



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

The year 2004 was dominated by developments in the oil markets, especially in the second half of the year. Up to mid-2004 ESCAP developing economies enjoyed buoyant growth; in the second half of the year, momentum appeared to falter in response to the rising price of oil. Nevertheless, on present trends, GDP growth for this group of economies is likely to be 0.6 percentage points higher in 2004 than the estimates of 6.2 per cent made earlier in the year. This unexpectedly positive outcome would be the result mainly of continued robust growth in East Asia, led by China and the turn-around in the Japanese economy. It would appear that, on balance, the sharp rise in crude oil prices in 2004 has thus far not significantly harmed economic growth in the region despite its considerable dependence on imported energy.

Oil prices dominated developments in 2004

The sharp rise in oil prices has translated itself into higher fuel prices at the pump for motorists and surcharges on air travel; however, it has not yet contributed to a more general slowdown in consumer spending growth or in production over the region as a whole, although the situation varies between economies. How high energy prices eventually impact the overall regional economy is a matter of uncertainty and will depend upon how long the current phase of high prices lasts (see box). But for now their adverse effects on household spending and production appear to have been contained.

High oil prices have undoubtedly added to upward pressure on overall consumer prices to some degree. However, the impact so far has been relatively modest, with consumer price indices creeping up by an additional 0.5-1.0 percentage points in the region compared with 12 months earlier. In most countries in the region, the weight of energy is relatively small compared with, say, food. China and India, the two largest economies in the region, have faced more acute price pressures, but not all of them are due to higher oil prices. Nevertheless, on the basis of past experience, should crude oil prices rise further, or even remain at present levels for several more months, the risks of higher inflation will increase significantly across the region.

A major impact of higher oil prices on the region is that they may contribute to a reversal in inflationary expectations. Some central banks have begun to raise interest rates pre-emptively to counter the risk of potentially higher inflation later in 2004 and 2005. Many observers have interpreted

¹ Prepared by Shahid Ahmed, Economic Affairs Officer, Poverty and Development Division, ESCAP.

Impact of high oil prices in the ESCAP region

Two previous episodes of rapid, large and relatively long-lasting increases in oil prices – known as the “oil shocks” of 1973 and 1981 – plunged the global economy into recession on both occasions. The current level of oil prices, with spot prices standing at 14-year highs, does not yet merit the description of an oil shock. Output growth in the region continues to remain relatively strong and price pressures, by and large, appear to have increased only marginally in most economies, for the time being at any rate. Nevertheless, there are fears that should oil prices remain at their present level for some time, say, until mid-2005, the adverse effects on output and prices would become more visible and more widespread across the region. From the perspective of the ESCAP region, given its size and diversity and its growing role as a driver of regional and global GDP growth, it is important that policy makers and others be aware of the potential impact of high oil prices on the economies of the region.

A high price of oil acts as a tax on both production and consumption. According to the International Energy Agency, the effect of a sustained US\$ 10 rise in the price of a barrel of oil, i.e., a rise that persists for at least 12 months, would tend to reduce growth in the following year in the ESCAP region, other things being equal, by 0.8 percentage points. Other calculations suggest that higher production costs on account of oil would push inflation up by 0.5 percentage points. It should be stressed, however, that these numerical relationships are based upon the experience of the two oil shocks referred to above. In the interim much has changed, principally a decline in the use of oil as a proportion of GDP growth, i.e., the lower energy intensity of manufacturing and services nearly everywhere but more so in the developed than in the developing countries. Hence, it is unlikely that high oil prices will automatically lead to the same adverse effects on output and prices now. Nevertheless, the effects of a long-lasting increase in oil prices would be adverse.

From the perspective of the ESCAP region, it is self-evident that the effects of high oil prices would not be uniform: one, there would be obvious differences between oil-exporting and oil-importing countries; two, there would be differences between the more developed and less developed economies in the region; and three, Governments could and, indeed, would take countervailing measures, such as changes in the taxes and subsidies that are levied on oil products in virtually all ESCAP member countries. There would be changes, too, in monetary policy to counter the inflationary effects of high oil prices. The overall impact of high prices hence becomes difficult to measure.

In the ESCAP region, although there are a number of countries that produce oil, only seven are net exporters: Azerbaijan, Brunei Darussalam, the Islamic Republic of Iran, Kazakhstan, Malaysia, the Russian Federation and Viet Nam. Indonesia, traditionally a large producer and exporter of energy, is now a net exporter of natural gas but not of oil. China is a major oil producer (3.5 million bpd) but is also a large oil importer (2.4 million bpd). Most other economies produce varying, sometimes significant, quantities of oil but still need to import the bulk of their requirements. Japan, the Republic of Korea and Taiwan Province of China, three of the five largest economies in the region, produce no oil. India produces 0.8 million bpd and imports 2.1 million bpd, while Singapore imports 0.7 million bpd of crude and exports 0.6 million bpd of oil products. Broadly speaking, the region remains a large net importer of oil and therefore vulnerable to a sustained rise in oil prices. The consumption of oil in the ESCAP economies is estimated to be equivalent to 4.5 per cent of GDP but is on a gradual downward path, particularly in the developed and middle-income developing economies.

