



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

OVERVIEW

The first few months of 2002 were characterized by a sense of optimism as most observers felt that the world economy and much of the ESCAP region, despite experiencing a series of major shocks, had nevertheless displayed remarkable resilience. In the United States of America, the world's largest economy, following a brief downturn in the last quarter of 2001, growth had resumed in the first quarter of 2002 at a seemingly brisk pace aided by supportive monetary policies. Although the European Union (EU) failed to match the United States in dynamism, Japanese GDP grew marginally in this period. There was a growing consensus that strong growth in the United States would translate itself into faster world trade growth as the year progressed, with beneficial effects for the developing countries generally and, more specifically, growth in the ESCAP region. Overall, the signs until well into the second quarter of 2002 suggested that the global economy had recovered smartly after one of the shortest and shallowest downturns in recent economic history.

Within a matter of weeks, towards the middle of the year, optimism was largely dissipated. The succession of major corporate accounting frauds and bankruptcies in the United States, together with a lack of evidence that corporate earnings were recovering in line with the apparent strength of the United States economy, severely undermined confidence in United States stock markets and, indeed, in stock markets across the globe. Closer scrutiny of United States first quarter data revealed that the numbers underlying the seemingly strong pace of GDP growth reflected an inventory rebound; there was little evidence of a significant upturn in hitherto-depressed corporate capital expenditures. These misgivings turned to alarm when it became known that the United States economy had actually grown at a listless 1.3 per cent annual rate in the second quarter of 2002 and first quarter growth was revised downwards. More seriously, revisions to 2001 data showed that, contrary to what had been announced earlier, the United States economy had actually contracted for three quarters in 2001 before recovering in the fourth. Overall growth for 2001 was consequently revised from 1.2 per cent to a mere 0.3 per cent for the United States, its worst performance since 1991.

The optimism in early 2002 had dissipated by mid-year

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The result was that business confidence plummeted and by September 2002 confidence in a robust global recovery in 2002 had all but evaporated. Forecasts for the global economy based on a combination of official estimates are given in table 1.

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

(Percentage)

	1999	2000	2001 ^a	2002 ^b	2003 ^b
Economic growth (percentage change of GDP)					
World	2.9	3.9	1.4	1.7	2.9
Developed economies	2.7	3.8	0.8	1.7	2.5
Japan	0.8	2.4	-0.3	-0.5	1.0
United States of America	4.2	3.8	0.3	2.5	3.0
European Union	2.4	3.5	1.6	0.8	1.8
Developing economies	3.5	5.7	3.9	4.2	5.2
Developing countries in the ESCAP region	6.3	7.0	3.1	4.9	5.7
Growth in volume of trade (percentage)^c					
World	5.3	12.6	-0.1	2.1	6.1
Developed economies	5.2	12.0	-1.1	1.2	5.4
Export	7.8	11.8	-1.3	1.7	6.2
Import	4.3	15.0	2.6	3.2	6.5
Developing economies	1.3	15.9	1.6	3.8	7.1
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
<p>Sources: United Nations, <i>Global Economic Outlook</i> (October 2002); IMF, <i>World Economic Outlook, September 2002: Trade and Finance</i> (Washington, 2002); and <i>The Economist</i> (London, 14 September 2002).</p> <p>^a Estimate.</p> <p>^b Forecast.</p> <p>^c Exports and imports (goods and services).</p> <p>^d Developed and developing economies ratios weighted at purchasing power parity.</p>					

The ESCAP region was apparently immune to the worsening external environment

In the ESCAP region the effects of these changes have primarily manifested themselves in swings in overall business sentiment. There has been a weakening of stock markets that had risen strongly in early 2002 in anticipation of a strong pick-up of the global economy later in the year. Notwithstanding growing doubts about the strength of the global recovery and weaker business confidence, expectations for overall GDP growth in the region have, however, remained surprisingly upbeat. Indeed, the latest forecast by the United Nations *World Economic and Social Survey* identifies Asia and the Pacific as the fastest-growing region in the world in 2002 with ESCAP developing economies likely to show output growth of 3.2 percentage points more than the growth in global output. This apparent immunity to the weakening external environment extends over much of the region. There is naturally some variation in subregional growth patterns but this has more to do with the relative strength of domestic factors in the different subregions than the impact of global developments. In East and North-East Asia, GDP growth in China and the Republic of Korea up to the middle of 2002 has been

in excess of forecasts made at the beginning of the year. In addition, the economies of Hong Kong, China, and Taiwan Province of China, despite showing negative or only marginal output growth in the first quarter of 2002, are nevertheless expected to exceed their 2001 performance comfortably. In South-East Asia, Malaysia, the Philippines and Thailand are expected to match forecasts made for 2002 at the beginning of the year, while Indonesia and Singapore are expected to fall marginally short, the latter after having grown strongly in the first half of the year. In the other subregions, quarterly GDP data are available only for India, the Russian Federation and Turkey. Based on performance up to the middle of 2002, GDP growth in 2002 is expected to fall very slightly below expectations in India and to exceed forecasts in the Russian Federation and Turkey. It is worth noting that in the case of the latter two forecasts had been pitched on the low side following the lacklustre performance of those economies in 2001. In the developed countries of the region, Japan's economy is anticipated to contract at a slower pace than expected at the beginning of the year while Australia and New Zealand are broadly expected to match forecasts made at the beginning of the year. Overall, at the time of writing, it seems that the ESCAP region should escape any noticeable deterioration in performance compared with forecasts made at the beginning of the year.

This welcome development is the outcome of both external and internal causes. On the external front, regional and bilateral trading links have fuelled trade dynamism in the region in 2001 and 2002. FDI-induced componentization of production, especially in South-East Asia, has given rise to enhanced trade flows within the region. Above all else, the region is home to some of the most dynamic economies in the world. In the latter context, there is ample evidence that trade accompanies growth just as much as growth accompanies trade. It is interesting to note, for instance, that whereas imports by Japan, the largest economy in the region, grew by 22 per cent in 2000 and then declined by 5 per cent in 2001, China, the second largest economy in the region, increased its imports by 40 per cent in 2000 and 14 per cent in 2001. The available evidence suggests that these trends are being maintained in 2002 although the pace has slackened somewhat. 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. 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*

While it would be premature to draw any longer-term conclusions from first-half performance in the ESCAP region, it seems that many economies of the region have found new sources of strength to stimulate output growth in 2002. Following the export-led recovery in 1999 and 2000 and the sharp slowdown suffered in 2001, occasioned by the collapse in ICT demand in the United States, several economies in the region have been boosting growth with a significant degree of fiscal and monetary stimulation. Some economies, for example in South Asia, have traditionally been less export-driven and more domestic demand-driven, but in the two largest economies of the region, China and India, domestic investment expenditures and consumption demand, though dampened by factors such as the weather and

floods, have propelled output growth side by side with the stimulus provided by net exports. In both 2001 and 2002 a new and not entirely unexpected source of strength in the region is the part played by the increase in intraregional trade arrangements between the developing countries of the region.

