



## GLOBAL AND REGIONAL ECONOMIC DEVELOPMENTS: IMPLICATIONS AND PROSPECTS FOR THE ESCAP REGION<sup>1</sup>

### The global setting

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

*The global economy showed unexpected strength in 2003*

However, at the same time as growth picks up steam, new policy issues will inevitably arise in the months ahead. In addition, as explained in the concluding section of this chapter, short-term policy issues have to be placed within a longer-term continuum. Most countries in the ESCAP region have to confront major development challenges that go beyond short-term economic management and embody structural change, such as progress in poverty eradication, in accordance with internationally agreed goals and commitments, notably the Millennium Development Goals. However, these longer-term objectives may not be reached if there is too much preoccupation with the short term and in the absence of more explicit policy interventions involving the application of additional financial and non-financial resources.

Within the ESCAP region, despite the rise in intraregional trade and the impact of domestic growth-enhancing measures, reliance on the United States economy continues; the United States still directly accounts for over 20 per cent of the exports of developing countries of the ESCAP region. Such reliance is a matter of concern for the region in that it intimately links the region to cyclical developments in the United States economy with growing current account and fiscal deficits. Concurrently, in many

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**Table 1. Selected indicators of global economic conditions, 2000-2004**

	2000	2001	2002 <sup>a</sup>	2003 <sup>b</sup>	2004 <sup>b</sup>
<b>Economic growth (percentage change in GDP)</b>					
World					
At market exchange rates	3.9	1.4	1.9	2.0	2.9
At PPP exchange rates	4.8	2.4	3.0	3.2	4.1
Developed economies	3.9	1.0	1.8	1.8	2.9
Japan	2.8	0.4	0.2	2.7	1.4
United States of America	3.8	0.3	2.4	2.6	3.4
European Union	3.6	1.7	1.1	0.8	2.0
Developing economies	5.7	4.1	4.6	5.0	5.6
Developing countries in the ESCAP region	7.3	3.5	5.6	5.4	5.8
<b>Growth in volume of trade (percentage)<sup>c</sup></b>					
World	12.6	0.1	3.2	2.9	5.5
Developed economies					
Exports	12.0	-0.8	2.2	1.6	5.2
Imports	11.9	-1.0	2.2	2.8	4.8
Developing economies					
Exports	14.4	2.7	6.5	4.3	6.9
Imports	16.1	1.6	6.0	5.1	7.8
<b>Inflation rate (percentage)<sup>d</sup></b>					
CPI in the developed economies	2.2	2.2	1.5	1.8	1.3
CPI in the developing economies	5.8	5.8	5.3	5.9	4.9
<p><i>Sources:</i> United Nations, Project LINK Research Centre, "Current Quarter Model Forecast for the Japanese Economy" (September 2003); IMF, <i>World Economic Outlook, September 2003: Public Debt in Emerging Markets</i> (Washington, International Monetary Fund, 2003).</p> <p><sup>a</sup> Estimate.</p> <p><sup>b</sup> Forecast.</p> <p><sup>c</sup> Exports and imports (goods and services).</p> <p><sup>d</sup> Developed and developing economies ratios weighted at purchasing power parity.</p>					

developing economies of the region while overall external positions remain favourable, domestic public debt is rising. This rising incidence of macro-economic imbalances could presage significantly increased instability in global financial markets in the near future.

### ***Grounds for cautious optimism for 2004***

In the near term, Governments of ESCAP member countries are also faced with the policy challenges of sustaining the momentum of growth by preserving business and consumer confidence, maintaining their commitment to the agenda of trade liberalization in the face of setbacks and difficulties in negotiations, such as those at the Fifth WTO Ministerial Meeting, held at Cancún, Mexico, in September 2003, and coping with the rapid increase in bilateral trade agreements. While there are grounds for cautious optimism with respect to the near-term growth prospects, it would be imprudent to assume that all countries will be able to negotiate the next 12-18 months smoothly. As stressed by the ESCAP secretariat in previous issues of the *Bulletin* and the *Economic and Social Survey of Asia and the Pacific*, individual Governments need to remain committed to macroeconomic

prudence, good governance and flexibility in day-to-day economic management. Simultaneously, Governments must facilitate structural change to enable their economies to maintain competitiveness in a globalizing world economy. For the long term, the greatest challenges for the developing countries in particular emanate from meeting the Millennium Development Goals and agreements on sustainable development reached at the World Summit on Sustainable Development.

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

### **Developed countries**

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

First, in the United States, household spending has been the principal driver of growth since the ending of the IT bubble in 2000. Corporate investment expenditure, despite improved balance sheets, has failed to pick up significantly, until recently at any rate. The signs are that this phase could be coming to an end. Profitability is improving and this, combined with low borrowing costs, is expected to translate into higher investment expenditure in the months ahead. New capital equipment is also likely to be needed after two years of declining investment and on account of the rapid obsolescence of most ICT-related high-tech capital equipment.<sup>2</sup> Nevertheless, corporations remain saddled with enormous debts, a legacy of the post-bubble economy, and any broad-based investment upturn in the near term is likely to be weak.

Second, while there are encouraging signs with regard to corporate capital investment, question marks hang over both the sustainability of household spending in the face of weak employment data and the wider repercussions of the twin deficits, external and fiscal, on growth in the

*Uncertain prospects  
for more robust  
growth in the  
United States  
in 2004*

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<sup>2</sup> The Semiconductor Industry Association is predicting growth of semiconductor sales by 10.1 per cent in 2003 and 16.8 per cent in 2004 (*Bangkok Post*, 6 August 2003).

United States economy over the next 12 months. Consumer and business confidence revived strongly following the formal ending of military action in Iraq but subsequent events in that country have served to undermine both to some extent. As a result, there are signs that spending on durable goods is tending to weaken. In particular, remortgages, a major factor in sustaining consumer spending over the last two or three years, appear to be tailing off as a result of uncertainty on the jobs front. Growth in the United States economy in both 2002 and 2003 has not been accompanied by higher employment. On the contrary, unemployment rose from 5.7 in September 2002 to 6.1 per cent in September 2003 and job losses continue to occur in the manufacturing sector.

***The current account  
and fiscal deficits  
in the United States  
are a worry***

Third, with regard to the simultaneous emergence of the twin deficits, the situation has significant worrisome elements. The United States current account deficit of -5.2 per cent of GDP is the worst in the country's history and there is the likelihood of a further deterioration in 2004. Here the principal concern is that the appetite of foreigners to invest in United States assets could be flagging. In the last two years the composition of capital flows has changed significantly. FDI in the United States has become negative and private portfolio flows financed only about a quarter of the deficit early in 2003, the remainder being funded by short-term speculative capital flows and official purchases of bonds by foreign central banks. This lack of enthusiasm for United States assets has already revealed itself in the decline of the dollar trade-weighted exchange rate by more than 15 per cent between September 2002 and September 2003. A weakening dollar will further dampen capital inflows into the United States unless compensated by higher returns.<sup>3</sup>

On the fiscal side, the deficit has risen above 4.5 per cent of GDP and, until growth revives in a more robust fashion, is unlikely to come down significantly. All things considered, the fiscal deficit is unlikely to boost long-term growth.<sup>4</sup> Recent empirical evidence from the United States, and indeed elsewhere, lends support to the view that budget deficits, over time, push up interest rates. In the United States, there has already been a steepening of the yield curve for bonds in recent months with a rise in long-term interest rates. Furthermore, there is a view, based upon macroeconomic simulations for a variety of differing scenarios, that deficits induced by tax cuts do boost activity in the short term. However, the rise in long-term rates eventually negates the boost owing to the slower capital accumulation caused by higher interest rates. It should also be noted here that, given the increased integration of capital markets, trends in United States interest rates could have a direct bearing on interest rates in other countries, possibly leading to higher global interest rates with negative spillovers on global growth.

Nevertheless, taking together the growing evidence of an upturn with the overall balance of forces operating in the United States economy,

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<sup>3</sup> The United States Federal Reserve, however, stated in October 2003 that interest rates would remain low "for a long time" (*Financial Times*, 28 October 2003).

<sup>4</sup> IMF, *United States: 2003 Article IV Consultation* (Washington, International Monetary Fund, 2003).

the consensus is that, while there is significant uncertainty in making an accurate assessment of prospects for 2004, the risks to growth at this stage are not immediate. It is possible, however, that with a resumption in capital spending, output growth could be at, or very close to, the long-term trend rate of growth of the United States economy of around 3.5 per cent a year in the second half of 2004.

