



GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION¹

OVERVIEW

Following the sharp slowdown of the global economy in 2001, signs of a return to more robust growth became evident in the first quarter of 2002. These encouraging signs, however, dissipated quickly and activity in the global economy lost momentum steadily against a backdrop of weakening consumer and business confidence as the year progressed. The risk of military conflict in Iraq and the nuclear situation in the Democratic People's Republic of Korea contributed to heightened uncertainty while the continuing fragility of corporate balance sheets led to more pronounced risk aversion on the part of investors and households in 2002. Stock markets virtually across the world experienced a third year of falling indices. Although countered by monetary easing in the main economies, both developed and developing, a strong recovery of the global economy consequently proved elusive in 2002. By and large, these factors are likely to persist and a significant improvement in the growth rate of the global economy is considered unlikely until well into 2003. Forecasts for the global economy and for trade, commodity prices, inflation and interest rates are summarized in table I.1.

In the ESCAP region the effects of these developments manifested themselves largely in swings in overall business sentiment and not in GDP growth in 2002 (see chapter II). Stock markets, which had risen strongly in the early part of the year in anticipation of a strong pick-up of the global economy later in the year, weakened considerably in the second half of 2002. Notwithstanding growing doubts about the strength of the global recovery and weaker business confidence, overall GDP growth in the region remained surprisingly strong. Indeed, the latest estimate by the United Nations *World Economic Situation and Prospects 2003* identifies Asia and the Pacific as the fastest-growing region in the world in 2002; the expansion in ESCAP developing economies' output was 3.4 percentage

The optimism in early 2002 dissipated during the year

The ESCAP region was apparently immune to the worsening external environment

¹ This is a revised and updated version of "Global and regional economic developments: implications and prospects for the ESCAP region", in *Bulletin on Asia-Pacific Perspectives 2002/03* (United Nations publication, Sales No. E.02.II.F.69).

Table I.1. Selected indicators of global economic conditions, 1999-2003

	1999	2000	2001	2002 ^a	2003 ^b
Economic growth (percentage change of GDP)					
World	2.9	3.8	1.1	1.7	2.8
Developed economies	2.7	3.2	0.7	1.3	2.3
Japan	0.8	2.6	-0.3	-0.6	0.9
United States of America	4.2	3.8	0.3	2.4	2.5
European Union	2.4	3.3	1.5	1.1	2.3
Developing economies	3.5	5.6	2.4	3.3	4.7
Developing economies of the ESCAP region	6.4	7.1	3.2	5.1	5.4
Economies in transition	6.3	7.0	3.1	5.0	5.7
Growth in volume of trade (percentage)^c					
World	5.3	12.6	-0.1	2.1	6.1
Developed economies					
Export	5.2	12.0	-1.1	1.2	5.4
Import	7.8	11.8	-1.3	1.7	6.2
Developing economies					
Export	4.3	15.0	2.6	3.2	6.5
Import	1.3	15.9	1.6	3.8	7.1
Commodity prices (annual percentage change; US dollar terms)					
Non-fuel primary commodities	-7.0	1.8	-5.4	4.2	5.7
Oil	37.5	57.0	-14.0	0.5	-0.8
Inflation rate (percentage)^d					
CPI in the developed economies	1.4	2.3	2.2	1.4	1.7
CPI in the developing economies	6.9	6.1	5.7	5.6	6.0
Short-term interest rates					
United States	5.4	6.5	3.7	1.8	1.6
Japan	0.2	0.2	0.1	0.1	0.0
Euro area	3.0	4.4	4.2	3.3	3.0
Exchange rates (nominal units per US dollar)^e					
Yen per US dollar	113.9	107.8	121.5	125.4	122.5
Euros per US dollar	0.939	1.085	1.118	1.063	1.003

Sources: United Nations, "Project LINK World Economic Outlook: Aggregate Table" (October 2002); IMF, *World Economic Outlook* (Washington, September 2002) and *International Financial Statistics*, vol. LV, No. 11 (November 2002); OECD, *OECD Economic Outlook No. 72* (December 2002); *The Economist*, various issues; and national sources.

^a Preliminary estimate.

^b Forecast.

^c Exports and imports (goods and services).

^d Developed and developing economies ratios weighted at purchasing power parity.

^e Period average.

points more than global output growth. This apparent immunity to the weakening external environment extended over much of the region. The observed variation in subregional growth patterns had more to do with the relative strength of domestic factors in the different subregions than the impact of global developments.

A welcome development was the surge in intraregional trade, which, in turn, was the outcome of both external and internal causes. On the external front, regional and bilateral trading links fuelled trade dynamism in the region in both 2001 and 2002. FDI-induced componentization of production, especially in South-East Asia, served to enhance trade flows within the region. Moreover, the evidence also suggests that intraregional trade has moved beyond the trade in ICT components to embrace a wider range of non-ICT products and services as well. Above all else, the region is home to some of the most dynamic economies in the world and, in this context, there is ample evidence that trade accompanies growth just as much as growth accompanies trade. Notably, imports by Japan, the largest economy in the region, grew by 22 per cent in 2000 and then declined by 8 per cent in 2001. However, China (the second largest economy in the region) increased its imports by 35.8 per cent in 2000 and 8.2 per cent in 2001. The available evidence suggests that these trends were maintained in 2002 although the pace slackened somewhat. On the internal front, fiscal stimulus and monetary easing have supported the growth of domestic demand, though with some attendant risks.