However, future prospects continue to be uncertain

Against this somewhat ambivalent background, prospects for 2002 and 2003 for both the global economy and the ESCAP region remain positive though with some underlying uncertainty. This uncertainty is compounded by the threat of war in Iraq, which could potentially exacerbate the weaknesses in the global economy.² One effect that is already making itself felt is the rise in oil prices, which will negatively influence the terms of trade for the region. While there are some grounds for optimism as far as the ESCAP region is concerned that growth will remain largely unaffected by the weakening global economy in the short term at least, risks on the downside should not be ignored. It has to be remembered that global trade and the stimulus provided by expanding exports to the United States and Japan have been major factors in output growth for many economies in the region, especially following the 1997 crisis. Given this, the principal influences for the ESCAP region are essentially the following:

First, global conditions generally and the outlook for the United States and Japanese economies in particular remain critical influences on economic performance in the region. In this respect, as stated above, confidence in a robust recovery in the United States and by inference in the global economy in 2002 has been significantly eroded in recent months. Strong bearish forces have gripped stock markets in the United States and in much of the rest of the world and holders of wealth in the form of equities have suffered major losses, although rising house prices have been an offsetting factor helping to preserve household wealth.

Second, at this stage it is not possible to predict how these various forces are likely to make themselves felt in 2002 and 2003. The current consensus is that in the United States consumer confidence should remain largely intact in the months ahead, underpinned by a buoyant housing market. As such, a revival of corporate capital spending in 2003, the one missing element in a stronger recovery in that country, could provide a new impetus for output growth. Elsewhere, in the EU, after easing slightly in the second half of 2002 economic growth is expected to pick up in 2003. Even in the case of Japan, the consensus view is that it is likely to experience a less severe output contraction in 2002 than was forecast earlier in the year, followed by a slow but positive recovery in 2003.

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

Third, for the ESCAP region these trends and the balance of probabilities implicit in them suggest that growth should be in accordance with forecasts for 2002 followed by a further, though, in all likelihood, modest acceleration in 2003. Details of forecasts for output growth in 2002 and 2003 in the main economies of the region are discussed elsewhere in the chapter. At the same time there are concerns that global and hence

² For one view, see Sachs (2002).

regional stock market weakness could persist for a considerable time, well into 2003, not only aborting a revival in corporate capital spending but ultimately impacting on consumer confidence and spending in the region as well. Moreover, persistent weakness in United States stock markets, in which foreign investors are major participants, could lead to a disorderly repatriation of liquidated investments from the United States, undermining global financial markets. This could, in turn, generate adverse repercussions on both corporate and consumer confidence virtually across the globe. 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? The relevant issues were raised in the *Bulletin 2001/02* 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. However, their main features as viewed from the current perspective are highlighted below.

*Policy issues
the region must
contend with*

- **One**, how can economies preserve the momentum of growth and thus counter the social distress that slower growth inevitably brings in the face of a global economic environment that is weakening once again?
- **Two**, how efficacious 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, or where inflation is low and declining, as in East Asia?
- **Three**, what are the likely implications for 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 the scope for national and regional policy initiatives, in both the short and long terms, with regard to the questions raised here? Interwoven with these issues are policy measures needed to mitigate the negative effects on employment 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 succeeding sections. The relevant policy options can be summarized here as follows:

- **One**, a commitment to preserve growth through domestic demand stimulation within a framework of macroeconomic stability is needed. There are major shortcomings in the physical infrastructure of many, if not most, developing ESCAP economies. Investment in infrastructure alongside expenditure on human resources development will not fully offset the diminution in external demand but will contribute both to short-term growth and to improving long-term competitiveness.
- **Two**, maintaining macroeconomic prudence depends primarily on having a credible approach to the risks of policy slippage. Governments have in the past been somewhat lax in their commitments in this regard. A low inflationary environment allows somewhat more policy leeway than in the past but Governments should be alive to the risks of both overshooting and undershooting macroeconomic objectives.
- **Three**, a volatile external environment and exchange rate instability should not interfere with the progress towards trade liberalization, whether taking place on a multilateral or bilateral basis. Trade liberalization is not only a matter of reducing tariffs but of actively removing the more mundane impediments to trade such as customs clearance procedures and cumbersome trade-financing mechanisms.
- **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 was reported in the *Economic and Social Survey of Asia and the Pacific 2002*, the developed countries experienced an unexpected and sharp slowdown with 2001. In terms of the global impact, the slowdown manifested itself in a precipitate decline in world trade in 2001 compared with 2000, with the growth in the volume of trade slowing sharply and actually declining in value terms. 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. There was evidence of a tentative turnaround in global output growth led by the United States 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 have weakened in 2001-2002, gearing ratios have worsened and access to

finance for many has become restricted, especially for the less creditworthy, paradoxically in the face of easier interest rates.

An important feature of the 2001-2002 slowdown, briefly interrupted by growth in the last quarter of 2001 and the first half of 2002, has been that it has not been 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. It has instead been a spontaneous 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. Investors, for their part, encouraged by extravagant claims on behalf of ICT and the so-called new economy, eschewed scepticism and were instrumental in inflating the bubble. The result was that capital was misallocated on a massive scale. Much of it will have to be, and is being, written off. These matters were alluded to in the *Economic and Social Survey of Asia and the Pacific 2002* as well as in the previous edition, where the risks facing the global economy from the bursting of the 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 a prolonged period of volatility in the stock markets. This is proving to be the case.

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

The 2001 slowdown originating in the United States has certain peculiar characteristics that could serve to shed light on the course of events in 2002 thus far.

First, it was triggered by and concentrated in the ICT sector for which the ESCAP region is a major supplier of inputs. Following the over-investment in ICT and ensuing massive write-offs, corporate investment expenditures have had to be effectively suspended until corporate balance sheets are rebuilt. This will involve a painful period of restructuring with many corporate bankruptcies probable.

Second, in an environment of growing optimism, exaggerated profit expectations also began to be applied to other traditional sectors of the economy as benchmarks. In response, some companies in the United States began to artificially inflate their earnings, 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 been weakened virtually on a worldwide basis, including the ESCAP region.

Third, the impact of the associated stock market bubble 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 have tumbled to very low levels in 2001 and 2002 in all developed countries. In Japan interest rates are, and have been, close to zero for some time, while in the EU, the European Central Bank, though

*Low interest
rates have kept
consumption strong*

constrained by its EU-zone inflation target, has reduced interest rates by almost a full percentage point in the 12 months since July 2001. In consequence, private consumption has offset the investment and inventory-driven slowdown and prevented a more wide-ranging downturn. In the United States the wealth effect of rising housing equity has counterbalanced the declining value of share ownership. But in the process it has worsened the external imbalance in the United States by causing a surge in imports and has thus introduced a new source of uncertainty into the global economy. In Japan and the EU, the position is somewhat different as regards institutional arrangements and individual characteristics, in terms of consumer behaviour and preferences, in so far as the interface between the real economy and the financial environment is concerned. The following paragraphs attempt to shed light on the relevant trends in the main developed countries.