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

*Japanese growth:  
how sustainable?*

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

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

***EU economic  
performance  
remains weak***

For these reasons, the overall judgement is that Japan will not be able to sustain growth at its present pace into 2004. Further, given the poor performance of the Japanese economy over a number of years, its potential growth rate may now be significantly below the 4 per cent a year that Japan achieved in the 1980s. In other words, an upturn in Japanese GDP growth will only be an improvement on its recent performance and not a return to the robust growth of the 1980s.<sup>5</sup>

In late 2002, there were signs that growth in the EU would become stronger in 2003. In the event, the most probable outcome is likely to be a slight deceleration, with growth in France, Germany, Italy and Netherlands slowing perceptibly in mid-2003, registering negative growth in the second quarter of 2003. Only the United Kingdom of Great Britain and Northern Ireland is an exception to this trend but there too growth is turning out to be somewhat weaker than first forecast. Unemployment remains high in all the main EU economies, again with the exception of the United Kingdom.

The below-trend performance of the EU is turning out to be deeper and more prolonged than anticipated, especially following the introduction of the euro.<sup>6</sup> More disquieting, it is displaying some of the negative traits of the Japanese economy of the last decade. For example, there is general agreement that long-term structural factors, rather than cyclical forces or short-term geopolitical shocks and uncertainties, are hampering the revival of growth in the EU. This is most evident in Germany, the largest EU economy, where the high cost of the welfare State (severely compounded by the costs of reunification) has recently been exacerbated by the problems of an overvalued exchange rate. In 2003, the counterpart of a weakening dollar has been a stronger euro that has seen its trade-weighted exchange rate appreciate by more than 10 per cent in the 12 months from September 2002 to mid-September 2003 and by much more against the dollar on a bilateral basis. Germany's problem is now likely to be experienced by the EU as a whole as a stronger euro reduces the potential for export growth outside the euro zone.

In virtually all EU economies, with the exception of the United Kingdom, considerable product and labour market rigidities also remain. These are reflected in low rates of corporate investment and of productivity growth, especially over the previous five years. These rigidities came into sharp relief following the ending of the asset price bubble of the late 1990s, when unemployment climbed upwards and has remained high. More determined reform efforts in France and Germany have not yet garnered the required political support for implementation, while room for fiscal manoeuvre to stimulate growth is limited given the already high deficits in the EU. There is some scope for monetary easing given the undershooting of inflation targets, but the European Central Bank has not shown a willingness to cut interest rates pre-emptively in anticipation of the reduced price pressures

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<sup>5</sup> BIS, *73<sup>rd</sup> Annual Report* (Basel, Bank for International Settlements, 2003).

<sup>6</sup> IMF, *World Economic Outlook, September 2003* (Washington, International Monetary Fund, 2003).



that should follow the appreciation of the euro. This has almost certainly weakened the momentum of growth in the euro zone. As a result, the short-term outlook is weaker than assessed 12 months ago, despite the more optimistic forward-looking business surveys in a number of EU economies.

### **Developing countries**

The moderate but uneven recovery in the global economy in 2002, interrupted by the pre-war uncertainties of the Iraq crisis, was reflected in an even sharper divergence of growth rates in the developing countries. While there was relatively strong growth in the Asian economies, led by China, in 2002, other regions fared less well. In 2002, Latin American economies collectively experienced a contraction in output and growth slowed, or was flat, in other developing countries, including the oil-exporting countries, with the exception of Central and South Asia. In 2003, the rapid ending of military hostilities in Iraq in the first quarter was followed by the SARS crisis in the second quarter. However, the two events are reckoned to have had only a small impact on the developing countries, even within the Asian and Pacific region. Growth rates dipped in the second quarter of 2003 but the available indications are that in the second half of the year growth will more than offset the effects of the Iraq war and SARS-related slowdown earlier in the year. Indeed, according to World Bank estimates,<sup>7</sup> developing countries as a whole should exceed 2002 growth by more than 1 percentage point in 2003. Once again, the Asian economies will be the best-performing group, with other developing countries also improving upon their performance in 2002. Growth in the region is in part cyclical following the 2001 downturn and in part driven by rapidly shifting production patterns in East and South-East Asia.

### ***Divergent growth in developing countries***

The recent performance of the developing countries owes much to the strength of world trade (see table 2) and to stronger commodity prices (see table 3). In 2002, world trade volumes grew by around 3 per cent, following a small decline in 2001, and non-oil commodity prices recovered after more than a decade of decline. Weakness in manufactured goods prices was also reversed, although prices firmed only marginally. The most striking feature of global trading trends in 2002 was that while import demand by the developed countries grew by 1.3 per cent, that by developing countries grew by 5.6 per cent (for a graphic presentation, see figure I). On the basis of currently available information, these trends are likely to have strengthened significantly in 2003. World trade growth is expected to reach 6.7 per cent, with developed country import demand growing at 5.3 per cent and developing country import demand growing at almost double that rate, namely, over 10 per cent. The more rapid growth of international trade by the developing countries is particularly evident in the Asian region, where the developing economies are again expected to outperform other developing countries in 2003. Broadly speaking, these trends are expected to continue into 2004.

### ***Rapid growth of trade in developing countries***

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<sup>7</sup> World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).

**Table 2. World trade and prices,<sup>a</sup> 1991-2003**

	<i>Annual percentage changes</i>					
	<i>1991-2000</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003<sup>b</sup></i>
Trade volumes	7.3	5.8	13.3	-0.6	3.3	2.9
Trade prices (in US dollars)						
Manufactures	-0.9	-1.8	-4.7	-2.4	2.6	12.8
Oil	2.1	37.5	57.0	-14.0	2.8	14.2
Other commodities	-0.9	-6.7	4.5	-4.0	0.6	5.0
Terms of trade						
Developed economies <sup>c</sup>	0.2	0.1	-2.9	0.4	0.8	1.1
Developing economies	0.0	5.8	7.2	-3.9	1.8	-0.4
<p><i>Sources:</i> IMF, <i>World Economic Outlook</i>, cited in BIS, <i>72<sup>nd</sup> Annual Report</i> (Basel, Bank for International Settlements, 2002); and IMF, <i>World Economic Outlook, September 2003: Public Debt in Emerging Markets</i> (Washington, International Monetary Fund, 2003).</p> <p><sup>a</sup> Goods only.</p> <p><sup>b</sup> IMF forecast.</p> <p><sup>c</sup> Advanced industrial economies plus newly industrializing Asian economies (Hong Kong, China; Republic of Korea; Singapore; and Taiwan Province of China).</p>						

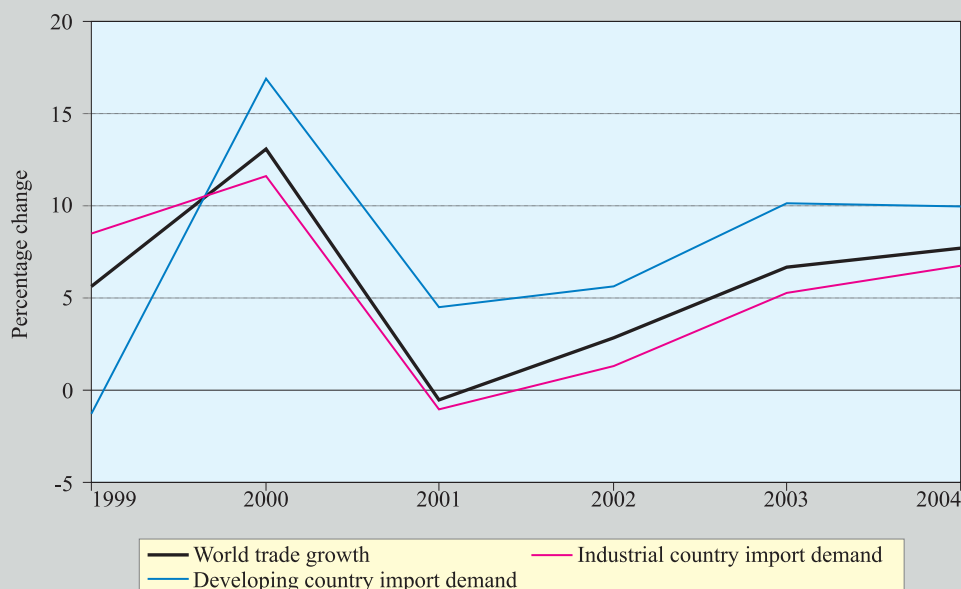
**Table 3. Indices of major commodity prices, 1996-2003**