Intraregional trade was an important factor in supporting growth

Prospects for 2003 for both the global economy and the ESCAP region embody a significant level of underlying uncertainty. The uncertainty is compounded by the threat of war in Iraq and the nuclear situation in the Democratic People's Republic of Korea, which could potentially exacerbate the prevailing weaknesses in the global economy.² The rise in oil prices, if it persists, will have a negative impact on the region's terms of trade, among other adverse ripple effects. There are some grounds for optimism that growth in the ESCAP region will remain largely unaffected by the weakening global economy, at least in the short term. Nevertheless, risks on the downside should not be ignored. In particular, global trade and the stimulus provided by expanding exports to the United States of America and Japan have been major factors in output growth for many economies in the region, especially following the 1997-1998 financial and economic crisis. Given this, the principal influences for the ESCAP region are essentially the following:

However, future prospects continue to be uncertain

First, global conditions generally, and the outlook for the United States and Japanese economies in particular, remain a major determinant of the economic performance in the region. In this respect, confidence in

² For one view, see Jeffrey D. Sachs "Economic effects of a war with Iraq", *The Nation*, 3 October 2002.

a robust recovery in the United States and by inference in the global economy in 2003 has been significantly eroded in recent months, as noted earlier. Strong bearish forces have gripped stock markets in the United States and in much of the rest of the world, causing holders of wealth in the form of equities to suffer major losses. Rising house prices have been an offsetting factor helping to preserve household wealth, however.

Second, it is not possible to predict at this stage how these various forces will interact in 2003. The current consensus is that in the United States consumer confidence should remain largely intact in the months ahead, though with some risks on the downside. As such, a revival of corporate capital spending in 2003, the one missing element for a stronger recovery in that country, could provide a new impetus for output growth. Meanwhile, economic growth in the European Union (EU) is expected to pick up in 2003 after easing somewhat in the second half of the previous year. The consensus view as regards Japan is that its economy is likely to expand at a modest pace in 2003.

***ESCAP growth
is likely to be on
target in 2002 and
to accelerate
modestly in 2003***

Third, the balance of probabilities suggests that growth in the ESCAP region could experience a slight acceleration in 2003. Details of forecasts for output growth in the main economies of the region are discussed elsewhere in chapter II. At the same time, however, there are concerns that global and hence regional stock market weakness could persist well into 2003. Foreign investors are major participants in United States stock markets and any disorderly repatriation of liquidated investments from the United States would undermine global financial markets; this would, in turn, generate adverse repercussions on both corporate and consumer confidence virtually across the globe. In another context, persistent weaknesses in United States stock markets would hurt corporate capital spending, ultimately impacting on consumer confidence and spending in the region as well. Finally, in a weakening overall economic environment, risk aversion by investors could intensify, resulting in a sharply reduced availability of finance for non-investment grade borrowers, both corporations and countries.

What are the policy issues that arise for the region from the foregoing analysis? Some of the relevant issues were raised in the *Survey 2002*, but as is self-evident the implied policy trade-offs are constantly evolving and have to be examined afresh. They also vary between subregions and between countries. Their main features as viewed from the current perspective for the region as a whole are highlighted below:

- One, how can economies preserve the momentum of growth, and thus counter the consequent social distress arising from slower growth, in the face of a deteriorating global economic?

- Two, how effective is it to rely on fiscal and monetary stimulus, and what are the pitfalls of doing so, particularly in economies where the burden of public debt is already on the high side, as in South Asia; and what are the implications in economies where inflation is low and declining, as in East Asia?
- Three, what is the likely impact on the ESCAP region of external developments such as the realignment of the dollar exchange rate vis-à-vis other world currencies, and a rapid correction of the long-standing and now growing United States current account imbalance?
- Four, how can the stock markets of individual countries in the region and, indeed elsewhere, sustain the confidence of market participants in the face of intensified bearish trends in the United States and other developed country stock markets?
- Five, what are the areas and scope for national and regional policy initiatives, in both the short and long terms, with regard to the questions raised above? Interwoven with these issues are policy measures needed to mitigate the negative effects on employment and social distress of a slowdown in the ESCAP region.

These and other matters bearing upon global economic trends and their likely impact on the ESCAP region are considered at greater length in chapter II. The relevant policy options for consideration can be summarized here as follows:

- One, it is essential that there be a commitment to preserve growth through domestic demand stimulation but within a framework of sustained macroeconomic stability. In this context, there are major shortcomings in the physical infrastructure of many, if not most, developing ESCAP economies. Investment in infrastructure alongside expenditure on the multifaceted development of human resources will not fully offset the diminution in external demand but will contribute to short-term growth as well as to improving long-term competitiveness.
- Two, the maintenance of macroeconomic prudence depends greatly on having in place a credible approach to manage the risks of policy slippage. A low inflationary environment at present allows somewhat more policy leeway than in the past, but Governments should be alive to the likelihood of overshooting and/or undershooting macroeconomic objectives.

- Three, a volatile external environment and exchange rate instability should not interfere with the progress towards trade liberalization, whether or not this takes place on a multilateral or bilateral basis. In this context, the removal of the more mundane impediments to trade such as time-consuming customs clearance procedures and cumbersome trade-financing mechanisms would serve to stimulate domestic production and the restructuring process as well.
- Four, the highest standards in corporate governance should continue to be promoted and agreement sought within the region on the minimum standards of enforceability in corporate reporting.
- Five, regional cooperation in trade and financial matters should continue to be emphasized while national competitiveness is promoted at the same time.

GLOBAL ECONOMIC DEVELOPMENTS

Developed countries

The global slowdown in 2001 was reflected in a sharp drop in world trade

As reported in the *Survey 2002*, there was an unexpected and sharp slowdown in the developed countries, causing a sharp decline in the growth of world trade volume, and an absolute decline in world trade value, in 2001 compared with 2000. The slowdown was driven by an abrupt deceleration in corporate capital spending in ICT, which was itself caused by rising inventories, declining profits and growing indebtedness in corporations. A tentative turnaround in global output growth led by the United States occurred in the first quarter of 2002 but this was primarily the result of a cyclical inventory turnaround. There was little or no evidence of a revival in corporate capital spending, the main driver of growth in the United States in the second half of the 1990s. In fact, the balance sheets of corporations weakened in 2001-2002 and the worsening gearing ratios restricted access to finance for many, especially the less creditworthy, paradoxically in the face of very low interest rates.