In the United States, as already noted, stock markets continue to remain weak and volatile despite low interest rates. In the real economy there are some tentative signs of a modest upturn in manufacturing activity and private consumption has so far remained strong, with retail sales standing 6.1 per cent higher in August 2002 compared with a year earlier. Low interest rates and a buoyant housing market have driven private consumption but these sources of consumer strength cannot be presumed to continue indefinitely. Investment expenditures by corporations, a better bellwether of medium-term prospects, are expected to contract again in 2002 following the contraction in 2001.

*The inflow of capital
to the United States
is reversing itself*

Trends in the United States must be viewed against the fact that gross national saving has fallen again in early 2002, the fiscal deficit has re-emerged and the current account deficit has widened from 4.0 to 4.5 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 have consequently risen substantially standing nearly 13 per cent higher at end-September 2002 compared with end-December 2001. Since the beginning of 2002 the dollar has depreciated against several currencies, primarily the euro, in an environment of increased volatility, and precious metal prices have also risen.

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

In Japan, notwithstanding the fact that interest rates have been reduced close to zero, demand remains weak owing to the influence of a variety of long-term domestic factors, including chronically weak consumer confidence and structural impediments such as over-capacity and an unreformed 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 factors. Export growth declined in 2001 following the collapse in the ICT sector in the United States, while consumption remains depressed by the massive and persistent loss of personal wealth over the last 10-12 years that 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 in 2000 but then falling back rapidly in 2001. Despite interest rate reductions, savings

remain high and the balance of payments 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 whether growth in the near term can be driven by exports. Exports have picked up only weakly thus far in 2002, the weaker exchange rate being offset by low demand for Japanese exports.

In the EU, growth faltered palpably in the first half of 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 only modest growth up to July 2002 in the EU with the exception of the United Kingdom and some of the smaller economies. Indeed, in September 2002 unemployment stood at 8.3 per cent in the euro zone compared with 8.0 per cent 12 months earlier. Overall, the EU 15 are unlikely to meet expectations for 2002 held earlier in the year. On the plus side, the recent appreciation of the euro and the pound sterling in the face of monetary easing should counter any lingering threat of inflation breaking official targets, giving some room for monetary easing. On the minus side, however, the overall climate of uncertainty generated by stock market turmoil and concerns about the strength of the United States economy are likely to dampen both non-euro zone export growth and capital investment in the second half of 2002. Moreover, in the face of persistent high unemployment, consumer demand is unlikely to provide a major stimulus to 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.

Performance in the European Union has been flaccid

Looking ahead over the next 4-6 quarters, the balance of forces currently arrayed in the developed countries seems to be evenly poised between slightly higher or flat GDP growth on the one hand and output contraction on the other. The view of the United States Federal Reserve Board is that recovery in the United States is likely to remain sluggish and that risks, by and large, are weighted towards continuing weakness. Earlier in the year, IMF was guardedly optimistic about both United States and global economic prospects. However, in the absence of a visible turnaround in business sentiment and greater likelihood of negative influences adversely affecting consumer spending, such as stock market turmoil or a weaker housing market, forecasts for both 2002 and 2003 have been scaled down for both the United States and the EU. For Japan, the consensus is that the economy will contract in 2002 but by less than was feared earlier in the year. It should, however, show positive growth in 2003. None of the major developed countries is thus likely to have a positive influence on the global economy in the short term. Prospects for the developed countries must also be viewed against an environment characterized by low and declining inflation and low interest rates but with some uncertainty as regards the fiscal situation. With regard to the latter, despite recent spending increases there remains some modest

The major developed economies are unlikely to be engines of global growth in the near term

scope for fiscal stimulus, particularly in the United Kingdom. However, the EU is constrained by its Growth and Stability Pact while Japan's public debt is already uncomfortably high. The implications of these phenomena are discussed more fully elsewhere in the chapter.

Developing countries

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

The sharp slowdown of the global economy in 2001 inevitably impacted adversely on the developing countries with lower growth in output and further weakness in commodity prices and implied terms of trade losses (table 2).³ Despite widespread easing of fiscal and monetary policies the loss of the external stimulus could only be partially compensated for by growth in domestic demand in 2001. Accordingly, there were severe declines in output 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 were largely immune to the slowdown in 2001.

Table 2. Indices of commodity prices, 1996-2002

(1995 = 100)

	1996	1997	2000	2001	2002 June
World	98.8	95.7	77.3	73.1	73.3
Food	112.2	100.1	73.5	75.8	79.9
Beverages	82.6	109.5	61.0	49.4	51.7
Agricultural raw materials	97.3	91.0	79.4	74.0	71.0
Metals	88.1	90.7	83.9	75.8	74.1
Fertilizers	113.7	115.0	107.4	101.2	100.5
Memo:					
Palm oil (Malaysia)	84.6	86.8	49.2	45.6	64.7
Rice (Thailand)	105.4	94.3	63.5	53.8	63.0
Rubber (Malaysia)	88.7	64.4	43.7	38.0	53.1
Sugar (US import price)	97.0	95.1	84.1	92.5	86.7
Tea (Sri Lanka)	126.5	134.5	119.9	114.3	114.1 ^a
Timber:					
Hardwood logs (Malaysia)	98.5	92.4	73.8	62.2	63.4
Hardwood sawnwood (Malaysia)	100.1	89.5	80.9	66.0	69.2
Softwood logs (United States)	105.3	95.6	93.3	81.4	70.6
Softwood sawnwood (United States)	103.1	97.8	94.7	94.1	75.0
Sources: IMF, <i>International Financial Statistics Yearbook 2001</i> (Washington, 2001); and <i>International Financial Statistics</i> (Washington, August 2002).					
^a March.					

³ The all-items commodity index of *The Economist* had declined by nearly 15 per cent in the 12 months to October 2001. It has since risen somewhat but at 73.2 stands almost 27 per cent below its level of 1995 (2002).

In late 2001 and early 2002 indicators of activity in most developing countries strengthened in response partly to domestic stimulus measures and partly as demand for exports, especially to the United States, appeared to recover. In particular, evidence of a 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 output growth in the developing countries in the region and also lead to a modest firming of commodity prices. The latest indications are that, for now, the external stimulus from the United States is likely to wane in the months ahead. All things considered, growth will need to be sustained primarily by domestic measures or by intraregional trade in 2002 and perhaps well into 2003.

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

West Asia's economic fortunes in 2002 and 2003 primarily rest on energy demand and prices, the level of violence in the Israel-Palestine conflict and, now, more seriously the danger of military action against Iraq. The most probable consequence of the two conflicts 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 sharply restricted investment activity and tourism in and around the countries immediately involved and any increase in their intensity would automatically depress economic activity in the entire region even if it benefited energy prices in the short term. On balance, therefore, it is unlikely that West Asia will be able to match 2001 performance in 2002. Prospects for 2003 can only be described as moderately hopeful, assuming that conflicts in the region can be contained and/or prevented and energy prices and production levels continue broadly unchanged at their present level.

In Central Asia, the larger economies are rather more diversified than in West Asia. However, here, too, energy prices continue to exert a crucial influence on their overall levels of activity and output growth. The economy of the Russian Federation has grown at a respectable pace thus far in 2002 on the back of higher energy prices and higher industrial production. Barring unforeseen developments, this pace is considered sustainable in 2002 and into 2003. The same broad scenario should apply to other economies in North and Central Asia, given their links with the Russian Federation.

