at -0.1 per cent and slightly positive in the Republic of Korea, at 0.6 per cent from 1967 to 1986.[21] The averages for the Chinese and Indian real short-term rates between 1990 and 2004 were 1.1 per cent and 1.3 per cent, respectively. Lending rates were also extremely low in China, and they have remained well below the growth rate of GDP, which may be considered as a proxy for the rate of return on investment in fixed capital; as a result, they have consistently stimulated the creation of new capital. In India, real lending rates were on average close to real growth of GDP (fig. 1.11).[22]

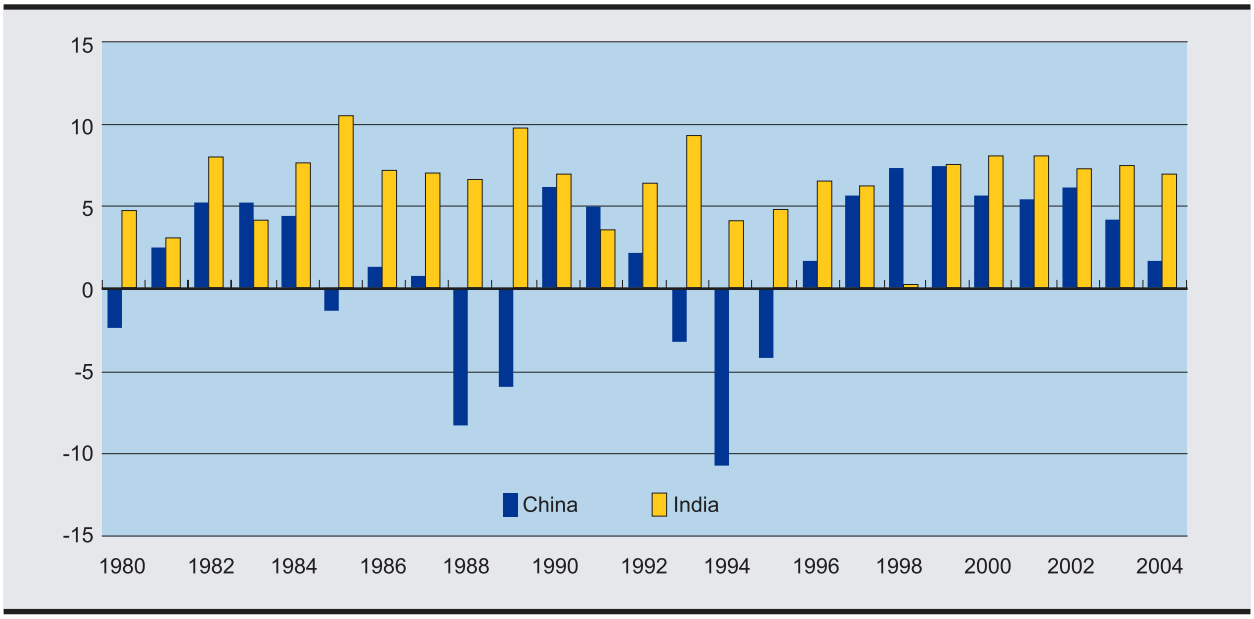
The pro-growth stance is as true for domestic monetary conditions as for the main external condition: the real exchange rate. The four countries' development paths were supported by low and fairly stable real exchange rates, which contributed to a high level of competitiveness on the world market.[23] The real effective exchange rates of China, India and the Republic of Korea depreciated throughout most of their catching up periods with major devaluations taking place at the beginning of the 1990s in India and in the mid-1990s in China. Thus monetary stability and competitive valuation functioned as strongly supportive and stabilizing elements of the high-growth periods in all of the four countries without fuelling inflation.[24]

China and India were able to create a favourable monetary environment throughout the 1980s and early 1990s and, even more importantly, to defend these positions throughout the past decade. Since 2000, China has had to justify its pro-growth monetary policy against external political pressure and, despite continued currency appreciation in real terms during and after the Asian financial crisis it has managed to preserve competitiveness and the expansionary stance of its monetary policy. The Indian real effective exchange rate has remained stable over the past

Figure 1.11

REAL INTEREST RATES[a] IN CHINA AND INDIA, 1980–2004

(Per cent)



Source: UNCTAD secretariat calculations, based on IMF, International Financial Statistics database.
a Nominal lending rates deflated by consumer prices.

decade. Financial crises in India (in 1991) and in China (in 1994) had the effect of radically changing their monetary regimes; both countries consequently adopted an anchor approach for their exchange rates at a rather low level in order to being able to defend their respective positions unilaterally (*TDR 2004*). Only recently and under enormous political pressure has China modified its external monetary regime slightly by introducing a more flexible band for the exchange rate and by envisaging a basket approach instead of unilateral fixing against the dollar.