(1995= 100)

	<i>1996</i>	<i>1997</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003 May</i>
Palm oil (Malaysia)	84.6	86.8	49.2	45.6	62.1	66.2
Rice (Thailand)	105.4	94.3	63.5	53.8	59.8	61.6
Rubber (Malaysia)	88.7	64.4	43.7	38.0	48.7	60.0
Sugar (US import price)	97.0	95.1	84.1	92.5	90.8	94.8
Tea (Sri Lanka)	126.5	134.5	119.9	117.1	113.4	..
Timber:						
Hardwood logs (Malaysia)	98.5	92.4	73.8	62.2	63.1	71.1
Hardwood sawnwood (Malaysia)	100.1	89.5	80.9	66.0	70.0	75.2
Softwood logs (United States)	105.3	95.6	93.3	81.4	75.3	80.7
Softwood sawnwood (United States)	103.1	97.8	94.7	94.1	90.9	91.9
<p><i>Sources:</i> IMF, <i>International Financial Statistics Yearbook 2002</i> (Washington, International Monetary Fund, 2002); and <i>International Financial Statistics</i> (Washington, International Monetary Fund, July 2003).</p>						



Figure I. External environment for developing countries, 1999-2004



Source: World Bank, *Global Economic Prospects and the developing countries 2003* (Washington, World Bank, 2003)

Recovery in global high-tech markets has played a pivotal role in world trade growth in 2002 and 2003. After the demand for semiconductors and related equipment collapsed in 2001, there was an expectation that recovery, when it came, would be sharp. ICT and its components are products with rapid obsolescence, a feature that leads to periods of very high growth followed by sharp slowdowns. Manufacturers are often reduced to being price takers as the amplitude of the production and demand cycles can, and has, led to overproduction. This is an area in which both East and South-East Asia have a strong competitive advantage. Furthermore, as noted in previous discussions on this subject, production of ICT is heavily “componentized”, leading to strong intraregional trade in inputs with the final product often, but not always, exported outside the region. Table 4 shows the buoyancy of developing country exports, with export growth in general outpacing import growth in the main developed economies, reflecting the increase in trade between developing countries.

What impact will these developments have on developing countries in general and on the Asian economies in particular? As already observed, sharply varied growth patterns are likely to characterize economic activity across countries and regions in the short run. For instance, growth prospects in East and South-East Asia and, to a somewhat lesser degree, South Asia, are more buoyant than in other developing countries. These countries are both major centres of manufacturing and important commodity producers. Aided by a low interest rate environment and the inventory dynamics of low working capital costs, production of ICT is on a rising trend. As costs and prices have declined, the demand for new consumer products, such as

*Developing economies  
of the ESCAP region  
to enjoy stronger  
growth in 2004*

**Table 4. Rate of growth of exports and imports, selected ESCAP economies**

	2000		2001		2002		2003 <sup>a</sup>	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Bangladesh	23.7	7.8	2.6	0.1	-5.1	-13.2	19.9	6.3
China	27.8	35.8	7.0	8.2	22.1	21.3	34.0	39.9
Hong Kong, China	16.2	18.7	-6.0	-5.6	-29.6	-0.1	4.1	13.8
India	18.7	5.1	7.1	12.3	9.7	12.3	18.4	14.7
Indonesia	27.6	39.6	-9.3	-7.6	1.5	1.1	25.6	30.6
Iran (Islamic Republic of)	34.5	29.7	-8.3	11.6	-4.6	14.0	35.6	20.3
Malaysia	16.1	25.5	-10.1	-10.1	9.7	11.0	19.7	13.2
Pakistan	8.5	7.3	0.6	-7.7	7.4	10.1	28.0	31.1
Philippines	7.3	2.1	-15.6	-5.8	23.6	44.5	11.3	14.2
Republic of Korea	19.6	34.0	-12.8	-12.1	7.8	7.8	18.1	21.6
Russian Federation	42.2	11.8	-19.9	9.0	29.9	23.4	25.7	24.4
Singapore	20.2	21.2	-11.8	-13.8	2.8	0.4	16.7	15.3
Taiwan Province of China	22.0	26.5	-17.1	-23.4	6.3	5.0	6.8	9.4
Thailand	17.9	23.0	-5.6	0.2	5.7	4.3	20.8	18.8
Turkey	4.5	34.0	12.8	-24.1	11.9	22.8	27.0	37.8
Viet Nam	25.5	33.2	-6.9	6.1	14.5	15.5	46.9	19.7
<b>Memo:</b>								
United States	11.8	18.1	-5.3	-4.7	-5.2	1.9	4.3	14.3
Japan	14.1	22.1	-15.6	-8.0	3.3	-3.4	13.5	17.9
European Union	2.9	6.0	0.5	-1.7	5.4	3.3	11.3	17.8
<i>Sources:</i> IMF, <i>Direction of Trade Statistics</i> (CD-ROM), September 2003; and national sources.								
<sup>a</sup> Data relate to the first quarter of 2003, except for Taiwan Province of China, in which case the data refer to the second quarter.								

mobile telephones, personal computers and household electronics, has risen rapidly. In addition, buoyancy in the manufacturing sector has spilled over into services. The resultant strong GDP growth has translated into rising incomes; these in turn have boosted the demand for, and the production of, a broader range of goods, particularly cars, and this has resulted in remarkable vibrancy in intraregional trade in East and South-East Asia.

This positive overview should not, however, be construed to imply that, from a forward-looking perspective, risks for developing countries of the region are now non-existent or negligible. The recent trading dynamism of China, for example, has been built upon a rapid increase in the global market share for a wide range of products. Although China's market share still constitutes only 5 per cent of global exports, it has already generated a degree of resentment in several countries. Retaliatory action in the form of trade barriers thus cannot be ruled out. The dynamics of high-tech markets, with their history of boom and bust, is another potential hazard. Intraregional trade itself owes some of its recent strength to the growth of household incomes, reflected in buoyant consumer demand, in the developing countries

of Asia. This demand has been stimulated in part by looser fiscal and monetary policies. It is self-evident that there are limits beyond which the easing of fiscal and monetary policies is neither possible nor desirable. Hence, all developing countries in the Asian and Pacific region are faced with major policy trade-offs in maintaining the momentum of growth in 2004. The likely impact of the global economic environment and the policy issues it raises for the various subregions of ESCAP are discussed more fully elsewhere.

### **Financial market and related developments**

Side by side with trade, financial markets play an important role in the global economy. Apart from the provision of finance, financial markets are a medium for the transmission of the collective judgements of investors and, as such, they act as monitors and bellwethers, not merely in matters of corporate performance but also in the performance of national Governments. With the rapid spread of globalization since the early 1990s, financial markets, despite bringing in a wider pool of investors and savers within their ambit, have been seen to be prone to excessive swings in sentiment.<sup>8</sup> In consequence, their ability to provide appropriate pricing information to investors has been adversely affected. Over the years, markets have also developed a tendency to overshoot or undershoot equilibrium values, be it equity or bond prices or exchange rates. The functioning of financial markets in themselves thus creates significant policy issues. Regardless of their deficiencies, however, financial markets are the primary interface between the real economy and the preferences of savers and investors all over the world. As much as the real economy drives financial markets, the latter equally have an impact on the real economy.

*The international  
financial system ...*

The bursting of the equity bubble, unfavourable geopolitical developments and corporate governance scandals have severely tested global financial markets in recent years. By and large, however, the markets have shown considerable resilience in coping with these events. In fact, by late September 2003, stock markets virtually across the world had risen by a fifth or more, reflecting increased confidence in the future. Bond markets had also risen, but by less, as investors were beginning to discount the likelihood of further decreases in interest rates. Indeed, yields on long-dated bonds had begun to rise in the second quarter of 2003 as investors realized that the large United States fiscal deficit would inevitably mean higher interest rates at the longer end of the time spectrum in due course. Major exchange rate realignments had also taken place, primarily the depreciation of the United States dollar and appreciation of the euro, but these had not plunged the markets as a whole into turmoil.<sup>9</sup>

*... shows resilience ...*

A part of the mood of optimism that began in 2002 has been based upon real improvements in corporate balance sheets and performance, a process

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<sup>8</sup> IMF, *Global Financial Stability Report: Market Developments and Issues* (Washington, International Monetary Fund, September 2003).