*Sustainable growth
is foreseeable
in Central Asia*

In other parts of the world, for instance, 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 had recourse to external support in order to pre-empt a complete financial collapse, Brazil having had to arrange a massive US\$ 30 billion stand-by with IMF in August 2002. Uncertain prospects for the United States economy, political tensions in Colombia and 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, with the possible exceptions of Mexico and Peru.

*The outlook for
African economies
has worsened during
the course of 2002*

Economic performance in Africa held up relatively well in 2001 compared with other parts of the world despite the global slowdown. Until early 2002, performance was expected to strengthen further in 2002 in response to a stronger external environment. Oil-producing countries were expected to benefit in particular. The short-term outlook has, however, become 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 when the external environment deteriorates and the chronic nature of internal conflicts in many countries are key influences bearing on economic performance over much of the African continent. In view of these considerations the outlook for both 2002 and 2003 suggests either no improvement over 2001 performance or, more likely, a slight deterioration.

Trade and financial market developments

An important element in the slowdown in 2001 was the role played by international trade and financial flows in transmitting changes in economic activity in the global economy. Trends in world trade and prices over the last decade and in 2001-2002 are given in table 3. The most notable feature in world trade growth is the fact that strong volume growth has been accompanied by price weakness almost across the board with the exception of oil. Capital

Table 3. 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 (in US 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 from BIS, 72nd Annual Report: 1 April 2001-31 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).

flows to the developing countries and to developing Asia are given in table 4. These rose strongly up to 1996 but have been fluctuating at a considerably lower level since 1997. For example, in 2002 developing Asia is expected to receive only a quarter of the private capital flows it received in 1996. No early revival is indicated on the basis of available information.

Table 4. Net capital flows^a of developing countries and of developing Asia, 1995-2003

(Billions of US dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total^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
Net other 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									
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
Net other 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, September 2002: Trade and Finance* (Washington, 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.

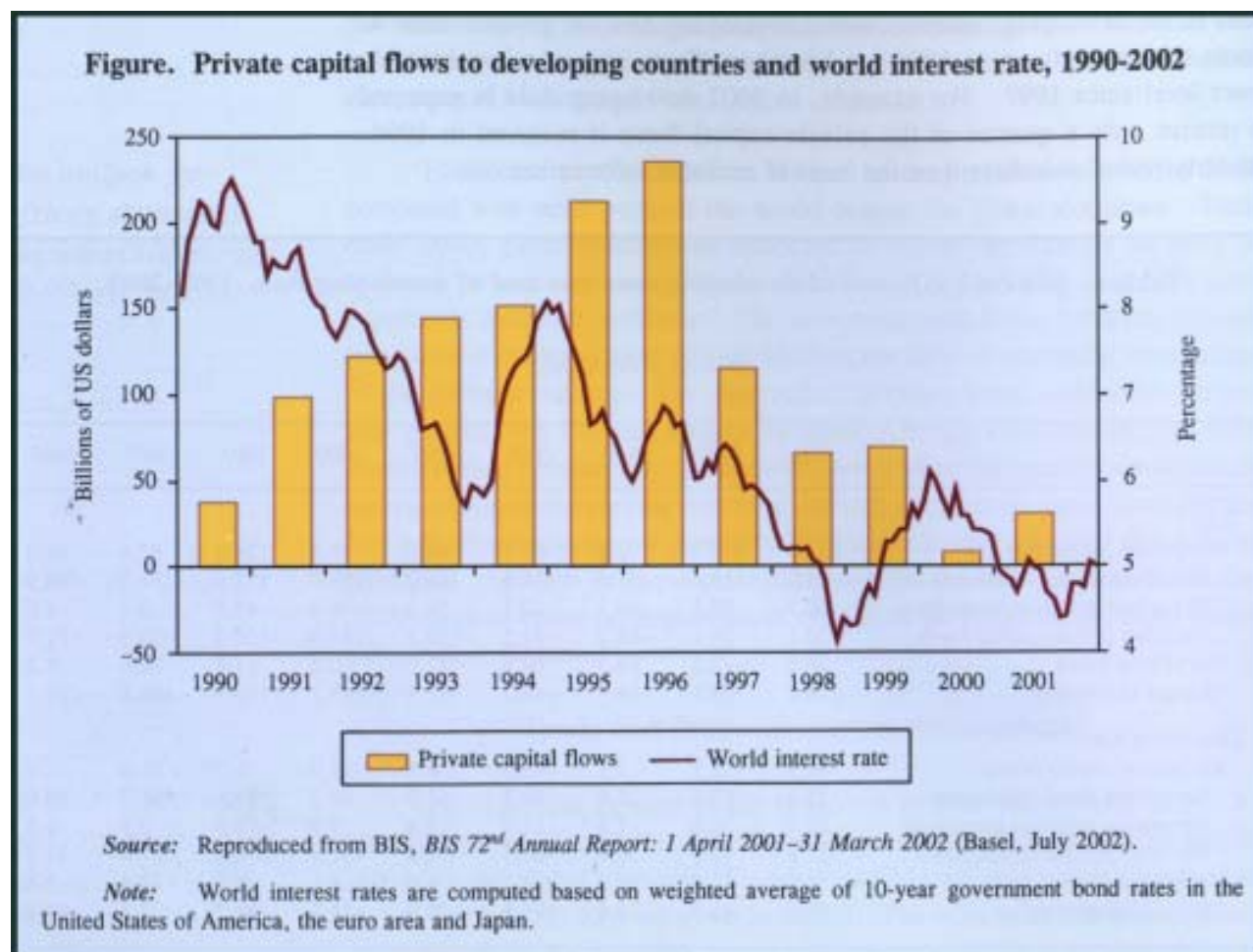
^b Excludes Hong Kong, China.

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

^d A minus sign indicates an increase.

As explained in previous issues of the *Survey* over the years, with greater specialization, trade flows represent an increased proportion of output in today's economies. Moreover, vertical integration implies that individual sectors are likely to be influenced by developments specific in those sectors rather than in the wider economies of the countries where particular production facilities are located. However, the ability of international trade flows to overcome country-specific macroeconomic conditions should not be overstated. World trade growth declined sharply in 2001 in tandem with the global slowdown and the best estimates for 2002 suggest an increase of only 2.6 per cent in volume terms, but this is 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 prices of internationally traded commodities and manufactures fell. Given the anaemic nature of the global economy and little upward pressure on prices, 2003 could well be a repeat of 2002, with a modest increase in volume and flat or declining prices.

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



Low interest rates in developed countries have not stimulated capital outflows to developing countries

Although in 2001 there was a synchronized slowdown in output growth almost across the globe, the forces propelling developments in the United States are rather different from those in either Japan or the EU. Nevertheless, there is greater convergence in financial conditions, namely, in the direction of interest rates changes, as financial markets have become more integrated in recent years and inflationary pressures have abated across the world. Thus, changes in financial conditions in one country are likely to affect others more strongly than in the past. 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 (see figure). Is this trend likely to continue in the future? The evidence since 1999 suggests otherwise. For one thing, interest rates in many developing countries have also fallen to low levels owing to poor loan demand and monetary easing and 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.