Price stability and pro-growth monetary conditions of the Asian countries are in stark contrast to those of other developing regions. Latin America, for example, has over the past three decades experienced high and highly volatile inflation rates and very restrictive monetary policies as well as overvalued exchange rates. Different policy instruments used in Asia for coping with inflationary pressures have been more effective, both in terms of price stability and economic growth. In particular, by stabilizing the price level through non-monetary instruments, such as an income policy or direct price controls,[25] monetary policy was freed from the task of permanently fighting inflationary dangers. Empirical evidence provided in *TDR 2003* has shown that the freedom to set pro-growth macroeconomic conditions (interest rates and exchange rates) has been a key feature of Asia's success in comparison with Latin America.

In this respect, the macroeconomic regime, in a broad sense, is an important component for an explanation of Asia's comparatively good performance. The successful Asian countries were able to permanently stimulate investment because a special assignment of policies created the space for pro-growth monetary policy and a competitive exchange rate. Sound institutional and structural conditions were not seen as substitutes for supportive macroeconomic policies but the precondition for applying them. The Chinese example, in particular, shows that even in a very open economy with large FDI inflows, the labour market and, to a very large extent, the money and capital markets may remain within the realm of national

governments and central banks. The Asian experience demonstrates that globalization has not reduced the need for economic policy to act at the national level; in fact that need may even have increased. The smoothing of the adjustment process to more open markets, the stimulation of investments and the maintenance of overall competitiveness of an economy is, more than ever, the responsibility and the opportunity of national governments.

4. Challenges for sustained growth in China and India

Rapid growth in China and India over the past two and a half decades have made the East and South Asian region a new growth pole in the world economy. The challenge for the two countries now is to ensure the sustainability of their growth momentum. There is a need to strengthen the factors underlying their current growth, as well as to address existing challenges.

One of these challenges is how to foster the pace of structural change. History shows that in the development process, the importance of manufacturing and services increases both in output and employment, whereas that of agriculture declines. In China and India, by contrast, the role of agriculture in economic development will continue to be of great importance for many years to come, given that the majority of their populations still live in rural areas, and the sector still employs 50 to 60 per cent of the workforce in both countries.

For China, expanding GDP and employment in manufacturing and exporting sectors has been imperative, but services will, in the future, provide more employment opportunities. In Japan and the Republic of Korea the services sector compensated for the declining contribution of the industrial sector to GDP in the 1980s and 1990s, respectively. In India, in contrast to China and the NIEs in the high growth period of the 1990s the share of industry in GDP has remained constant while that of services has risen rapidly. This might pose a challenge for sustained growth, as productivity increases in the services sector are normally less strong than in the manufacturing sector. Nevertheless, outsourcing in IT and business processing has expanded rapidly, offering many new opportunities for a country with weak infrastructure and low investment in fixed capital, but equipped with a fairly large educated workforce.

Although considerable productivity gains are to be expected from structural change and increased use of economies of scale, technological upgrading can accelerate the catching up process. Since China and India launched their economic reforms, the pace of integration has been increasing due to major structural changes in the world economy. Production sharing in global manufacturing and services has enabled China, and subsequently India, to integrate into the world economy by using their absolute advantage of a low-cost, educated workforce. In comparison with the home grown industries of Japan and the Republic of Korea, it took much less time for the specialized activities in China and India to become part of the international supply chain. However, industrialized countries are increasingly reluctant to transfer technologies and know-how as part of their engagement, particularly in China.

China has tried to circumvent this trend by attracting FDI, which, ideally, incorporates the transfer of required technology to the host country. However, despite granting ever-increasing preferential treatment to foreign ventures that include the transfer of advanced technologies, there are indications of difficulties in acquiring the needed technological know-how through this channel. It is well known that such spillover is limited due to the prevalence of "technology mercantilism" of foreign ventures whereby TNCs seek to retain control over their technologies. In response, China has shifted its policy to include the purchase of key hardware, products and know-how. However, so far China lacks the ability to indigenize most imported technologies. Significant manufacturing capabilities have been developed, but most of them are aimed at producing by means of original equipment manufacturing to supply TNCs and large brand name retailers.

India's industry has succeeded in developing certain knowledge-based industries in sectors such as pharmaceuticals, basic organic chemicals and IT. As with China's manufacturing sector, however, there is the danger that the Indian IT industry will remain trapped at the low end of the

market, exporting services such as debugging, testing, conversion and installation of software, and importing expensive branded software and hardware products.

As more developing countries develop capacities to produce labour-intensive manufactured goods, competition in manufactured exports will also intensify. Thus there is an additional strong imperative for technology upgrading, to support more diversified and higher value-added production, which would enable both countries to maintain their economic growth.