The slowdown was a result of the bursting of the asset price bubble in the United States

The 2001-2002 slowdown has an important feature in that it was not the result, as has usually been the case in the past, of a deliberate policy tightening in the face of rapid growth leading to supply constraints and price pressures. Instead, it was a correction of an asset bubble in the shape of overinflated valuations of ICT-related stocks that had encouraged too many companies with only the rudiments of a business plan to raise capital in the stock markets. Encouraged by extravagant claims on behalf of ICT and the so-called new economy, investors themselves eschewed scepticism and were instrumental in inflating the bubble. Consequently, capital was misallocated on a massive scale and much of it will have to be, and is being, written off. These matters were alluded to in the

Survey 2002, where the risks facing the global economy from the bursting ICT bubble were also analysed. It was stressed then that the overhang of excess capacity and debt could take a long time to work itself out, generating in the process a prolonged period of volatility in the stock markets. This is proving to be the case.

The 2001 slowdown originating in the United States has certain peculiar characteristics that could shed light on the observable events in 2002. First, it was triggered by and concentrated in the ICT sector, for which the ESCAP region is a major supplier of inputs. Following the overinvestment in ICT and ensuing massive write-offs, corporate investment expenditure has, in effect, been suspended until corporate balance sheets are rebuilt. This will involve a painful period of restructuring with many probable corporate bankruptcies.

Second, in an environment of growing optimism, exaggerated profit expectations were also applied as benchmarks for other traditional sectors of the economy. In response, some companies in the United States began to inflate their earnings artificially, sometimes illegally, in contravention of accounting norms and standards. When these accounting malpractices were discovered, a severe crisis of confidence occurred that gravely undermined American stock markets, affecting both new- and old-economy shares alike. Stock markets have consequently been weakened virtually on a worldwide basis, including the ESCAP region, though with one or two notable exceptions.

Third, the stock market bubble and its associated ripple effects occurred in an environment of negligible inflation and low interest rates. All evidence of an impending slowdown in the real economy in 2001 was met with successive reductions in interest rates in the United States, which now stand at 40-year historical lows. Interest rates also tumbled to very low levels in 2001 and 2002 in other developed countries. In Japan interest rates are, and have been, close to zero for some time. The European Central Bank, though constrained by its EU-zone inflation target, has reduced interest rates by more than a full percentage point. In consequence, private consumption has offset the investment and inventory-driven slowdown and prevented a more wide-ranging downturn. In addition, the wealth effect of rising housing equity has counterbalanced the declining value of share ownership in the United States. However, the external imbalance in the United States has worsened in the process, mainly through a surge in imports; this has thus introduced a new source of uncertainty into the global economy. In Japan and the EU, the interface between the real economy and the financial environment is somewhat different because of different institutional arrangements and individual characteristics, in terms of consumer behaviour and preferences. The following paragraphs attempt to shed light on the relevant trends in the main developed countries.

Low interest rates have kept consumption strong

In the United States, as already noted, stock markets remain weak and volatile, despite low interest rates in 2002. In the real economy, for example, there were some tentative signs of a modest upturn in manufacturing activity in the middle of the year and private consumption remained strong generally. However, both lost some buoyancy in the second half of 2002. Low interest rates and a strong housing market have driven private consumption but these sources of consumer confidence cannot continue indefinitely. Investment expenditures by corporations, a better bellwether of medium-term prospects, contracted again in 2002 following the contraction in 2001.

The inflow of capital to the United States is reversing itself

Economic trends in the United States must be viewed against the fact that gross national saving fell again in 2002, the fiscal deficit re-emerged and the current account deficit widened from 4 to 5 per cent of GDP. Weak stock markets have led to a gradual but steady withdrawal from, and repatriation of, dollar-denominated assets held by foreigners. These have been partly reinvested in United States Treasury bonds but a significant portion has gone into European and United Kingdom government and corporate bonds. Bond prices consequently rose substantially, standing nearly 20 per cent higher at end-December 2002 compared with end-December 2001. During 2002 the dollar also depreciated against several currencies, primarily the euro, in an environment of increased volatility; the prices of precious metals also rose during the year.

Economic growth in Japan continues to be hampered by long-standing domestic problems

Interest rates have been reduced close to zero in Japan but demand remains subdued owing to, among other adverse long-term factors, chronically weak consumer confidence and structural impediments such as overcapacity and inadequate reform in the financial sector. The impact of certain short-term factors, such as the yen-dollar exchange rate, is a source of additional concern. To date, the decline in GDP has been caused by both external and domestic forces. In particular, export growth declined in 2001 and 2002 following the collapse in the ICT sector in the United States. Meanwhile, the massive and persistent loss of personal wealth over the last 10-12 years continued to depress consumption, a trend which is most visible in the endemic weakness in the property and stock markets. Business investment has followed an erratic course, rising briefly in response to improved export prospects but falling rapidly in 2001 and 2002. Despite interest rate reductions, savings remain high and the external current account surplus has begun to creep upwards again to 3 per cent of GDP. The latter phenomenon has major implications for the yen exchange rate and in terms of the sustainability of export-driven economic recovery in the near term.

In the EU,³ growth faltered palpably in 2002. Barely perceptible growth in Germany, Italy, Belgium and Austria was accompanied by below-trend growth in France and the United Kingdom of Great Britain and Northern Ireland. Reflecting high levels of unemployment and poor consumer confidence, retail sales showed a marginal decline up to September 2002 in the EU, with the exception of the United Kingdom and some of the smaller economies. Indeed, unemployment stood at 8.4 per cent in the euro zone in October 2002 compared with 8.0 per cent 12 months earlier. Overall, the EU-15 were unable to meet earlier economic expectations for 2002. On the plus side, however, the recent appreciation of the euro and the pound sterling in the face of monetary easing should counter any lingering threat of inflation overshooting official targets, thus giving some room for monetary easing. On the minus side, the overall climate of uncertainty generated by stock market turmoil, concerns about the strength of the United States economy and a rapid appreciation of the euro itself are likely to dampen both non-euro zone export growth and capital investment in 2002. Moreover, in the face of persistent high unemployment, consumer demand is unlikely to provide a major stimulus to economic activity in the short term. Only in Denmark, Sweden and the United Kingdom (the three economies outside the euro zone) is consumer spending showing a degree of buoyancy. The United Kingdom economy is very similar in this respect to that of the United States with rather low business confidence being offset in large measure by strong consumer spending on the back of a strong property market; both of the latter appeared to be losing strength towards the end of 2002, however.