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. Lower interest rates have diverted funds from the developing countries to consumers in the United States, worsening the current account deficit as a buoyant housing market sustains the wealth effect.

A feature of the global slowdown in 2001 and uncertain recovery in 2002 in the developed countries is the marked difference in performance between the domestic and externally oriented-sectors. 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 of the United States economy 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. The result is that firms have lost pricing power to a significant extent, a factor that has contributed to the low rates of inflation, indeed a degree of deflation, in the United States and in many other parts of the world.

The phenomenon of 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 non-investment grade borrowers have experienced a widening of spreads, countering the effects of lower interest rates. Lenders have not been averse to shifting finance from corporate and sovereign borrowers to the personal sector for housing mortgages and personal consumption. This shift has indirectly supported strong consumer spending in the United States and reduced the impact of the diminution in corporate investment spending and rising unemployment. Such effects are less strong in Japan and the EU but are not entirely absent.

In the past, as stated above, interest rate differentials exercised a major influence on the volume of capital flows with developing countries typically receiving a higher volume of private capital flows when interest rates are low in the developed countries. In 2001 and 2002 the decline in interest rates has coincided with a weakening global economy and increased investor risk aversion. Potentially disruptive financial crises in Turkey, Argentina, Uruguay and Brazil have increased risk aversion considerably. Low interest rates no longer lead to an increase in private capital flows to developing countries. In fact, in several Asian economies cross-border lending turned positive in 2001-2002 for the first time since mid-1997. FDI flows to developing countries have remained steady but as in previous years they continue to be directed to a small number of countries, with China the principal recipient of these flows.

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

Lenders have become more discriminating in their choice of borrower

*Credible
macroeconomic
policies can improve
investor perceptions*

Although overall capital flows to developing countries displayed a measure of resilience in 2001-2002, many countries with high debt/GDP ratios, high debt service requirements or a large element of short-term debt relative to reserves are, and will remain, highly sensitive to changes in international financial market sentiment. However, the adoption of credible macroeconomic policies can mitigate the negative effects of high indebtedness. This phenomenon is most visible in the EU candidate countries, which are perceived by investors to have policy frameworks defined by the needs of EU entry and, hence, to be less risky than other countries with similar external debt profiles.

The overall global economic and financial environment prevailing in 2002 does not suggest that private capital flows to developing countries are likely to increase in the near future. Banks are likely to remain cautious given that asset quality tends to deteriorate in slowdowns. 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.

*Little real increase
is likely in ODA*

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 recur in 2002 with the IMF assistance just announced for Brazil. Over the medium term, as indicated in the Monterrey Consensus adopted at the International Conference on Financing for Development in March 2002, donors are more aware of the importance of ODA for long-term development needs and for the fight against poverty. However, given the overall economic and fiscal situation in the donor countries, this is unlikely to lead to higher disbursements in 2002 or 2003 except for the special needs of Afghanistan.

Prospects for the ESCAP region

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

The global economic slowdown in 2001 reduced GDP growth of ESCAP developing countries from 7 per cent in 2000 to 3 per cent in 2001. Earlier in 2002 there were some indications that a rebound in the global economy led by the United States combined with easier domestic policies would lead to a higher pace of growth in the ESCAP developing countries than the 4.2 per cent rate that had been forecast. In the event, however, the rebound appears to have lost steam in the United States and growth has failed to accelerate appreciably in either the EU or Japan on a sustainable basis. Indeed, the risks are weighted towards a period of even slower growth over the next 12 months than was forecast at the beginning of 2002. Most observers are now of the opinion that the global economy is unlikely to show strong growth until well into 2003 or possibly later; in other words, the contribution from a rebound in world trade and hence from net exports to growth in ESCAP developing countries over the next 4-6 quarters is likely to be moderate at best. Sustaining growth in 2002-2003 at around 5 per cent as currently forecast will thus depend primarily on stimulating domestic demand. Growth within the region could also be sustained and, indeed, enhanced by higher intraregional trade flows.

The evidence up to the middle of 2002 suggests that growth as forecast earlier in the year is broadly on track over much of the region. Moreover, it provides a base for the momentum to be sustained in the months ahead. In East Asia, with the exception of Hong Kong, China, GDP growth is strongly positive in China and the Republic of Korea and up to expectations in Taiwan Province of China. Indeed, in the latter, industrial production in August 2002 was 5.8 per cent higher than in August 2001 and overall GDP grew by 3.0 per cent in the second quarter of 2002 on a year-on-year basis. In South-East Asia, where trade-to-GDP ratios are among the highest in the world, growth in output has nevertheless been up to or beyond expectations. In Singapore, for instance, there has been a striking rebound in industrial production in the first half of the year, industrial output standing nearly 16 per cent higher in August 2002 than in August 2001. In South Asia, India's economy continues to expand at, or slightly higher than, its long-term rate of 5-6 per cent. However, prospects for the remainder of 2002 are likely to have been blighted to some degree by a combination of floods and drought that afflicted the country in mid-2002. Economic performance elsewhere in South Asia is also likely to be affected by either floods or drought. However, an easing of tension between India and Pakistan is likely to benefit economic performance in the subregion along with progress in macroeconomic reforms.

Given these varied trends within the region, the question that arises is whether the overall momentum of growth can be sustained and whether this apparent immunity can be preserved into 2003. Details of forecasts of growth in 2002 and 2003 are given in table 5. The forecasts are based upon the following assumptions: (a) no major hostilities in Iraq, (b) no sustained increase in oil prices or disruption in the energy markets, (c) no new extended period of turmoil in the financial markets, (d) no significant exchange rate realignments and (e) only a limited impact of floods and drought in China and India and of terrorism in South and South-East Asia.

As mentioned elsewhere, the ESCAP 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 supportive domestic policies are concerned, there are, of course, limits beyond which it may be difficult or unwise to stimulate activity through public spending programmes or through monetary easing. One of the lessons of the 1990s emanating from Japan is that monetary easing in a low inflationary environment raises its own peculiar set of issues.