<sup>9</sup> BIS, *BIS Quarterly Review, June 2003: International Banking and Financial Market Developments* (Basel, Bank for International Settlements, 2003).

aided by the low interest rate environment. Another part, however, is based upon the way investors have been reacting to the prospect of a prolonged period of low interest rates; they are being pushed, willy-nilly, into seeking higher yields for their savings and risk aversion is becoming less strong, though in an uneven fashion. In the process, however, there is the danger that both equity and bond prices may be bid up, once more, to values above those that could be justified by underlying corporate earnings or by a realistic perception of the balance of risks involved in such judgements, especially the lack of evidence so far of a solid recovery in the global economy. In other words, the equity and bond markets may be becoming excessively inflated, a phenomenon that is evident in both developed and developing economies.

***... although private capital flows to developing economies are likely to decline in 2004***

As a result of the upsurge in the equity and bond markets in 2002 and 2003, private capital flows to developing countries, as well as those in Asia, rose significantly, with portfolio flows and FDI proving particularly buoyant (see table 5). The former are usually of a short-term nature and can be easily reversed. Moreover, they are instrumental in inflating asset price bubbles. FDI flows, by contrast, are long-term, usually with an ongoing contribution to both production and exports. FDI in Asia has been buoyant for some time, with China leading the way. Manufacturing continues to shift to the region to take advantage of good infrastructure, large domestic markets and productive, low-cost labour. However, prospects for 2004 indicate that some decline is on the cards in view of the apparent overcapacity in many manufacturing activities. Investor nervousness relating to the developing countries could rise as perceptions regarding the fiscal situation in many of those countries become less sanguine. At the same time, the emergence of large imbalances in the global economy, such as the United States current account and fiscal deficits and how the two are likely to be financed, may presage a period of heightened exchange rate instability with investors seeking safe-haven-type outlets for their savings, such as precious metals. In such a scenario, investors would tend to eschew cross-border transactions or demand extra returns.

***Exchange rates of Asian currencies are tending to appreciate***

Up to the end of September 2003, realignments in exchange rates had been borne primarily by the euro, aided by a number of smaller developed and developing country currencies. Any further depreciation of the United States dollar in the months ahead would, of necessity, involve a wider range of economies and currencies. In those circumstances, Asian economies would be directly affected, given the size of the external trade in their economies and the persistence of large current account surpluses, which have resulted in the build-up of massive foreign exchange reserves in some economies of the Asian and Pacific region. The export sectors in most Asian economies play a much bigger role than in the developing countries as a group and any significant realignment of exchange rates, especially those in which a degree of overshooting is involved, could imply significant short-term changes in competitiveness and, perhaps, in trade flows. For most developing countries, this process, already in evidence to some extent, could then involve changes in the output mix and redeployment of productive resources compressed into a short period of time.

**Table 5. Net capital flows<sup>a</sup> of developing economies and developing Asia, 1996-2004***(Billions of US dollars)*

	1996	1997	1998	1999	2000	2001	2002	2003	2004
<b>Total<sup>b</sup></b>									
Net private capital flows <sup>c</sup>	226.5	132.6	77.8	86.7	47.1	42.7	80.3	113.1	93.8
Net private direct investment	116.2	143.9	156.0	175.4	165.7	180.9	142.9	143.9	145.2
Net private portfolio investment	83.2	63.3	11.0	19.5	-3.8	-51.2	-52.9	-22.9	-16.8
Net other private capital flows	27.1	-74.6	-89.2	-108.2	-114.9	-87.1	-9.7	-8.0	-34.6
Net official flows	-1.8	42.6	57.6	7.6	-12.8	21.1	7.1	10.1	-16.0
Changes in reserves <sup>d</sup>	-104.6	-71.1	-49.7	-88.4	-117.2	-122.4	-211.6	-255.1	-148.5
<b>Developing Asia<sup>e</sup></b>									
Net private capital flows <sup>c</sup>	124.6	10.8	-42.1	4.6	-3.3	25.2	57.0	62.4	13.7
Net private direct investment	55.0	59.8	60.9	60.6	58.4	50.9	57.8	66.5	59.6
Net private portfolio investment	30.0	7.3	-17.2	11.5	4.3	-13.5	-21.1	-10.9	-16.5
Net other private capital flows	39.6	-56.3	-85.8	-67.5	-66.0	-12.2	20.2	6.8	-29.4
Net official flows	-13.0	17.1	26.1	3.9	1.9	-9.7	-9.9	-7.1	-7.6
Changes in reserves <sup>d</sup>	-46.9	-15.1	-67.8	-78.9	-49.0	-84.9	-167.1	-159.9	-93.7
<b>Memorandum:</b>									
Hong Kong, China									
Net private capital flows <sup>c</sup>	-7.1	10.8	-8.5	1.1	4.2	-6.6	-24.9	-27.7	-25.6
<p><i>Source:</i> IMF, <i>World Economic Outlook, September 2003: Public Debt in Emerging Markets</i> (Washington, International Monetary Fund, 2003).</p> <p><sup>a</sup> Net capital flows comprise net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private borrowing.</p> <p><sup>b</sup> Excluding Hong Kong, China.</p> <p><sup>c</sup> Because of data limitations, may include some official flows.</p> <p><sup>d</sup> A minus sign indicates an increase.</p> <p><sup>e</sup> Including Republic of Korea, Singapore and Taiwan Province of China.</p>									

One of the puzzles in the current situation relates to the behaviour of real estate, particularly housing prices. Housing and real estate prices have risen in virtually all countries of the world and their future course has important policy implications. Equity holdings and housing are the largest components of household wealth in developed countries, and increasingly so also in developing countries, and their values tend to move together over long periods. The same relationship holds true in the developing countries of the ESCAP region, where, if anything, the scarcity premium on urban real estate is even higher. However, three years after the equity markets began to decline real estate prices have continued to rise in most countries. Despite some cooling-off in recent months, the prices remain at historical highs in relation to disposable earnings. Indeed, there appears to be no immediate prospect of a price correction in most countries.

***Low interest rates  
fuelling the real  
estate boom***

A key factor in the housing boom has been the low interest rate environment in the region. The low rates have allowed borrowers to take on more loans relative to income, given the lower cost of servicing their debts. In the process, they have added to the market demand for housing and for real estate in general. Low interest rates have also forced savers to switch investments from financial assets to bricks and mortar. Some observers fear the creation of a bubble in housing with its attendant downside risks, as an increasing proportion of banking assets are, once again as in 1995-1997, invested in real estate. The majority of housing loans are tied to long-term interest rates and these have risen by approximately 40 basis points in the United States relative to 12 months ago.<sup>10</sup> As already mentioned, in an integrated global financial system the changing structure of interest rates in the United States will not remain confined to that country and will inevitably spill over into other markets. A firming trend in long-term interest rates will have an impact not only on the housing market but also on household consumption, especially debt-financed consumption. In other words, sustaining global growth in the months ahead could become problematic and require a policy approach which would involve the continuation of the low interest rate environment and simultaneously grappling with the possible emergence of asset bubbles in a number of economies.

**Prospects for the ESCAP region**

***Investment pickup  
to strengthen  
growth momentum  
in the ESCAP region***

Taking 2003 as a whole, despite the war in Iraq and the SARS crisis, the developing countries of the ESCAP region are likely to experience collective GDP growth very close to the rate achieved in 2002, when they were the fastest-growing economies in the world. Furthermore, on current trends, growth is expected to pick up additional momentum in 2004 should the global economy build up steam as posited earlier, via higher corporate investment expenditures, in the remaining months of 2003 and into 2004. Estimates for 2003 and forecasts for the ESCAP region for 2004 are given in table 6.

Comparable with the pattern in 2002, growth in 2003 has once again been driven by a combination of higher net exports, especially exports within the region, and buoyant domestic consumer demand. The short-term outlook for higher net exports, however, has to be seen in the light of a still rather fitful global recovery that could take time to become more firmly established, and a weaker dollar that has put upward pressure on a number of currencies in the region. There is thus the possibility of a loss of export momentum for some economies in the months ahead. Domestic policy measures, given their current constraints, may not be able to fully offset or mitigate changes in the external environment, at least in the short run.

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<sup>10</sup> *The Economist*, 18 October 2003.