*Growth performance
in the European
Union has been
flaccid*

Looking ahead over the next four quarters, the evidence available thus far seems to be evenly poised between higher or flat GDP growth in the developed countries. According to the United States Federal Reserve Board, recovery in the United States is likely to remain sluggish and probabilities, by and large, are weighted towards continuing weakness. Indeed, forecasts for 2003 have been scaled down for both the United States and the EU owing to the absence of a visible turnaround in business sentiment and, on the debit side, a greater likelihood of negative influences adversely affecting consumer spending, such as stock market turmoil or a weaker housing market. For Japan, however, there is consensus concerning positive economic growth in the country in 2003. Thus, the major developed countries are unlikely to have a noticeable positive influence on the global economy in the short term. Again, the

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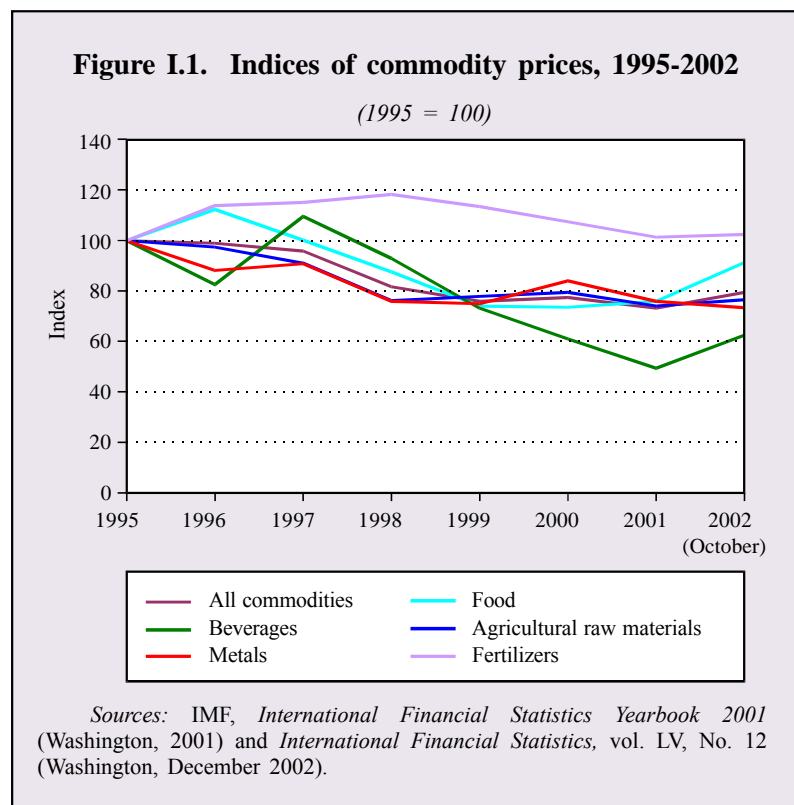
³ An event worthy of note from a long-term perspective was the announcement by the European Commission on 8 October 2002 that negotiations for membership in the EU had been concluded with Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. These countries should join the EU by June 2004 and will bring its membership to 25.

prospects for the developed countries must be viewed against an environment characterized by low and declining inflation and low interest rates, but also by some uncertainty as regards the fiscal situation. Specifically, the EU is constrained by its Growth and Stability Pact while Japan's public debt is already uncomfortably high.

Developing countries

Weak commodity prices worsened the impact of the global slowdown on developing countries in 2001

The global economic slowdown in 2001 contributed to lower growth in output and further weakness in commodity prices, and implied terms of trade losses, of the developing countries. The all-items commodity index of *The Economist* had declined by nearly 15 per cent in the 12 months to December 2001. It has since risen somewhat but at 75.2 index points it stands almost 27 per cent below its 1995 level (see figure I.1). The loss of the external stimulus could only be partially compensated for by growth in domestic demand in 2001. In particular, there were severe output declines in economies with high export-to-GDP ratios generally or with a large preponderance of exports to the United States. Although this assessment was generally true for the region, there were important exceptions as well. Notably, China and India, and many subregional economies in North and Central Asia, were largely immune to the slowdown in 2001.



In early 2002, however, indicators of activity in most developing countries strengthened in response partly to domestic stimulus measures (including the easing of fiscal and monetary policies), and partly to the apparent recovery of export demand, especially from the United States. Indeed, the economic turnaround in the United States in late 2001 led to significant upward revisions of growth forecasts for developing economies with large high-tech export sectors. Asia's slowdown in 2001 had been largely driven by the sharp decline in world demand for high-tech exports, which account for about 40 per cent of total manufactured exports from the region. A revival of

demand in the developed economies generally and for high-tech exports in particular was expected to provide additional strength to the region's output growth but also to lead to a modest firming of commodity prices. The latest indications are that, for now, the external stimulus from the United States, Japan and the EU is likely to wane in the months ahead. All things considered, growth will need to be sustained primarily by domestic measures or through intraregional trade well into 2003.

Domestic demand and an initial export recovery were behind strengthened performance in developing countries

West Asia's economic fortunes in 2003 primarily rest on external energy demand and prices, the manifest intensity of the Israel-Palestine conflict and, for now, the danger of military action against Iraq. The most probable consequence of the latter two factors is for energy prices to rise. Higher energy prices might benefit the energy-producing economies in the region in the short term but will almost certainly have a negative impact on global recovery. The conflicts in the region have also sharply restricted investment activity and tourism in and around the countries immediately involved. Thus, any increase in their intensity would automatically depress economic activity in the entire region. On balance, therefore, it is unlikely that West Asia will be able to match its 2002 performance in 2003.