In principle, oil-exporting countries would benefit both from the extra revenue that higher prices would generate and from the improvement in their terms of trade. Oil-importing countries, which constitute the bulk of ESCAP members, would, however, experience higher production costs and lower consumption and a net transfer of income to the oil-exporting countries. Between developed and developing countries, even if both are significant net importers, the effects would be markedly different: the former use roughly half as much oil per unit of output as developing countries. In addition, terms of trade losses can be recouped more quickly by developed countries than by developing countries, given the different price elasticities of their tradable goods. If oil-importing countries were to lower taxes or increase subsidies on oil products within, say, a constant tax-to-GDP ratio this would redistribute income from the general taxpayers to oil product users. In other words, there would be a variety of impacts depending upon the status of the particular country as an oil exporter or

importer, its level of development, its resource situation and what policy measures its Government took to deal with the high oil prices. Whether the impact would be deleterious to growth in the region and to what extent is very difficult to judge but the following aspects might shed some light on the situation.

Essentially Governments have sought to shield consumers from the full impact of high crude oil prices by either reducing the taxes and duties they levy on oil products or by not letting the final prices paid by consumers fully reflect the rise in crude oil prices that has occurred in the last few months. But, as oil prices have remained high for several months, both approaches will prove to be a heavy financial burden on the Governments concerned. In the first instance there would be a clear fiscal cost that will have to be made up through taxes elsewhere or through higher borrowing if the Government is committed to maintaining a particular level of spending; in the second instance, the Government would need to find the resources to compensate the oil companies, whether State or private, that have not been able to pass on the full cost of the crude oil to the consumers. As an illustration, in Indonesia, oil subsidies in 2004 are likely to amount to a staggering US\$ 6 billion or nearly a quarter of total government revenues, a huge fiscal burden on the Government. It is noteworthy that similar subsidization schemes are currently operating in a number of ESCAP member countries to protect consumers from the full extent of the rise in oil prices with varying fiscal consequences.

While the logic of subsidized oil product prices is understandable, such a policy approach is almost certainly not viable over the medium term given its high fiscal and opportunity costs. Moreover, subsidies invariably distort relative prices, discourage conservation and fuel efficiency in transport and encourage overuse of the subsidized items. Even apparently well-targeted subsidies, such as for diesel fuel, are likely to prove unsustainable over the medium term and eventually have the same negative effects as more general fuel subsidies. Moreover, with all fuel subsidies, the overall environmental impact is clearly negative.

It needs to be emphasized that the ability of subsidies to preserve a higher momentum of growth than would otherwise have been the case is likely to be true, at best, only in the short term. Eventually the higher costs of fuel would need to be allowed into the calculus of costs and benefits facing both the producers and consumers of energy and all activities in the economy would need to be evaluated on a uniform basis on resource allocation grounds. In that general context, high oil prices provide Governments with a window of opportunity to bring vital environmental issues relating to energy conservation to the forefront.

such measures of monetary tightening, modest though they are, as signalling the end of the low inflationary and interest rate environment of the last two years. The small rise in interest rates is not expected to have an adverse impact on short-term growth per se, but its indirect impact on business and consumer confidence may well gradually translate into negative effects on levels of demand and output over the next 12-15 months.

Compounding developments in the energy markets, in the United States of America and Japan, two important sources of external demand for economies in the region, output growth appears to have entered a soft patch compared with much of 2003 and the first quarter of 2004. Should this soft patch persist in the rest of 2004 and into 2005 it would lead to a weaker external environment that would then feed back into the domestic economies of the region. Thus, while the regional economy has so far been only marginally affected by the rise in oil prices and the firming trend of interest rates, the outlook for 2005 suggests that overall growth in the region is almost certainly likely to be lower than in 2004 (see table 1). Forecasts for 2005 are based upon an average price of US\$ 38 a barrel.

Higher oil prices have reversed inflationary expectations and led to firmer interest rates

Table 1. Selected indicators of global economic conditions, 2001-2005

	2001	2002	2003 ^a	2004 ^b	2005 ^b
Economic growth (percentage change in GDP)					
World					
At market exchange rates	1.4	1.7	2.7	4.1	3.4
At PPP exchange rates	2.4	3.0	3.9	5.0	4.3
Developed economies	1.0	1.6	2.1	3.6	2.9
Japan	0.4	-0.3	2.4	4.4	2.3
United States of America	0.5	2.2	3.1	4.3	3.5
European Union	1.7	1.2	1.1	2.6	2.5
Developing economies	4.1	4.8	6.1	6.6	5.9
Developing economies in the ESCAP region	3.6	5.8	6.2	6.8	6.2
Trade in goods and services (percentage)					
World	0.1	3.3	5.1	8.8	7.2
Developed economies					
Exports	-0.8	2.2	2.6	8.1	6.3
Imports	-0.7	2.6	3.7	7.6	5.6
Developing economies					
Exports	3.5	6.6	10.9	10.8	10.6
Imports	3.3	6.0	11.1	12.8	11.9
Inflation rate (percentage)^c					
CPI in the developed economies	2.2	1.5	1.8	2.1	2.1
CPI in the developing economies	6.8	6.0	6.1	6.0	5.5
<p><i>Sources:</i> United Nations, Economic Monitoring and Assessment Unit, "LINK global economic outlook" (April 2004); IMF, <i>World Economic Outlook, September 2004: The Global Demographic Transition</i> (Washington, IMF, 2004); and <i>The Economist</i>, 11 September 2004.</p> <p>^a Estimate.</p> <p>^b Forecast.</p> <p>^c Developed and developing economy ratios weighted at purchasing power parity.</p>					