**Table 6. Rates of economic growth of selected developing economies and North and Central Asian economies of the ESCAP region, 2001-2004**

(Percentage)

	<i>Real GDP</i>			
	<i>2001</i>	<i>2002</i>	<i>2003<sup>a</sup></i>	<i>2004<sup>b</sup></i>
<b>South and South-West Asia<sup>c</sup></b>	2.2	5.4	5.6	5.9
Bangladesh	5.3	4.4	5.3	5.7
India	5.6	4.4	6.0	6.3
Iran (Islamic Republic of)	4.8	6.5	6.7	6.8
Pakistan	2.7	4.4	5.1	5.3
Turkey	-7.5	7.8	4.6	5.0
<b>South-East Asia</b>	1.9	4.2	4.1	5.1
Indonesia	3.4	3.7	3.6	4.3
Malaysia	0.4	4.2	4.5	4.5
Philippines	3.4	4.4	4.5	5.0
Singapore	-2.4	2.2	1.0	4.9
Thailand	1.9	5.3	6.0	6.5
Viet Nam	6.9	7.0	6.9	7.2
<b>East and North-East Asia</b>	4.2	6.4	5.4	6.5
China	7.3	8.0	8.0	7.9
Hong Kong, China	0.6	2.3	2.0	4.8
Republic of Korea	3.1	6.3	3.1	5.0
Taiwan Province of China	-2.2	3.5	3.2	5.4
<b>North and Central Asia</b>	5.9	5.0	6.4	4.5
Russian Federation	5.0	4.3	6.0	4.0

*Sources:* ESCAP, based on IMF, *International Financial Statistics*, vol. LVI, No. 9 (Washington, International Monetary Fund, September 2003); ADB, *Key Indicators of Developing Asian and Pacific Countries 2003*, vol. 34 (Manila, Asian Development Bank, 2003) and *Asian Development Outlook 2003 Update* (Manila, Asian Development Bank, 2003); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2003), various issues; web site of the Inter-State Statistical Committee of the Commonwealth of Independent States, < www.cisstat.com > ; and national sources.

<sup>a</sup> Estimate.

<sup>b</sup> Forecast/target.

<sup>c</sup> The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2003/04 = 2003 for India and the Islamic Republic of Iran, and fiscal year 2002/03 = 2003 for Bangladesh and Pakistan.

Domestic demand has been stimulated by explicit growth-enhancing domestic policies in the shape of higher fiscal spending and lower interest rates. After nearly three years of fiscal and monetary easing, additional scope in both areas of policy is limited. Public debt as a proportion of GDP has risen significantly in a number of countries and is perhaps already close to its upper limit (table 7). Although inflation remains low and most countries run balance-of-payments surpluses, additional fiscal or monetary stimulus is nonetheless conditioned by external market perceptions. Market participants, rightly or wrongly, take a negative view of rising domestic debt; this could impinge upon the ongoing debt restructuring of corporations and banks in the region. Thus, new public debt has to form part of a longer-term strategy of

***Need for developing economies of the ESCAP region to stabilize public debt and restrain credit growth***

**Table 7. Debt indicators for selected Asian economies**

	<i>Public debt/GDP</i>			<i>External debt/exports</i>		
	<i>1996</i>	<i>2000</i>	<i>2002</i>	<i>1996</i>	<i>2000</i>	<i>2002</i>
Bangladesh	44 <sup>a</sup>	48	53	327	236	209 <sup>b</sup>
China	7	15	16	85	60	54
India	57	67	73	283	236	216
Indonesia	24	82	92	259	217	231
Malaysia	35	37	46	51	43	49
Pakistan	79 <sup>c</sup>	92	96	287	338	322
Philippines	53	66	74	197	134	158
Republic of Korea	8	17	22	126	78	82
Thailand	15	57	54	194	115	95
Turkey	38	51	100 <sup>b</sup>	175	227	228 <sup>b</sup>

*Sources:* BIS, *73<sup>rd</sup> Annual Report* (Basel, Bank for International Settlements, 2003); World Bank, *World Development Indicators* (Washington, World Bank), various issues; IMF, *International Financial Statistics*, vol. LVI, No. 9 (Washington, International Monetary Fund, September 2003).

<sup>a</sup> 1997/98.  
<sup>b</sup> 2001.  
<sup>c</sup> 1993.

keeping the debt-to-GDP ratio stable. The same constraints apply to the continuation of low interest rates. These have been accompanied in some countries by unsustainably rapid credit growth that will require corrective policy action before too long. However, by and large, the balance of risks vis-à-vis the near-term outlook remains neutral, with some likelihood of growth picking up in the second half of 2004. In the following paragraphs, the prospects for each subregion are briefly discussed. The discussion is performed restricted to the economies for which the requisite data for 2003 and forecasts for 2004 are available.

### ***Growth to pickup in South Asia***

In South Asia, GDP growth picked up in 2003 compared with 2002. India, the largest economy in this subregion, is likely to see a rise in its GDP growth rate in 2003 relative to 2002. A good monsoon has boosted agricultural production and raised the GDP growth rate. A further pickup in momentum is expected in 2004. The Indian economy appears to have boosted its GDP growth significantly over the last few years, notwithstanding slow progress in fiscal and structural reform. The question remains whether this higher pace of growth is sustainable over the medium term. In Bangladesh and Pakistan, too, the GDP growth rate has picked up in 2003 and this higher pace is likely to be sustained in 2004. In South Asia as a whole, the contribution of net exports to GDP growth has risen substantially over the

last two to three years. This has added to the growing strength of domestic consumption and investment demand, particularly in infrastructure. Improved inflows of remittances and foreign capital have improved the foreign exchange reserve position significantly in nearly all countries in South Asia. Exchange rates have appreciated relative to the dollar as a result. In the case of India and Pakistan, higher inflows of foreign resources have led to balance-of-payments current account surpluses. Although prospects for 2004 are for a pickup in GDP growth rates, especially in India and Pakistan, uncertainties remain. These are primarily external and could affect the contribution from net exports adversely if growth in the global economy remains tentative. Periodic increases in tension between India and Pakistan and the lack of stability in Afghanistan add to the overall climate of uncertainty in the subregion.

In South-East Asia, 2003 growth was particularly strong in Thailand, driven, for the most part, by buoyant consumption aided by a sharp upturn in exports. Firmer commodity and manufactured goods prices strengthened export earnings. These factors also applied to Viet Nam, where GDP growth remained buoyant in 2003. Growth was less strong in Indonesia and the Philippines, where the security situation tended to dampen business confidence. Singapore was the worst-affected economy in the subregion, having lost ground in consumer confidence sharply during the SARS crisis. However, the terrorist attacks overall and SARS appear to have had only a temporary economic impact in the subregion as a whole. SARS has adversely affected tourism and related activities, such as air travel, but was confined to the second quarter of 2003.<sup>11</sup> Tourism accounts for 4-6 per cent of GDP in South-East Asia generally and any temporary setback can be overcome either in the other components of GDP or later in the year by a revival in tourism itself. The outlook for 2004 is thus positive, barring any unforeseeable negative shocks such as terrorism. Rising exports to China in 2003 should continue to grow in 2004. Domestically, strong consumption growth, facilitated by easier macroeconomic policies, is likely to be sustained but could come up against rising personal debt levels and the need to begin fiscal consolidation in the near future. Subject to these qualifications, the subregion should enjoy stronger growth in 2004.

***South-East Asia  
demonstrates  
its resilience***

East Asia performed strongly in 2003, led by robust growth in China. In contrast, the Republic of Korea saw its GDP growth rate decline significantly. In China, growth was particularly robust in the first half of the year. Both domestic demand and exports have supported growth in China. Domestic demand is mainly investment-driven in China, but rapidly rising middle-class incomes are boosting personal consumption expenditure as well, leading to the production of a wide array of consumer goods and a surge in FDI and imports. The slowdown in the Republic of Korea was led by a sharp decline in domestic demand, caused by a fall in credit growth as the authorities sought to head off a crisis of personal indebtedness. Perhaps not

***Strong growth  
in China***

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<sup>11</sup> According to the World Tourism Organization, tourism overall grew in 2002 but growth was uneven. A similar pattern of uneven growth is expected in 2003.

unrelated to this action, there was also an easing of the housing boom. Accompanying the slowdown in domestic demand, export growth also slowed owing to price softness in ICT. In 2003, growth was less strong in Taiwan Province of China, and Hong Kong, China, barely skirted recession. The hitherto vibrant manufacturing sector in Taiwan Province of China remains tied to the dynamics of boom and bust in the global high-tech industry. Similar to the situation in Japan in the 1980s and 1990s, a “hollowing out” of manufacturing activity is under way, with many factories relocating from Taiwan Province of China to China. Unemployment and falling property prices in Hong Kong, China, have shaken consumer confidence and, as in Japan, the economy has become mired in deflation, prices having fallen for five straight years. Very low inflation also affects China to some extent, and Taiwan Province of China has seen no rise in prices for three years. Deflation, and even very low rates of inflation, tend to make the real cost of borrowing higher with unchanged interest rates. In both Taiwan Province of China and Hong Kong, China, interest rates are currently around 1 per cent and cannot be reduced much further. Notwithstanding these policy conundrums, prospects for the subregion in 2004 are that existing GDP growth rates will be broadly maintained, with some acceleration likely in the Republic of Korea and Hong Kong, China, as the global economy gains strength.