Meanwhile, the current economic situation in Latin America is dominated by events in Argentina and their fallout on the rest of the continent. Uruguay and Brazil have already fallen victim to the contagion from Argentina and both economies have needed to have recourse to external support in order to pre-empt a serious financial collapse. Brazil, for example, had to arrange a massive \$30 billion standby facility with IMF in August 2002. The uncertain prospects for the United States economy, political tension in Venezuela and ongoing financial market turmoil suggest that economic performance is likely to deteriorate in the short run with low or even negative output growth in all the main economies in the region, with the possible exceptions of Mexico and Peru.

Economic performance in Africa held up relatively well in 2001 compared with other parts of the developing world, despite the global slowdown. Until early 2002, performance was expected to strengthen further, particularly among oil-producing countries, in the year in line with a stronger external environment. However, the short-term outlook became less positive in the second half of 2002 in the face of increasing uncertainty in the global economy. The interaction between weak commodity prices and output, the limited ability of most African Governments to take countervailing measures on the domestic front (against a deteriorating external environment) and the chronic nature of internal conflicts in many countries are key influences bearing on economic performance over much of the African continent. These considerations suggest little or no improvement or, more likely, even a slight deterioration in the economic outlook for 2003 over the 2002 performance.

The outlook for African economies worsened during the course of 2002

Trade and financial market developments

An important element in the global slowdown in 2001 was the role played by international trade and financial flows in transmitting changes in economic activity within the world economy. The most notable feature in international trade is the coexistence of strong volume growth and weaknesses in prices almost across the board, with the exception of oil (see table I.2).

Table I.2. World trade and prices,^a 1991-2002

	<i>Annual percentage changes</i>				
	<i>1991-2000</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002^b</i>
Trade volumes	7.3	5.6	12.8	-0.7	2.6
Trade prices (United States dollars)	-0.8	-2.0	0.3	-3.5	-1.5
Manufactures	-0.9	-1.9	-5.1	-2.4	-0.5
Oil	2.1	37.5	57.0	-14.0	-5.3
Other commodities	-0.9	-7.0	1.8	-5.5	-0.1
Terms of trade					
Developed economies ^c	0.2	0.1	-2.5	0.4	0.6
Developing economies	0.0	4.5	7.4	-3.0	-1.6

Source: IMF, *World Economic Outlook*, cited in Bank for International Settlements, *72nd Annual Report: 1 April 2001-March 2002* (Basel, July 2002).

^a Goods only.
^b IMF forecast.
^c Advanced industrial economies plus newly industrializing Asian economies (Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China).

Capital flows to the developing countries and to developing Asia are given in table I.3. They rose strongly up to 1996 but have been fluctuating at a considerably lower level since 1997. For example, in 2002 developing Asia was expected to receive only a quarter of the inward flows of private capital in 1996. No early revival of capital inflows is indicated from the available information.

International trade in 2003 is likely to be little changed from the previous year

As explained in the *Survey 2002*, trade flows have absorbed an increased proportion of output in today's economies. Moreover, vertical integration in production means that individual sectors are likely to be influenced by factors specific only to those sectors, and not necessarily by developments in the wider economies of the countries where the pertinent production facilities are located. However, international trade flows are not totally insulated from country-specific macroeconomic conditions. World trade growth declined sharply in 2001 in tandem with the global

Table I.3. Net capital flows^a to developing countries and to developing Asia, 1995-2003*(Billions of US dollars)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total: all developing countries ^b									
Net private capital flows ^c	211.5	228.8	102.2	62.1	84.8	29.4	24.9	62.4	64.9
Net private direct investment	98.2	114.4	141.7	153.6	164.0	158.0	172.1	151.3	160.9
Net private portfolio investment	42.7	90.2	46.7	-0.1	34.3	-4.3	-42.6	-3.0	-4.0
Other net private capital flows	70.5	24.1	-86.2	-91.5	-113.4	-124.3	-104.6	-85.9	-91.9
Net official flows	26.5	-2.3	68.3	69.9	12.2	0.2	15.4	20.6	18.2
Changes in reserves ^d	-118.2	-108.1	-68.8	-48.2	-87.9	-113.2	-119.9	-146.6	-129.7
Developing Asia ^e									
Net private capital flows ^c	96.9	122.1	7.1	-45.9	6.8	-12.9	16.7	31.6	7.9
Net private direct investment	52.6	53.4	56.8	59.7	61.2	54.2	47.1	58.7	59.0
Net private portfolio investment	22.7	32.8	7.3	-17.9	14.4	4.3	-13.5	0.7	-9.7
Other net private capital flows	21.6	35.9	-56.9	-87.7	-68.8	-71.4	-16.8	-27.8	-41.3
Net official flows	4.5	-12.4	16.9	26.1	4.4	5.1	-5.7	-1.4	3.3
Changes in reserves ^d	-43.3	-46.9	-15.4	-67.4	-78.9	-48.7	-84.7	-97.4	-67.8

Source: IMF, *World Economic Outlook* (Washington, September 2002).

^a Net capital flows comprise net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private borrowing.

^b Excluding Hong Kong, China.

^c Because of data limitations, "Other net private capital flows" may include some official flows.

^d A minus sign indicates an increase.

^e Including Republic of Korea, Singapore and Taiwan Province of China.

slowdown and the best estimates for 2002 suggested an increase of only 2.1 per cent in volume terms; but this was likely to be offset by a decline of 1.5 per cent in prices. In value terms, world trade actually declined by 3.5 per cent in 2001 as a result of falling prices of internationally traded commodities and manufactures. Given the sluggish nature of the global economy and little upward pressure on prices, 2003 could well be a repeat of 2002, with an increase in volume offset by flat or declining prices.

A phenomenon observed in the 1990s was the rise in gross private capital flows from developed to developing countries as interest rates fell in the former. The evidence since 1999 suggests that this phenomenon has come to an end. For one thing, interest rates in many developing countries have also fallen to low levels owing to poor loan demand and monetary easing; thus they cannot fully compensate for increased risk aversion. For another, low interest rates have fuelled higher loan demand in some of the capital-exporting economies, particularly on the part of households.