As far as intraregional trade is concerned, there is evidence that the ESCAP region has expanded trade with itself rapidly, a process in which China has emerged as a significant importer, increasing imports by a remarkable US\$ 80 billion in the two years 2000-2001. The Republic of Korea, Malaysia, Taiwan Province of China, Singapore and the Philippines have been the major beneficiaries in this development. To what extent this impetus can be sustained, however, remains a subject for debate. One view is that growth in intraregional trade is likely to slow soon. This is due to the fact that demand for investment goods in the region, though expanding, remains essentially weak, given the overhang of excess manufacturing

An outbreak of hostilities in the Middle East would undermine forecasts for 2002-2003

Demand from China has stimulated intraregional trade but this may slow in future

Table 5. Rates of economic growth of selected developing economies of the ESCAP region, 2000-2003*(Percentage)*

	<i>Real GDP</i>				
	<i>2000</i>	<i>2001</i>	<i>2002^a</i>	<i>2002^b</i>	<i>2003^c</i>
South and South-West Asia^d	4.4	4.5	5.5	4.3	5.4
Bangladesh	5.9	5.2	4.3	4.3	5.1
India	4.0	5.4	6.0	4.3	5.6
Iran, Islamic Republic of	5.7	5.1	6.5	5.0	5.5
Pakistan	3.9	2.5	4.0	4.5	4.6
Turkey	7.4	-7.4	2.0	2.8	4.1
South-East Asia	6.1	1.6	3.2	3.7	4.7
Indonesia	4.9	3.3	3.8	3.5	4.4
Malaysia	8.3	0.4	3.2	4.4	5.8
Philippines	4.4	3.2	4.0	4.0	4.4
Singapore	10.3	-2.0	2.0	2.5	5.0
Thailand	4.6	1.8	2.5	3.9	4.4
Viet Nam	6.8	6.2	6.1	6.1	6.7
East and North-East Asia	8.2	3.3	4.3	5.6	6.1
China	8.0	7.3	7.0	7.6	7.6
Hong Kong, China	10.2	0.6	1.0	1.7	3.9
Republic of Korea	9.3	3.0	3.9	6.0	6.2
Taiwan Province of China	5.9	-1.9	1.7	3.3	4.5
Memo:					
Russian Federation	8.3	5.0	3.5	4.0	4.0
<p>Sources: ESCAP based on IMF, <i>International Financial Statistics</i>, vol. LV, No. 8 (Washington, August 2002); ADB, <i>Key Indicators of Developing Asian and Pacific Countries 2002</i> (ADB, 2002) and <i>Asian Development Outlook 2002 Update</i> (ADB, 2002); United Nations, "Project LINK World Economic Outlook", April 2002; The Economist Intelligence Unit, <i>Country Forecast</i> (London), various issues; and national sources.</p> <p>^a <i>Economic and Social Survey of Asia and the Pacific 2002</i> forecast.</p> <p>^b Latest available estimate.</p> <p>^c Forecast.</p> <p>^d The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2001/02 = 2001 for Bhutan, India and the Islamic Republic of Iran; fiscal year 2000/01 = 2001 for Bangladesh and Pakistan.</p>					

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 it is debt-financed and could thus pose systemic risks in some countries. Above all else, China's capacity to import is dependent upon its continued success as an exporter. China's export success and hence its capacity to increase imports from the region is ultimately strongly correlated to the strength of the global economy.

A further influence on the region's export and growth performance over the next 12-18 months is likely to emanate 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. For one thing, although regional currencies have tended to strengthen against the dollar, they still remain cheaper on a trade-weighted basis than, say, before the 1997 crisis. For another, the weaker dollar allows countries to speed up their dollar debt restructuring thus freeing up resources in cash flow terms that would otherwise have been used in debt servicing. An unknown in the situation, however, is how economies whose exchange rates are fixed to the dollar, and economies whose exchange rates are not and have experienced a degree of exchange rate appreciation, are able to compete among themselves. While the Republic of Korea, Singapore and Taiwan Province of China are competitors at the higher end of the technology scale, Malaysia, Indonesia, the Philippines and Thailand compete in several lines at the lower end. India, which uniquely in the region has seen its currency depreciate against the dollar since mid-2001, is not yet a major trading economy and thus does not have a significant role in this conundrum. The trading performance of selected ESCAP economies is given in table 6. These reveal strong export

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

Table 6. Rate of growth of exports and imports, selected ESCAP economies

	1999		2000		2001		2002 ^a	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Bangladesh	18.27	13.33	23.66	8.58	2.61	0.26	10.41	8.17
China	6.09	18.05	30.20	40.37	26.72	13.99	27.49	3.45
Hong Kong, China	0.06	-2.68	16.22	18.74	-12.78	-4.08	-18.74	5.20
India	5.37	8.62	14.39	9.42	0.88	-2.45	3.77	3.00
Indonesia	-0.39	-12.20	28.19	40.73	4.78	9.74	-1.17	-8.86
Iran, Islamic Republic of	60.31	-11.45	32.04	36.81	-8.02	9.70	-3.40	-7.60
Malaysia	15.08	12.30	16.09	25.50	-8.82	-8.60	3.86	13.48
Pakistan	0.07	10.63	8.49	7.31	1.55	-5.94	-9.05	-9.49
Philippines	20.27	-0.08	7.70	1.04	-9.54	13.80	-8.40	17.17
Republic of Korea	8.25	28.24	21.42	36.22	-12.16	-11.96	-0.35	0.64
Russian Federation	1.49	-29.47	68.00	49.95	-22.04	-2.56	-0.08	19.89
Singapore	4.41	9.32	20.22	21.21	-11.76	-13.82	-14.57	-15.98
Taiwan Province of China	9.96	5.76	21.98	26.49	-17.16	-23.41	-1.01	-6.37
Thailand	7.35	16.80	17.89	22.99	-5.58	0.22	-5.16	-9.55
Turkey	-1.81	-9.16	0.27	33.20	9.72	-23.53	3.40	3.56
Viet Nam	24.01	3.81	15.42	35.77	7.08	6.87	4.74	2.16
Memo:								
United States	1.51	10.99	11.77	18.10	-5.32	-4.69	-14.43	-11.58
Japan	8.06	10.49	14.06	22.14	-14.56	-5.41	-8.96	-3.27
European Union	3.09	4.58	3.04	6.19	0.38	-0.77	-8.49	-2.57

Sources: IMF, Direction of Trade Statistics CD-ROM, August 2002, and national sources.

^a Data for the first quarter of 2002, except for Taiwan Province of China, in which case data refer to the second quarter.

growth only in China, Bangladesh and Viet Nam. In others, the rate of growth in exports in 2002 is slower than in 2001. Most observers predict a stronger upturn in the second half of 2002 on the back of surprisingly strong consumer sentiment in the region. In the following paragraphs the immediate prospects for each subregion are briefly discussed.

The strong performance of the East Asian subregion is likely to continue

In East Asia, led by the continuing strong performance of the Chinese economy, the subregion is expected to exceed 2001 performance in 2002 and sustain this momentum into 2003. The only exception to this trend is likely to be Hong Kong, China, where there are as yet no signs of an economic turnaround and up to the second quarter of 2002 the economy was contracting. However, in terms of the subregion the slack in Hong Kong, China, is likely to be more than offset by Taiwan Province of China, which has raised its 2002 forecast on the back of better-than-expected exports up to the middle of the year.

Slowing exports will hit the economies of South-East Asia hardest

In South-East Asia the overall outlook is for a gradual strengthening of the momentum of growth with domestic spending stimulating domestic production in both 2002 and 2003. However, since all economies in the subregion have relatively high trade-to-GDP ratios any slackening in the pace of export growth will automatically have a negative impact on the pace of GDP growth. Moreover, in the main economies of the subregion levels of public debt are already on the high side so that fiscal stimulus may have reached its prudential limits. Scope for additional monetary easing, however, is theoretically available with inflationary pressures relatively muted, except in Indonesia. In addition, as exchange rates have appreciated relative to the dollar, lowering interest rates should pose no significant risks via the exchange rate on any “flow through” effects of higher energy or other imported input prices.