***Growth improves in  
the least developed  
countries and Pacific  
island economies***

On the basis of tentative information, GDP growth picked up in 2003 in the least developed countries. This was primarily the result of improved export growth as commodity prices rose. Least developed country exports are, however, still concentrated in a relatively narrow range of items, although newer exports such as garments are making a major contribution to exports and GDP growth. Tourism was adversely affected as concerns about security kept tourists away from several of the least developed countries, and especially from countries such as Nepal, where the security situation continues to give concern. On the positive side, inflationary pressures remained muted in 2003. For the future, taking the least developed countries as a whole, much depends upon the recovery of global growth in 2004 and more particularly upon growth in the ESCAP region itself, with which those countries are becoming increasingly integrated.

As in the case of the least developed countries, the Pacific island economies matched the rest of the ESCAP region in showing an improvement in GDP growth in 2003. The most visible turnaround appears to have occurred in Solomon Islands. Despite the fact that the Pacific island countries are away from the areas of tension, tourism displays a mixed trend. In 2003, the SARS-related downturn in international travel in the region also affected the Pacific island economies. For 2004, overall prospects are for GDP growth to match or exceed the performance in 2003, depending upon the strength of GDP growth in Australia and New Zealand.

Australia and New Zealand, with buoyant domestic demand, continued to show strong growth in 2003. The consensus view is that strong domestic demand should preserve the current momentum of growth in both countries, although the sharp appreciation of both the Australian and New Zealand dollars in 2003 could dampen export growth.

In Central Asia and the Russian Federation, growth has been led by buoyant private consumption and investment in the energy sector in which large inflows of FDI are currently taking place. In the Russian Federation, some deceleration from the over 7 per cent GDP growth recorded up to the second quarter of 2003 on a year-on-year basis is likely in the later part of 2003. In addition, with energy prices now entering a period of stability, 2004 should also witness easing in the overall GDP growth rate to a more sustainable 5 per cent.

***Growth to slow  
in Central Asia  
and the Russian  
Federation***

### **Near-term policy issues**

The relatively quick end to the war in Iraq, with minimal disruption of the energy markets and limited impact of the SARS crisis, suggests, on the face of it, that the main uncertainties facing the ESCAP region have been resolved. Both consumer demand and fixed investment should benefit, particularly in countries where such spending has been weak in recent months. In addition, the need to rebuild inventories from the current low levels should also contribute to output growth. Nevertheless, there is currently no unambiguous mood of optimism regarding the future even though the relevant signs and forecasts indicate an improvement in the global economy in 2004. The failure of the Fifth WTO Ministerial Meeting to push forward the Doha Development Agenda might suggest systemic weaknesses in the WTO-driven model of trade negotiations (see box). A further failure at WTO could undermine cross-border investment flows to a significant extent.

Some of this circumspection also relates to the aftermath of the twin bubbles, the Japanese bubble of the 1980s and the United States dot com bubble of the late 1990s, and their residues of high corporate debt levels, excess production capacity, especially in manufacturing, and low equity valuations. Both the Japanese and United States experiences indicate that the ending of asset bubbles tends to feed back into the real economy and the ensuing indebtedness and systemic problems in the financial sector can take a very long time to resolve. Another underlying fear could perhaps be of a new terrorist outrage, an event that makes investors and consumers nervous by its very unpredictability.

***The global economy  
faces a number  
of uncertainties***

The unwinding of external and fiscal imbalances in the United States, EU and Japan will have implications for the Asian and Pacific region, where a number of emerging economies have built up large balance-of-payments surpluses. These imbalances, reflecting the persistent and sustained external deficit of the United States, virtually the world's single engine of growth, have already contributed to the volatility of exchange rates, in particular the depreciation of the dollar. Further abrupt exchange rate adjustments cannot rebalance global external gaps on their own. Neither can Japan, China and other Asian countries or the EU, at this stage, compensate for slower growth in the United States, nor can fiscal and external deficits in that country be adjusted quickly. This implies the need for a more coordinated and smooth adjustment process from which no country can be immune in the face of increased global integration. The global situation will place a high premium on greater international and regional cooperation through both formal and informal channels.

### **Post-Cancún<sup>a</sup>**

The Fifth WTO Ministerial Conference at Cancún, Mexico, can no doubt be described as unparalleled in the multilateral trading environment: the largest number of members (148 with over 30 observers), over 4000 trade negotiators, the most ambitious agenda and, therefore, a lost opportunity. Not surprisingly, ever since that Sunday afternoon on 14 September, various commentators have been engaged in finger-pointing, seeking to identify a country or a group of countries as being most at fault for the Cancún collapse. This is, of course, the wrong approach if the talks are to be revived. The collapse is the collective responsibility of all as the benefits of multilateral trade liberalization are enjoyed by all. While trade liberalization benefits are not equally shared by all the liberalizing members, it is true that all countries benefit.

The Doha-mandated negotiating agenda is focused on development and on helping the poor, in particular. Successful completion of the Doha Round therefore has great potential to benefit both developing and developed nations alike: by World Bank estimates, it could bring 144 million people out of poverty by 2015, the year that world leaders set as a target for halving world poverty. It is further estimated that global income increases would be between US\$ 290 billion and US\$ 520 billion a year.

Liberalization of agriculture is one of the most important drivers of these benefits. Not surprisingly, it was first on the negotiating list. About three quarters of the world's poor live and work in rural areas and depend on agriculture for their survival. The Uruguay Round left much to be done on liberalizing agricultural trade and making the trading environment fairer. While some reforms took place, OECD subsidy payments to farmers are about six times the amount spent on ODA. Furthermore, developing countries continue to face high tariff and non-tariff barriers as well as increased pressure to open up their own domestic markets to heavily subsidized developed country products. At the same time, it is also true that the average levels of bound tariffs in the developing countries, in agriculture and in other sectors, are far higher than the levels prevailing in the developed countries. This goes against the fundamental economic justification for liberalizing trade: free trade first and foremost serves the interests of a country pursuing such a free trade policy.

Another two crucial sectors for fulfilling development and poverty reduction goals are the labour-intensive manufacturing sector and services. With respect to labour-intensive manufacturing, particularly textiles and clothing, for various reasons both developed and developing countries still maintain high trade barriers. Increasingly these barriers consist of safeguards, countervailing duties and anti-dumping measures which raise the cost of trade, especially for developing countries with limited resources to have recourse to dispute settlement processes.

Negotiation of further liberalization in services has also not moved forward as much as it could have as development depends heavily on access to high-quality, low-cost services. So far the liberalization of services reflects to a large extent the export interests of the developed countries, leaving aside subsectors of special interest for developing countries such as outsourcing and the movement of natural persons.

There was another big topic on the agenda – the so-called Singapore issues. Increasingly, at least some of these issues (competition, investment, government procurement and trade facilitation) appear to be moving away from the negotiating table. In the end, it was these issues that pushed the talks to an early closure without agreement. It turned out that the issues with the less direct economic impact for most of the countries prevented them from seriously addressing those such as agriculture and market access which would have brought much more substantive benefits to all.

In short, the talks failed for many reasons, including missed deadlines, misunderstandings about the stakes and the changed balance and dynamics of a much larger WTO. This should not prevent members from maintaining commitment to liberalizing trade, enhancing growth prospects and reducing poverty. Ways must be found to revive the process of meeting the Doha development goals. This means realizing that multilateral trade liberalization should not be taken for granted and that it does not happen on its own. It is based on reciprocity, non-discrimination and consensus. It is also slow and cumbersome. Perhaps the single most important result from Cancún is the realization that pragmatism and sincerity in negotiations are required to move a consensual process forward. And here developing countries too must be prepared to liberalize more boldly, to achieve their development goals. While developing countries rightly expect developed countries to open up their markets further, it is also true that some of the highest barriers to trade are among developing countries themselves.