*Low interest rates
in developed
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developing
countries*

Financial structures differ significantly across the world. Capital markets, as a source of investment finance, are typically stronger in the United States than in either Japan or the EU, where direct intermediation by banks is still common. Likewise, the housing market and housing mortgage finance are more important in household balance sheets in the United States than in Japan or the EU. This has implications for the wealth effect on consumer confidence. In fact, lower interest rates have diverted funds from the developing countries to consumers in the United States, partially financing the worsening current account deficit of the United States economy.

Profit margins of manufacturing companies have been eroded in the United States

Another feature of the global slowdown in 2001 and the fitful recovery in 2002 was the marked difference in performance between the domestic and externally oriented sectors in the developed countries. Manufacturing output growth has been weak in the United States while residential and public construction activity has remained strong. This reflects the differentiated responses of the trading and non-trading sectors to recent developments. Most notably in both 2001 and 2002, the profit margins of United States businesses in manufacturing came under increasing pressure. This phenomenon, visible in varying degrees in other developed economies as well, has been compounded by a build-up of excess capacity in several manufacturing activities. Firms have consequently lost their pricing power to a significant extent, a factor that has contributed to the low rates of inflation, and indeed a marginal degree of deflation, in the United States and in many other parts of the world.

Lenders have become more discriminating in their choice of borrowers

Low corporate profitability has, in turn, led to a marked shift in financing patterns both within and across different economies. Investment-grade borrowers have benefited from the easing of monetary conditions while those with non-investment status have experienced a widening of spreads, countering the effects of lower interest rates. In addition, lenders have not been averse to shifting finance from corporate and sovereign borrowers to the personal sector for housing mortgages and personal consumption. This trend has indirectly supported strong consumer spending in the United States and offset considerably the impact of lower corporate investment spending and rising unemployment. Such effects are less strong in Japan and the EU but they are not entirely absent either.

In the past, interest rate differentials had a major influence on the volume of capital flows, with developing countries typically receiving a higher volume of private capital flows when interest rates were low in the developed countries. In 2001 and 2002, however, declining interest rates coincided with a weakened global economy and higher investor risk aversion; the latter was further compounded by potentially disruptive financial crises in Turkey, Argentina and Brazil. Thus, low interest rates in developed countries did not lead to an increase in private capital flows to developing countries. In several Asian economies, however, cross-border

lending turned positive in 2001-2002 for the first time since mid-1997. FDI flows to developing countries have remained steady in general but, as in previous years, they continue to be directed to a small number of countries, with China being the principal recipient of these flows.

By and large, the overall capital flows to developing countries displayed a measure of resilience in 2001-2002. However, sentiment in international financial markets is highly sensitive to countries with high debt-to-GDP ratios, high debt-service requirements or a large element of short-term debt relative to reserves. The adoption of credible macro-economic policies can mitigate the negative effects of, and external perceptions associated with, high indebtedness. This phenomenon is most visible in the EU candidate countries, which are perceived by investors as having policy frameworks or having to adopt a policy stance defined by the needs of EU entry. As such, they are judged less risky than other countries with similar external debt profiles.

*Credible
macroeconomic
policies can
improve investor
perceptions*

The overall global economic and financial environment which prevailed in 2002 does not suggest that private capital flows to developing countries are likely to increase noticeably in the near future. Banks will remain cautious given that asset quality tends to deteriorate in an economic slowdown. Other investors are likely to be worried by the risks building up in Latin America. However, FDI flows are expected to remain broadly stable, and the relative immunity of Asian economies to a renewed slowdown in the United States could even lead to higher FDI flows to these countries in 2003 and beyond.

ODA increased in 2001 but this was mainly on account of large disbursements by the IMF-led programmes for Argentina and Turkey. A similar phenomenon will occur in 2002 with IMF assistance recently announced for Brazil. In parallel, however, there is now increased awareness among donors of the importance of ODA for long-term development needs and the fight against poverty. This is a reflection of the Monterrey Consensus adopted at the International Conference on Financing for Development, held in March 2002. Nevertheless, given the overall economic and fiscal situation in the donor countries, this is unlikely to lead to significantly higher disbursements of ODA in 2002 or 2003, except for the special needs of Afghanistan and other exceptional cases.

*Little real increase
is likely in ODA*

Implications for the ESCAP region

The global economic slowdown in 2001 reduced the GDP growth of developing members of ESCAP from 7 per cent in 2000 to 3 per cent in 2001. The economic rebound in early 2002, combined with easier domestic policies, was expected to lead to a higher pace of growth than the 4.2 per cent rate that had been forecast for the ESCAP developing countries. In the event, however, the recovery lost steam in the United

*Sustaining growth
in the ESCAP
region will depend
on stimulating
domestic demand*

States while growth failed to accelerate appreciably in either the EU or Japan. Indeed, it is now commonly agreed that the global economy is unlikely to show strong growth until well into 2003 or possibly later. In other words, the growth stimulus from a rebound in world trade and hence from net exports is likely to be moderate among the ESCAP developing countries over the next 12-18 months. Sustaining growth in 2003 at the rate achieved in 2002, around 5 per cent, will thus depend primarily on stimulating domestic demand. This could be sustained and, indeed, enhanced by higher intraregional trade flows.

An outbreak of hostilities in the Middle East would undermine forecasts for 2003

The evidence up to the third quarter of 2002 suggested that growth as forecast earlier in the year was broadly on track in much of the region. Such a performance, moreover, provides a base for the momentum to be sustained in the months ahead. However, this momentum is conditioned by the absence of: (a) major hostilities in Iraq, (b) a sustained increase in oil prices or significant disruptions in energy markets, (c) new or extended periods of turmoil in financial markets and (d) significant exchange rate realignments.

As mentioned elsewhere, the ESCAP developing region has managed to grow at a reasonable pace thus far through a combination of supportive domestic policies and greater intraregional trade. As far as the former are concerned, there are, of course, limits beyond which it may be difficult or less than prudent to stimulate activity further through public spending programmes or through monetary easing. One of the lessons emanating from Japan in the 1990s is that monetary easing in a low inflationary environment raises its own peculiar set of issues.