In both countries it will be crucial to ensure that the majority of their population reaps the benefits of economic growth, even if a price in terms of greater interpersonal inequality has been paid in the first round. The present analysis has shown that the growth of real wages in line with rising productivity is important for gaining general acceptance of the rapid processes of structural change. It is also of the utmost importance for maintaining the stability of the growth process and, hence, for the success of catching up at large. Investment depends on favourable demand expectations. Export demand is subject to the vagaries of the world market and national competitiveness, and no country can expect permanent increases in its global market shares. Therefore domestic consumption is the most important factor for stabilizing and sustaining private investment. ■

Notes

1 See United States Bureau of Economic Analysis, National Economic Accounts database, at: www.bea.gov/bea.

2 Oil exports alone amounted to $213 billion.

3 See Republic of Turkey, State Institute of Statistics, *Economic Panorama database*, at www.die.gov.tr.

4 Urban fixed-asset investment (whose evolution is used as an indicator for domestic investment) grew by 26.4 per cent year on year in January–May 2005, while the Government's goal is a 16 per cent investment growth for the whole year. See EIU (2005a).

5 See Instituto Nacional de Estadística, Geografía e Informática (INEGI), Indicador global de actividad económica database, at: www.inegi.gob.mx/est/.

6 Export and import volumes calculated by UNCTAD include re-exports; this may explain, at least partly, the differences between these estimates and those of other sources. For instance, the World Bank estimated that trade expanded by 10.3 per cent in 2004. See World Bank (2005).

7 Country groups in this publication slightly differ with those generally used in this report.

8 See UNCTAD (2005b) for a detailed analysis on recent FDI trends.

9 For a discussion on this issue, see Houthakker-Magge (1969), Krugman (1988), Hooper et al. (1998), Mann (2003) and Wu (2005).

10 The results of the seminal study by Freund (2000) have recently been confirmed by Croke et al. (2005) and Debelle and Galati (2005).

11 The source for all oil price data in this section is the UNCTAD Commodity Price Bulletin. Unless otherwise stated, quoted prices always refer to the nominal dollar price per barrel of Dubai/Brent/Texas (equal weights).

12 The share of oil consumption in total primary energy consumption in Japan decreased from 77 per cent in 1974 to nearly 50 per cent in 2003. During the same period, in North America this share went down from 45 per cent to 36 per cent. The five biggest European Union countries registered a fall from 45 per cent to 42 per cent (British Petroleum (BP), 2004).

13 For a more detailed discussion on intensity of energy use, see chapter II.

14 UNCTAD secretariat estimations, based on UN COMTRADE and UNCDB.

15 As argued by Akyüz and Gore (1996), the presence of such an investment-profit nexus played an important role in East Asian industrialization, as it had earlier, in Western Europe's growth during the three decades after the Second World War.

16 The analysis used breakpoint techniques of productivity growth series, measured by growth rates of GDP per worker as is frequently used in the literature on catching up and integration (Maury and Phiyaud, 2004; IMF, 2004a). While it revealed clear starting breakpoints for Japan, the Republic of Korea and China, the starting point cannot be determined as clearly for India. For the purpose of this analysis this starting point was 1980.

17 UNCTAD secretariat calculations based on Korea National Statistical Office, Statistical database KOSIS and UNCDB.

18 FFEs include equity joint ventures, contractual joint ventures, wholly-foreign-owned enterprises and joint exploration companies for special extraction industries. They range from large TNCs to small- and medium-sized enterprises (SMEs) owned mainly by investors of ethnic Chinese living in other parts of East Asia.

19 Productivity for India could be calculated only from 1991 to 2001, owing to data constraints.

20 The underlying data for this analysis incorporates "state-owned units, urban collective-owned units and other ownership units". It is sometimes argued that this definition does not cover the whole economy, as it excludes the rural segment. In any case, the figures provide the best possible proxy to show the trend of overall participation of wage recipients in productivity growth.

21 Preferential interest rates for export industries in Japan and particularly in the Republic of Korea, even further pushed down, de facto, the real interest rates. Thus, recorded average interest rates tend to be overstated.

22 In India, and particularly in China, not all companies and sectors have equal access to the banking system and bank credits; only those enterprises that have such access can therefore actually benefit from the low real interest rates.

23 See *TDR 2004* for a discussion of the concept of competitiveness.

24 *TDR 2004* (chap. IV, section B) examined the causality between depreciation and actual export promotion, and presented various countries' experiences at a more general level and with more recent datasets.

25 For a detailed discussion of China's non-monetary instruments, see Flassbeck et al., 2005.

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