Trade is an irreplaceable source of wealth creation and growth in the world, and we have yet to come up with anything better than the multilateral trading system to sustain development and contribute to peaceful relations among countries in the world. However, remembering Bhagwati's analogy of the bicycle, concerted pedalling will be needed, the sooner the better, to keep the multilateral trading system from teetering and falling over.

<sup>a</sup> Prepared by Mia Mikic, Economic Affairs Officer and Tiziana Bonapace, Officer-in-Charge, Trade Policy Section, Trade and Investment Division, ESCAP.

The hard tasks of external and internal adjustment on a global scale need to be viewed against the background of the forces of globalization. Globalization has accelerated, with startling speed, the shift of a whole host of manufacturing activities away from their traditional centres, that is, the developed countries, to some developing countries. The process implies that traditional producers now have to move into other areas of manufacturing, such as new products, new applications of technology, products higher up the value chain, or into services, much faster than before. In fact, the move is not likely to be limited to the developed countries. All countries, developed and developing, must adapt to the growing importance of China in the global economy. Unless the process of shifting simultaneously generates new jobs, or wage rates become more flexible in all economies, there could be a significant increase in unemployment in several economies. Broadly speaking, therefore, the need to be able to respond with speed and flexibility to the rapidly changing global economic environment has never been greater. The alternative could be the rebirth of protectionist tendencies, concerns about which have been heightened by the failure at Cancun.

One welcome aspect of recent developments has been that the global financial system has coped reasonably well with the strains put on it over the last two or three years.<sup>12</sup> Large-scale bankruptcies in ICT companies and weaknesses in the equity markets have not created major systemic problems in the financial sector. That sector, for its part, has not engaged in any marked retrenchment of credit, the credit crunch problem of recent years being both a supply- and demand-driven phenomenon. In fact, the financial sector in the region has speedily redeployed its resources to finance housing and personal consumption and has thus successfully stimulated higher levels of activity in several economies of the region.

***Reduced vulnerability  
of the global financial  
system to external  
shocks***

Nevertheless, it would be prudent for policy makers to monitor the health of the financial system more closely. Banks in the ESCAP region, especially those in the economies affected by the 1997 crisis, have for the most part not yet fully tackled the problems of impaired asset quality built up over the years. New bad loans would make them acutely vulnerable to insolvency, with serious spillovers into the real economy in the event of a slowdown. Asia's financial markets still face unresolved problems of

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<sup>12</sup> Alan Greenspan, Chairman, United States Federal Reserve, quoted in the *Bangkok Post*, 1 September 2003.

fragmentation and a lack of depth centring around an overdependence on bank finance.

***Low inflation and  
low interest rates  
have not eliminated  
cyclical fluctuations  
in economic activity***

The last few years have seen policies to lower inflation being remarkably successful, with some minor exceptions. Nevertheless, low inflation by itself has not minimized fluctuations in levels of output and activity. In theory, low inflation should have laid the basis for more stable growth and less variation in exchange rates. Together, these should have lowered risk premiums on investments. This rosy scenario has not, however, materialized. Low inflation has undoubtedly delivered benefits such as low interest rates, which have certainly boosted consumption expenditures. However, when invoking the test of promoting or impeding overall economic stability, the answer is more equivocal. Low inflation and low interest rates have proved to be necessary but not sufficient conditions for moderating the amplitude of fluctuations in key economic aggregates. Paradoxically, the low cost of borrowing probably leads to the creation of asset bubbles in real estate and in the equity markets. Regardless of whether problems of instability are considered to be permanent or temporary, how to minimize fluctuations in the economy remains an important policy question. More particularly, the question of how and when to intervene in the deflation of asset bubbles to prevent large-scale unwinding of balance sheets at a subsequent stage still has no satisfactory answer. Monetary authorities primarily focusing on low inflation thus face difficult policy dilemmas during the build-up of an asset price boom, whether in the stock markets or in real estate.

Structural changes in the real economy are always difficult to push through, even if the direction of change is reasonably well known. This is unfortunate, as experience shows that flexible economies grow faster, have lower unemployment and can adjust to shocks more quickly. From an Asian perspective, the need for continued structural reform is paramount. A concentration on export-led growth has delivered handsomely in terms of rapid output growth and efficiency, though perhaps not to the least developed countries, which continue to suffer from market access problems. It is perhaps time now to alter the focus to more sustainable, more domestically driven growth which, in the case of the least developed countries, will require significant external support in the form of ODA.

Against this background, domestic policy priorities will vary widely across the ESCAP region. In some economies, the recent appreciation in exchange rates, and their implied policy tightening, suggests that there is additional room for monetary easing. But simultaneously, it is vital that Governments do not discount the need to have in place credible programmes of fiscal consolidation. As explained in previous issues of the *Bulletin*, most economies in the region need to approach the issue of long-term public debt within an ongoing programme of fiscal reform, to reduce the burden of indirect taxation, improve incentives for production and re-examine their patterns of expenditure. In this context, it is worth noting that most economies in the ESCAP region have relatively low levels of public investment, especially in infrastructure. Such investments will have to be built up over the years. Other areas requiring State investment are education and

health. Governments in the region will have to find new and durable financing mechanisms for the public sector in the years ahead. The Asian Bond Fund is a good beginning. Other developing economies of the region should seek to replicate or acquire access to it.

The most urgent policy issue in the region is almost certainly the question of appreciating exchange rates. At the international level, much of the burden of dollar depreciation has been borne by the euro, with the yen giving some ground in recent weeks. In the event of further downward pressure on the dollar in the coming months, it would be both appropriate and desirable from a regional perspective that the burden be shared more widely. In these circumstances, it may be useful for the authorities in countries where reserves and current account positions have strengthened to consider the policy option of greater exchange rate flexibility, as is being urged in different forums. Such a policy option would reduce the need for sterilizing financial inflows and would automatically have the effect of tightening policy without having to raise interest rates when the need arises. It is worth pointing out that exchange rates exercise some influence on competitiveness, but not a decisive one. Long-term competitiveness is more a matter of product differentiation, quality control and timely delivery to customers rather than price competitiveness per se. It would be appropriate, too, for exchange rate policies to be coordinated within the region so that they are not used as proxies for improved competitiveness.

In the ESCAP region there has been a rapid accumulation of reserves in the last few years. Very large reserves, while clearly providing effective insurance against a foreign debt crisis, also have costs, mainly opportunity costs. It is true that the absorptive capacity of most economies of the ESCAP region in terms of deploying substantial additional financial resources in the public sector in a cost-effective manner, is limited. Nevertheless, the accumulation of reserves beyond what might be warranted by the need to meet trading and debt service needs is questionable. In fact, beyond a certain point large foreign reserves will make the exchange rate inflexible in practice with the burden of macroeconomic adjustment falling on the price level, as has happened in Hong Kong, China, and Taiwan Province of China, and perhaps even in China itself. By and large, excessive reserve accumulation may also reflect some degree of undervaluation of the exchange rate. More flexible exchange rates are thus a policy option worth considering in the current situation. Exchange rate stability is an important policy objective. With stable or falling price levels, some flexibility in exchange rates would expand the range of policy options in macroeconomic management.

A major policy issue facing all developing countries is the question of trade liberalization under the Doha Development Agenda. While the onus of success in this regard lies primarily with the developed countries, especially in the need to remove barriers to trade in agricultural commodities, developing countries for their part should do everything possible to remove impediments to trade in agriculture between them. The remarkable growth of intraregional trade and the rapid expansion of subregional trading agreements, such as those between ASEAN, China, Japan and the Republic

***Problem of  
appreciating  
exchange rates  
and rising  
foreign reserves***

***The Doha  
Development  
Agenda: option  
for developing  
economies of the  
ESCAP region***

of Korea and now between ASEAN and India, is testimony to the scope for enhancing trade not merely in manufactured goods but also in a wider range of agricultural commodities and services. Developing countries should not become hostage to the pace of liberalization at WTO but take initiatives themselves to lower barriers and promote trade in different areas. The objective of an ASEAN economic community is a goal that should be examined, and replicated as appropriate, in the region as a whole.