As regards trade, intraregional flows have expanded rapidly among countries of the ESCAP region. To what extent this impetus can be sustained remains a subject for debate, however. To some, intraregional trade is likely to slow soon because the demand for investment goods in the region, though expanding, remains essentially weak, a condition reflecting the overhang of excess manufacturing capacity in several economies. At the same time, domestic consumption demand, while currently buoyant, is expected to taper off in the absence of sustained increases in real income in the region. Indeed, much of such consumption is debt-financed and could thus pose systemic risks in some countries.

The weakness of the United States dollar may not be entirely negative for the region

A further influence on the region's export and growth performance over the next 12-18 months arises from the recent weakness of the dollar exchange rate and the strengthening of several regional currencies vis-à-vis the dollar. In theory, and on the face of it, this phenomenon could have a negative impact on these countries' competitiveness. In practice, the negative impact could be relatively small, however. The regional currencies may have strengthened against the dollar but they still remain cheaper on a trade-weighted basis than, say, before the 1997-1998 crisis.

In addition, the weaker dollar and lower interest rates serve to speed up the restructuring of dollar-denominated debt, thus freeing up resources in cash flow terms that would otherwise have been used in debt servicing. It is not clear, however, how competitive advantage has changed among economies whose exchange rates are fixed to the dollar and among those whose exchange rates are not fixed but have, nevertheless, experienced a degree of exchange rate appreciation.

Policy issues and challenges

The developing countries of the region performed well in 2002 and could experience a modest improvement in 2003. Nevertheless, at these rates of growth, they would still be a good two percentage points or more below the rates achieved in 1996. The implied shortfall in output translates into lower levels of job creation and, through reduced tax yields, new pressures on government budgets. The immediate policy challenge, therefore, is to regain and sustain the pre-1997 momentum of growth in the region as a whole.

A point to emphasize is that sustaining the momentum of growth is necessary not merely for its own sake but to provide Governments with the resources to address emerging social issues and problems and alleviate poverty and social distress progressively through the higher levels of employment made possible by durable growth. But economic growth is also needed to help in resolving issues pertaining to corporate and financial sector reform as enunciated in the *Survey 2002*. As discussed previously, significant progress has been made in dealing with these matters over the past five years. However, more decisive action would almost certainly be facilitated by an environment in which businesses, Governments and the public could all discern improvements taking place and reform efforts are not perceived or cease to be construed as an ongoing form of penance. It has to be recognized, too, that reforms are an essential, continuing process that needs to be securely anchored in a realistic framework of development and poverty reduction strategies in developing countries.

On the domestic front, given the higher or rising levels of public debt in many countries, a fundamental question is the degree to which fiscal stimulus can be maintained over the medium term without running the risk of getting caught in the debt trap, a situation where debt starts to grow faster than the means to service it. As discussed in the *Survey 2002*, the issue of fiscal sustainability arises in all economies, including those where the budget deficits have historically existed for some time and where public debt, as a ratio of GDP, has risen to a high level. The same consideration of fiscal sustainability applies to countries where rising public debt is a relatively new phenomenon.

Developing members of ESCAP have still to regain their pre-crisis momentum

Higher growth is needed to continue with poverty alleviation in the region

***Lower interest rates
have not always led
to credit growth***

Monetary policy is also facing difficult choices in several economies.⁴ Facilitated by lower interest rates in the developed countries and lower inflation locally, most economies in the region (except one or two) were able to keep interest rates low in 2002. However, lower interest rates have not led to higher credit growth, thus far at any rate. There is a view that despite low interest rates new capital expenditure is unlikely to be undertaken, given the excess capacity still in existence, and monetary easing could instead lead to a build-up of consumer debt in the months ahead.

Thus, monetary easing is as circumscribed in the real world as is fiscal policy, and its stimulating effects could be greatly nullified by a deflationary psychology. The monetary authorities have to ensure that the current phase of low and declining inflation is not transformed into a prolonged deflationary phase. It is also necessary to be aware of the forces causing downward pressure on prices and to fashion an appropriate response to the phenomenon.

On the external front, the size of the current account deficit of the United States along with financial market turmoil poses a major challenge not just for policy makers in the United States but in all open developing economies of the world. Present estimates suggest that the United States current account deficit is likely to increase from 4.7 per cent of GDP in 2002 to 5.0 per cent in 2003.

***Correcting the
United States trade
imbalance poses
dangers for the
global economy***

It has been argued for some time that the external imbalance in the United States is unsustainable. The imbalance rose from 1.5 per cent of GDP in 1995, a level at which it had stabilized in the previous two decades, to 4.7 per cent in 2002. Although alarmist talk regarding this deficit has tended to be consistently belied over the years, it is nevertheless true that such a sizeable shortfall cannot continue indefinitely. There would be a threshold above which foreigners would become unwilling to hold United States assets. Some observers argue that the subsequent rebalancing of investors' portfolios away from United States assets could involve a huge readjustment of the dollar exchange rate. Clearly, this might not happen suddenly but the rebalancing process would still pose a considerable challenge for participants in world financial markets and the regional economies as well.

***ESCAP region
to maintain
commitment to
trade liberalization***

By and large, the first requirement is for countries in the region not to add to the uncertainty and possible dislocation in international transactions by taking restrictive measures in the areas of trade and

⁴ Falling inflation automatically makes monetary conditions tighter even without an increase in interest rates. See Centre for European Policy Studies, *Fiscal and Monetary Policy for a Low-Speed Europe*, 4th Macroeconomic Policy Report of the CEPS Macroeconomic Policy Group, 2002.

financial flows. Regardless of actions being taken by other countries, countries in the ESCAP region should maintain their commitment to the agenda of liberalized trade and financial flows.

In this context, significant momentum has built up within the region independently of WTO through FTAs in the last two to three years. The ASEAN-China commitment to move to a free trade agreement in 10 years is one prominent example. FTAs between Singapore and Australia, Japan, New Zealand and the United States, and between Australia and the United States, for which negotiations have just commenced, are others. Singapore and the Republic of Korea are due to start negotiations later in 2003 for an FTA. From the perspective of the least developed countries, the Japanese Government announced in December 2002 that it would extend the generalized system of preferences to least developed countries, giving them duty-free and quota-free access to Japan starting in fiscal year 2003.