The domestic situation in some South Asian economies is not likely to be conducive to growth

South Asian economies are the least export-driven of all in the region. Hence, the likelihood of a weaker external environment does not have the same implications for this region. However, as the economies are more domestically driven any adverse developments on the domestic front will have a negative impact on growth. Both India and Pakistan are thus likely to be affected by the prolonged tension between the two, which will divert expenditures into defence in the short term and could have a dampening effect on private investment. In addition, Pakistan has seen a significant rise in terrorism that could severely undermine both investor and consumer confidence for the foreseeable future, not to mention the diversion of both public and private resources to higher spending on domestic security. Prospects for Bangladesh are more likely to be affected by the global slowdown in view of the growing importance of non-traditional exports in its economy. Sri Lanka's prospects have improved with the cease-fire in the domestic civil conflict.

The outlook for Central Asia is broadly positive

In Central Asia, the pace of growth is expected to moderate in 2002 from its 2001 pace in any event as economies came up against long-standing structural impediments in their transition to market-based systems. Also, problems with the lack of macroeconomic consolidation in most of the economies could hamper growth in the medium term. For now, in the

Russian Federation, output has continued to grow at slightly above the pace forecast for 2002. With energy prices tending to strengthen, the outlook for this region as a whole is broadly positive into 2003 on the back of improving external balances, rising foreign reserves and greater exchange rate stability. The latter in particular should allow more domestic and external investment to take place and keep inflationary pressures in check.

The overall outlook for the three developed countries of the region is predominantly influenced by Japan, given the size of its economy. The latest forecast for Japan indicates that despite the improved performance shown in the first half of 2002, GDP is expected to contract in 2002 by around 0.5 per cent, significantly less than the earlier forecast of a contraction of 1.2 per cent. However, as the external environment is displaying renewed weakness, growth in 2003 is not likely to reach the modest 1.5 per cent rate forecast earlier this year. Output growth of 1.1 per cent is the current estimate for Japan in 2003. For Australia and New Zealand, growth in 2002 should be close to the rate forecast earlier in the year or fall short slightly. For 2003, the outlook is more uncertain with the balance of risks broadly neutral for the two economies with some potential on the upside.

Policy issues and challenges

In the *Economic and Social Survey of Asia and the Pacific 2002* it was forecast that the developing economies of the region would collectively improve their growth performance in 2002 by about 1 percentage point to 4.2 per cent with a further acceleration to 5.4 per cent in 2003. However, at these rates of growth the developing countries of the region would still be a good 2 percentage points or more below the rates achieved in 1996. The loss of output implied by this shortfall translates itself into fewer jobs created in the economies of the region and, through lower 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. As is self-evident from the earlier discussion, some subregions are better situated than others in terms of their level of dependence on external demand to sustain growth and in their ability to take appropriate measures at the domestic level. However, the general policy issues and challenges that arise are applicable *mutatis mutandis* to the region as a whole.

It should be emphasized at the outset 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 to alleviate poverty and social distress progressively through the higher levels of employment that growth generates. Growth is also needed to help in the resolution of issues pertaining to corporate and financial sector reform as enunciated in the *Bulletin 2001/02* and *the Survey 2002*. Although significant progress has been made in dealing with these matters over the past five years, 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 would cease to be

ESCAP developing countries have still to regain their pre-crisis momentum

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

construed as an ongoing form of penance. It has to be recognized too that in developing countries reforms are an essential, continuing process that needs to be securely anchored in a realistic framework of development and poverty reduction strategies.

*Fiscal sustainability
remains an important
issue for policy*

On the domestic front, given that public debt has risen in many countries, the fundamental question is the degree to which fiscal stimulus can be maintained over the medium term without running the risk of countries being 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 deficits caused by high public spending have historically existed for some time and public debt as a ratio of GDP has risen to a high level; it also applies to countries where rising public debt is a relatively new phenomenon.

There is no doubt that, with public debt in the region having nearly doubled from 29 to 52 per cent of GDP between 1996 and 2001, the question of sustainability is one that has to be posed for essentially three reasons. First, in a globalized world economy, financial markets are no longer comfortable with rising levels of public debt, especially if there is a possibility that some of it may have to be monetized. In countries where public debt is perceived to be rising unsustainably fast, access to external sources of finance, whether in the form of bank loans or bonds, is likely to be curtailed or be available only at a significant premium or both. Second, there is the danger that the public sector's increasing claim on resources will pre-empt investment funds for the private sector. The need for greater investment in public goods notwithstanding, the private sector is in danger of being "crowded out" and the overall level of investment efficiency lowered. Finally, long-term interest rates in the economy are in danger of being driven upwards. Thus, the fiscal stance has to be managed within a credible and stable medium-term strategy in which the overall level of debt is seen as remaining within prudential limits. Countries that allow themselves to be defined by images of instability or by reports of erratic changes in policies will have to face a costly risk premium in financial markets.

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

The management of monetary policy is now also raising difficult policy choices for several economies.⁴ Facilitated by lower interest rates in the developed countries and lower inflation, most economies in the region, with one or two minor exceptions, have been able to lower interest rates significantly from mid-2001 to mid-2002. In most countries, however, lower interest rates have not led to higher credit growth, thus far at any rate. The slow progress of bank restructuring and the large overhang of corporate indebtedness have clearly put a limit on the supply of new credit. Equally, there are problems from the demand side in the form of excess production capacity. Here, lower interest rates have, however, enabled many heavily indebted borrowers to restructure their debts and improve cash flow. But it

⁴ Falling inflation automatically makes monetary conditions tighter even without an increase in interest rates. See Centre for European Policy Studies (2002).

is arguable whether corporate balance sheets have been strengthened in the process and new capital expenditures encouraged. The general view is that given the excess capacity still in existence new capital expenditures are unlikely to be undertaken in the months ahead and monetary easing may merely lead to the build-up of consumer debt.

The fundamental problem appears to be that with interest rates already low further easing seems to produce only small additional effects. This has been seen in Japan, the EU and even to some extent the United States. This is because in an arithmetical sense, reductions of, say, 25 basis points or so when interest rates are already around 3 per cent or less will generate quite small savings in debt service. It is also because in economies where deflation has emerged and prices have started to fall, real interest rates can actually start rising. This can negate the effects of monetary easing completely. Indeed, with a falling price level, an apparently stable exchange rate can also perversely appreciate in real terms, thus effectively tightening policy further. Again, Japan is a prime example of this phenomenon. As of August 2002, in addition to Japan, China, Hong Kong, China, Singapore, Taiwan Province of China and Thailand were either experiencing deflation or were very close to it. It appears to be the case that once deflationary expectations have become established they are as difficult to shake off as inflationary expectations. Moreover, they tend to become self-fulfilling unless quickly reversed.