### **Long-term development challenges**

#### ***Sustaining development so as to meet the Millennium Development Goals and the objectives of the World Summit on Sustainable Development***

The objectives of development are relatively invariant over time. These can be summarized as promoting economic growth, delivering improvements in the quality of life of the people and promoting fairness and equity in the distribution of the rewards generated by growth so as to make the growth process sustainable. Environmental considerations are a recent addition. The relative emphasis placed upon these objectives can and has varied over time and in different countries depending upon their stage of development and the prevailing socio-political ethos of the country concerned. The new challenge that all developing countries face is that these objectives have to be pursued in a world economic environment defined by intensified globalization and competition between countries. The trade liberalization agenda at WTO sets the parameters within which developing countries have to function in the spheres of trade in goods, services and FDI. International agreements or compacts such as the Millennium Development Goals and the objectives of the World Summit on Sustainable Development provide benchmarks against which the performance of all countries will be measured in relation to the eight Goals and the key outcomes of the World Summit. Indeed, the international community has also identified, through the Monterrey Consensus reached at the International Conference on Financing for Development, the appropriate means and policies to achieve the Goals and the objectives of the World Summit over a defined time-span.

In the real world, the pursuit of development is rarely a smooth or effortless exercise. Quite apart from the impact of unpredictable natural events, such as drought, disease, floods and acts of terrorism, policy makers in Governments are often constrained by the power of vested interests, hamstrung by weak institutions and a lack of information that induces policy errors and misjudgements and leads to poor policy implementation. In fact, democratic politics itself creates a bias in favour of shorter time horizons for decision-making, as the typical life of an elected Government is no more than five years before it must renew its mandate with its electors. Long-term objectives are often pushed into the background as a result. Policies whose impact creates winners and losers are difficult to implement if the losers cannot be compensated in some way. There is the perennial problem of balancing centralized control over resources against their decentralized distribution. Above all else, poor governance in which weak leadership is combined with a lack of motivation among public sector functionaries can negate the gains of development, even in societies apparently run by democratically elected Governments.

Against such a complex background, it is a major challenge for any Government to look at the short term as an integral stage in the pursuit of long-term goals and thus to pursue a development agenda primarily determined by long-term objectives. Yet, for development to succeed in a demonstrable way, Governments need to combine short-term economic management with a long-term strategy in which realistic goals are laid out and society as a whole can see, and identify with, the direction and pace of long-term change and development.

All development is ultimately structural change. Some of the driving forces of structural change are external, consisting of the changing patterns of international trade and investment; others are driven by changes in technology whereby technological change and innovation make particular production techniques and goods obsolete. Governments should therefore facilitate structural change and not resist it, although it is essential that there be arrangements to protect workers who lose their jobs in the process; robust institutions and adequate resources will also be needed to retrain such workers. In a globalizing world, structural change, in turn, will be based upon countries being able to maintain and, indeed, enhance their international competitiveness as the ratio of trade to GDP rises. Productivity and efficiency are vital prerequisites for competitiveness and growth; these involve investment in public and merit goods that enhance skills and education, provide for public health and foster the relevant arrangements and institutions for their long-term development. In other words, the role of the public sector, taken in its widest significance, is critical in this process. The public sector has not only to provide leadership in terms of setting objectives but also to simultaneously provide crucial inputs for meeting them, in the form of rules, regulations and oversight. In all developing countries the constraint on financial resources is a fact of life that cannot be wished away. The public sector has therefore to facilitate the involvement of private sector skills and resources in meeting long-term objectives, such as through public-private partnerships.

*Development  
necessitates  
structural change*

In this context it is worth stressing that because resources are scarce Governments should target their expenditures more carefully. By and large, they should avoid activities that the private sector is able and willing to carry out. Such expenditures tend to have high opportunity costs and any gains accruing to the national balance sheet are purely technical, as the private sector would have carried out such investments anyway. Governments should invest more in such areas as infrastructure and public education, which then attract or “crowd in” additional private investment. Empirical research for East Asian economies indicates that there have been substantial gains in terms of investment and growth from the positive externalities generated by the public sector.<sup>13</sup>

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<sup>13</sup> World Bank, *Global Economic Prospects and the Developing Countries 2003* (Washington, World Bank, 2003).



There are currently a number of fundamental long-term objectives that all developing countries have agreed to pursue, those constituting the Millennium Development Goals and those contained in the Plan of Implementation agreed at the World Summit on Sustainable Development. Without going into detail, the two together oblige Governments to have a long-term development strategy that enables them, *intra alia*, to halve poverty between 1990 and 2015 and to pursue sustainable development, broadly defined to include poverty reduction, protection of the natural resource base and ensuring the health of the people; all this is to be achieved in a rapidly globalizing world economy.

### ***The goals of poverty reduction ...***

What are the policy challenges that Governments will have to contend with in pursuit of these objectives? There are no precise answers and individual Governments will have to look at their specific circumstances to decide how to meet the challenges. For instance, costing the Millennium Development Goals raises complex issues of unreliable data, the clear need for substantial extra financial and non-financial resources and changes required in the priorities of government expenditures. Recent research suggests that there are difficulties in determining the exact relationship between a given level of financial resources and the corresponding reduction in the level of income poverty. In the light of this uncertainty, within the limits of given financial resources, which interventions aimed at poverty reduction should then be assigned priority? Moreover, on equity grounds it would seem self-evident that policy interventions in poverty reduction should benefit all the poor equally. What would be the policy implications of ensuring such an outcome? It is clear that greater financial resources alone are not going to guarantee the achievement of the Goals. The effective and efficient utilization of these resources, as well as well-targeted policies and programmes and investment in human capital, will also be needed. Governments of the region thus need to critically reassess their policy approaches in this area and discuss them, both formally and informally, in regional forums, to develop the most effective means of achieving the Goals. A long-term route to poverty reduction is cross-border migration within the region. If organized in a sensible way it could be implemented without the feared political upheavals or difficulties, as has been done by the EU.

### ***... and sustainable development***

The objective of sustainable development similarly creates major policy dilemmas. Thus, for instance, while the linkage between economic growth and poverty reduction is obvious, the relationship between economic growth and the environment is less clear and might even work in the opposite direction. In fact, judging by the experience of the ESCAP region, rapid economic growth has been often accompanied by a range of adverse environmental impacts. Moreover, the poor tend to be disproportionately affected by environmental deterioration. There is thus a strong need to establish robust mechanisms and institutions to coordinate national economic policy-making in different areas. These fall into two broad genres, the first the so-called command and control measures that utilize the authority of the Government in forcing economic agents to adhere to sustainable environmental practices, and the second market-based instruments, consisting of interventions in relative prices with taxes and subsidies to bring private and social costs



more into line. Both approaches are equally valid and useful according to the circumstances and the prevailing institutional capacity of individual countries. The policy dilemma consists in their impact on levels of poverty. Here, too, the problem essentially lies in substantial gaps in the analytical knowledge of the impact of various policies. These arise from gaps in data that properly capture environment-poverty interlinkages. The relatively intangible nature of environmental costs and the negative externalities that they generate are difficult, if not impossible, to subsume within a practical matrix of impact assessment exercises. Formulating effective policies would be more difficult still. Nevertheless, Governments must take action within these limitations and the most practical approach would be to learn from the successes of countries in the region. Regional cooperation in this sphere would thus be very useful.

Finally, how do the Millennium Development Goals and the objectives of the World Summit link up with the issues raised at the International Conference on Financing for Development and embodied in the Monterrey Consensus? The Consensus recognizes that each country has the primary responsibility for its own social and economic development. Primary responsibility refers here to policy approaches: it does not refer to a sufficiency of resources. Few, if any, developing countries, especially least developed countries, have the resources to successfully meet the Goals and the objectives laid out at the World Summit. But extra resources, especially raised in the form of debt obligations, will create their own problems. The Asian economic crisis of 1997 and the current situation in South Asia are testimony to the vulnerabilities inherent in this area of policy. In the crisis countries, vulnerability, primarily via excessive external debt, plunged the countries into a crisis that sharply increased poverty; in South Asia, the combined effect of internal and external indebtedness has been to raise the cost of capital. Overall GDP growth has suffered as a result. Moreover, countries with high domestic debt are now facing a new resource crunch, in the form of a rising burden of debt-servicing. In the past, these countries have not invested enough in education, health and infrastructure, with the result that there is no secure foundation for long-term growth. The Monterrey Consensus spells out the need for countries to enhance the funding of education, health and infrastructure, if necessary by widening the tax base. Millennium Development Goal 8 refers to developing a global partnership for development, that is, raising ODA and expanding market access, particularly at a time when textile and garment quotas come to an end at the beginning of 2005. To what degree, and how, these daunting challenges of development can be met should become the subject of debate and discussion in the region so that Governments can devise realistic approaches for long-term development.

***Finding the resources  
for development: the  
Monterrey Consensus***