Financial market instability poses rather more complex issues. As at end-December 2002, the trade-weighted exchange rate of the dollar had depreciated by about 10 per cent and stock markets in the United States had fallen by about a fifth. The latter trend precipitated sell-offs virtually across the world, although markets in the ESCAP region have escaped some of the downside pressures. Forecasts are notoriously unreliable where stock markets are concerned and speculating about the next 6-12 months is hazardous in the extreme. However, if the decline in stock markets is prolonged, it could feed back negatively onto the global and regional economies.

With greater globalization, the world's stock markets have become much more correlated regardless of an individual country's fundamentals; and it would be futile to seek to shield individual markets from instability occurring in the bigger, more international markets. Nevertheless, countries in the region could redouble their efforts at enhancing standards of corporate governance and of transparency in corporate accounts. They should also take bold action concerning incidents of corporate malfeasance should they come to light in the future. Greater cooperation in maintaining exchange rate stability is worth exploring but the processes involved raise complex issues. Implementation would appear to be some years away.

As countries of the region gear up to tackle their short-term challenges, they must not lose sight of the need to maintain and, indeed, enhance their competitiveness in the medium term. Competitiveness has both macro and micro aspects and economic and non-economic determinants. Strong public and private contributions are needed to build and sustain the competitive edge.

Falling stock markets partly reflect a loss of investor confidence

Countries in the region need to continue work on enhancing competitiveness

***Cooperative action
to tackle common
problems of the
world economy is
the way forward***

Finally, all countries, whether developed or developing, should strive to tackle the common problems of the world economy in a new spirit of partnership and remain engaged to that end. This is a theme which, as has been suggested in various forums, including in particular the International Conference on Financing for Development, held at Monterrey, Mexico, in March 2002. At that meeting, Governments of developed and developing countries agreed that through ODA the benefits of globalization could reach people living in poverty in many low-income countries. To that end, partnerships between ODA donors and recipient countries must be enhanced and donor assistance structured around the recipient country's own strategy for development. Such partnerships could be extended to other areas, such as containing financial market volatility.

The World Summit on Sustainable Development, held at Johannesburg, South Africa, in August-September 2002, provides another good example of greater cooperation between the developed and developing countries. While falling short of the expectations of many, the World Summit nevertheless signified that developed and developing countries are dependent upon each other to achieve durable progress in solving the world's myriad economic, social and environmental problems. While the Summit has enhanced awareness of environmental issues, it remains true that without much greater cooperation between countries even the limited agreements reached at Johannesburg will be difficult to implement.

However, cooperation does not require that large events like the Johannesburg Summit be staged. Existing international and regional bodies provide forums and vehicles for cooperative endeavours to be identified and implemented. For their part, developed countries should be prepared to take more robust action in the areas of international financial flows, trade, debts and global governance. Developing countries, for their part, should make their domestic policies and institutional arrangements more development-friendly, a prerequisite to improving the utilization of ODA, reducing poverty and tackling deficiencies in the pursuit of these aims on the basis of durable "ownership". Effective ownership and participation require good governance at all levels of society based on realism and honesty, especially in matters concerning previous policy shortcomings in these areas.

As reported in the *Survey 2002*, through the Doha Development Agenda, WTO members agreed to launch a new round of trade negotiations. It is critically important for the global economy that the commitments made at Doha be honoured and that no slippage occur in the time frame for the completion of negotiations in different areas.

In this connection, it needs to be reiterated that the issues outlined by the Secretary-General in his report "Road a map towards the implementation of the United Nations Millennium Declaration" are both urgent

and relevant to Doha. The issues are, inter alia, the need for developed nations to comply fully with commitments made under the Uruguay Round for access to their markets for the products of the developing countries in agriculture, textiles and clothing and to ensure that the next round of trade negotiations is truly a development round. It is vital, hence, that the Fifth WTO Ministerial Conference, which is to be held at Cancún, Mexico, in September 2003 and is to take stock of the post-Doha issues and concerns of the developing countries and the progress in negotiations, not get bogged down in discussions over procedural matters and deal constructively with substantive issues that lie at the heart of the Doha Development Agenda.

The overall conclusion for the ESCAP region thus consists of a reiteration of suggestions made in previous issues of the *Survey* to support sustainable growth by members over the next 12-18 months and beyond: (a) to speed up structural reforms to make their economies more competitive; (b) to prepare for and manage globalization better by a deeper understanding of the interactions between international and national policies and financial markets; (c) to continue to deepen financial markets and reduce dependence on any one source of finance for development; (d) to strengthen the formulation and implementation of policies, especially prudential macro policies; (e) to enhance the quality of governance in both the public and private sectors; and additionally (f) to minimize conflicts of interest in the field of governance.⁵

It is a truism that the course of events over the next 12 months or so will be conditioned not only by policies but also by unforeseen events. Experience, however, suggests that flexible public policies, based upon a credible and realistic framework of expectations, cannot only insulate economies considerably from adverse developments, but also cushion the impact on economic activities of unforeseen events when they happen. Not all adverse developments can be fully countered by policies and resource constraints remain a problem to be resolved by all economies, developed and developing, but, as has been seen, good policies can contribute to mitigating the adverse effects of disasters, natural or man-made, and to bringing about a quicker recovery in their aftermath. In hindsight, the ESCAP region has displayed considerable resilience in dealing with the 1997-1998 crisis and in meeting the challenges it posed in both the economic and social fields; this applies to the countries directly affected by the crisis as well as to others. The 2001-2002 slowdown provided another opportunity to fashion new policy responses to promote growth in 2003 and, for the region as a whole, to resume its pre-1997 pace of economic and social development.

*The policy agenda
for the ESCAP
region is little
changed from the
previous year*

⁵ H. Kharas, "Staying on guard", *Bangkok Post*, 5 July 2002.