Thus, monetary easing is as circumscribed in the real world as is fiscal policy, and its stimulative effects could be nullified if a deflationary psychology takes hold. The monetary authorities have consequently to ensure that the current phase of low and declining inflation does not transform itself into a prolonged deflationary phase. Monetary policy has traditionally been built around the threat of inflation and the inflationary syndrome continues to exercise considerable influence in central banking attitudes. However, with inflation benign by historical standards there is a need to refashion policy priorities and recognize that deflation poses as much a threat to growth as inflation does. Monetary authorities need to be aware of the forces causing downward pressure on prices and to fashion an appropriate response to the phenomenon. It would appear that in countries pursuing an inflation targeting regime the objective should not be one of achieving a low rate of price increases per se but to achieve instead an overall environment of price stability in which relative prices have room to adjust freely. Inflationary pressures in developing countries are not purely monetary phenomena but are often the result of temporary supply bottlenecks. Too rigid an adherence to particular rates of inflation may not be conducive to the movement of factors of production between different uses in the economy.

On the external front, the size of the current account deficit of the United States along with prolonged turmoil in the financial markets poses a major challenge not just for policy makers in the United States but in all the more open, developing economies of the world. Present estimates suggest

Continued monetary easing in a low inflation, low interest rate environment is problematic

Monetary policy has to be recast if deflation is to be avoided

that the United States current account deficit is likely to increase from 4.7 per cent of GDP in 2002 to 4.9 per cent in 2003. In recent months, the United States fiscal situation has also deteriorated sharply and the budget surplus of 2.5 per cent of GDP forecast for the fiscal year 2002 only a year ago has been converted into a deficit of 1.6 per cent of GDP. On current assumptions the surplus is not likely to reappear before fiscal 2007. With continuing turmoil in United States financial markets these factors could presage a large-scale repatriation of assets held by foreigners in the United States, theoretically triggering a collapse in the dollar exchange rate with major knock-on effects on business and consumer confidence.

*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, having risen from 1.5 per cent of GDP in 1995, a level at which it had stabilized in the previous two decades, to 4.5 per cent in 2001. Although alarmist talk regarding this deficit has tended to be consistently belied over the years, it is nevertheless true that the imbalance cannot be allowed to persist indefinitely. In that event, net external liabilities of the United States would rise to an extremely high level in due course and 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, if this were to happen suddenly it would generate enormous dislocations in world financial markets and the global economy.

*The ESCAP
region can contribute
to global stability
by maintaining
commitments to
trade liberalization*

The first requirement hence 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 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 regard, it might be a valuable gesture, with more than mere symbolic value, to advance the 2010 deadline that ASEAN members have committed themselves to for dismantling all tariff barriers. Equally, the ASEAN-China agreement to move to a free trade arrangement in 10 years could be given greater momentum through the "early harvest" tariff reductions in an accelerated tariff reduction plan. Such actions would signal intent on the part of the authorities to improve trading links between the countries concerned; for investors they could point to the massive size of the potential market and thus encourage early decision-making with regard to new investment expenditures. Trade should also be supported with efforts at improving trade facilitation and at streamlining payments mechanisms. In the latter context, tie-ups between Japanese banks and the Bank of China to facilitate trade between Japan and subsidiaries of Japanese companies operating in China are a case in point. Japan is also more favourably disposed towards regional trade liberalization having concluded a free trade agreement with Singapore and is currently in negotiations with the Republic of Korea and Thailand.

Financial market instability poses rather more complex issues. As of end-September 2002, the trade-weighted exchange rate of the dollar had depreciated by about 3 per cent. In the same period, stock markets in the United States had fallen by about a fifth, precipitating sell-offs virtually across the world, although markets in the 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 on the global economy. In so far as the stock market declines reflect a correction of inflated values they are an appropriate and, indeed, welcome development. If, however, they are symptomatic of a loss of investor confidence they could herald a period of great uncertainty for both investors and managers in which investment decisions are postponed, corporate distress and bankruptcies increase and growth becomes less robust. The available evidence suggests that both factors are at work. There has been a drastic correction of inflated stock prices in the high-technology sectors, especially in telecommunications, but the succession of corporate scandals occurring in the United States suggests that investor confidence has also been gravely shaken. Indeed, the great fear for the next few months is one not so much of further price corrections in the stock markets but of a more pervasive loss of confidence extending to the household sector should artificial profits or new corporate scandals be revealed. Here, the region's ability to take protective measures is much less. 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 should seek to redouble their efforts at enhancing standards of transparency in corporate accounts and of corporate governance in the region and to take bold action should incidents of corporate malfeasance come to light in the future. As far as greater cooperation in exchange rates is concerned, the idea is worth exploring but raises complex issues. Implementation would appear to be some years away.

Falling stock markets partly reflect a loss of investor confidence

As countries of the region gear up to tackle their short-term challenges they must not lose sight of the need to sustain progress in the medium term to maintain and, indeed, enhance their competitiveness. Competitiveness has both macro and micro aspects and economic and non-economic determinants. The former lie in a prudential framework of macroeconomic policies that provide internal and external stability, while the latter consist of efforts to improve total factor productivity and enhance the absorption of technology by enterprises. Productivity, in turn, depends upon a mixture of investments in public goods, such as physical and social infrastructure in the diffusion of new technology in the economy and in the development of human resources. Strong public and private contributions are thus needed to build and sustain competitiveness.

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, as has been suggested in various forums, including in particular the International Conference on Financing for Development, held at Monterrey, Mexico, in March 2002, 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. At the Monterrey 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 this 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.

Like the International Conference on Financing for Development, the World Summit on Sustainable Development at Johannesburg, South Africa, in August-September 2002 is a 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, to improve the utilization of ODA, to reduce poverty and to tackle deficiencies in the pursuit of these aims on the basis of "ownership". Effective ownership requires 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 *Economic and Social Survey of Asia and the Pacific 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 are honoured and no slippage occurs in the time frame for the completion of negotiations in different areas.

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

The overall conclusion for the ESCAP region thus consists of a reiteration of suggestions made in previous issues of the *Bulletin* and *Survey* to support sustainable growth by member Governments over the next 12-18 months and beyond: to speed up structural reforms to make their economies more competitive; to prepare for and manage globalization better by understanding the interaction between international and national policies and financial markets; to continue to deepen financial markets and reduce

dependence on any one source of finance for development; to strengthen the formulation and implementation of policies, especially macroprudential policies; to enhance the quality of governance in both the public and private sectors; and to minimize conflicts of interest in the field of governance (Kharas 2002).

It is a truism that the course of events over the next 12 months or so will be conditioned not only by policies but equally by unforeseen events. Experience, however, suggests that flexible public policies, based upon a credible and realistic framework of expectations, can not only prevent adverse developments but can also cushion the impact on the economy of unforeseen events when they happen. Not all adverse developments, however, can be fully countered by policies and the constraint on resources is a datum for all economies, developed and developing, circumscribing the capacity of Governments to take corrective action in a timely fashion. But, as has been seen, good policies can contribute to mitigating the adverse effects of disasters, natural or man-made, and to a quicker recovery in their aftermath. The ESCAP region has displayed considerable resilience in dealing with the 1997 crisis and in meeting the challenges it posed, for the countries directly affected as well as for others, in both the economic and social fields. The 2001 slowdown provided another opportunity to fashion new policy responses to promote growth in 2002 and 2003 and for the region as a whole to resume its pre-1997 pace of economic and social development.

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