A slower momentum of growth in 2005 will have adverse social consequences

Any marked or prolonged slowdown in the momentum of growth, were it to occur, would generate significant social and macroeconomic repercussions for the Governments of the region. Sustained, buoyant growth has been instrumental in generating the increase in employment that lifted millions out of poverty after the 1997-1998 economic crisis and again after the slowdown following the ending of the dot.com boom in 2001. Buoyant growth has also enabled economies in the region to enjoy macroeconomic stability although public debts have tended to rise. A slowdown would therefore not only generate immediate social and economic consequences but may also damage the longer-term prospects for the region by reducing public investment in vitally needed physical and social infrastructure. On the macroeconomic front, a slower pace of growth would in all likelihood constrain the growth of tax revenues and could thus be instrumental in widening fiscal deficits once again in several economies. A more sustained rise in inflation would automatically trigger higher interest rates that would add to the cost of servicing the public deficits, as well as affecting consumer spending.

Experience suggests that a firmer trend in interest rates combined with rising fiscal deficits could cause private investment expenditure to be crowded out or postponed, at least in the short term. Furthermore, restraint in the growth of public spending as revenue growth flattens out would inevitably lead to slower progress or cutbacks in the delivery of public sector services and in vital social programmes in many economies of the region. In a worst-case scenario, the region could therefore not only see a deceleration in the momentum of growth over the next 12-15 months but also possible setbacks in social indicators.

But for now, little can be said with certainty as to how events will unfold in the months ahead and how the economic situation in the region will evolve. Both national Governments in the region and international and regional multilateral bodies are broadly hopeful that, despite the current hiccups, the global economy remains on track. Nevertheless, the need for vigilance, especially with regard to oil price trends and their inflationary implications, is perhaps greater than it was only a few months ago. As at October 2004 there is a degree of optimism that inflationary pressures can be contained in most economies, and interest rates, although having bottomed out, are not expected to increase rapidly, or to very high levels, over the next 12-15 months.

However, it would be prudent to concede that not all regions and not all economies may be able to conform to this rosy scenario. In the region as a whole, risks vary and individual Governments may need to critically re-examine their degree of vulnerability to current developments and to assess how they might be able to maintain the current momentum of growth.

In this context, it is worth noting that growth in the region has become more autonomous in the last few years with the rapid increase in intraregional trade, for example, rising import demand from China; it has also become more domestically driven. Nonetheless, it still remains dependent to a significant degree on external demand, and export growth remains a crucial element in maintaining the current growth momentum. Exports depend on demand from the United States and Japan, and the EU to a lesser extent. Against that background, any simultaneous slowdown in China, Japan and the United States and continuing lacklustre growth in the EU could thus have an adverse impact on the region as a whole during the remainder of 2004 and in 2005. Other downside risks emanate from developments in the commodity and financial markets and their impact on imponderables such as consumer and business confidence. Above all else, the risk of terrorism remains ever-present in the region, as are periodic episodes of avian influenza, which can lead to significant setbacks to growth in the short term. The incidence of avian influenza in 2004, while less serious compared with 2003, has already led to a number of human deaths in South-East Asia and its future progression remains uncertain.

***Significant
uncertainty lies
ahead***

Governments must ensure that the momentum of growth is maintained

Depending on how energy and commodity prices behave in the months ahead, the extent of the external slowdown in 2005 and what impact, if any, these developments have on the financial markets, Governments in the region will need to take appropriate measures to ensure that the domestic momentum of growth remains broadly unaffected and to simultaneously minimize any macroeconomic instability induced by external events. They will also need to ensure that long-term development goals continue to receive due attention.

In the following pages the outlook for the region over the next 15 months is examined against the background of the current global economic setting, developments in international trade, including trends in commodities, and the amalgam of influences currently bearing on the financial markets and how these might impact on consumer sentiment and corporate behaviour in the region. Finally, the balance of risks to growth emanating from these developments and the main policy issues that arise as a result for the Governments of the region, including some longer-term development policy challenges, are discussed.

The global setting

Developed countries

The United States economy exercises a major influence in the region

With a weight of 21 per cent in global output and 11 per cent of global imports, 42 per cent of which are sourced from Asia-Pacific, the United States economy continues to exercise a major influence on the region. For that reason, the soft patch in which the American economy has found itself in mid-2004 needs to be more carefully examined. Analysts have alluded to a number of possible causes of the soft patch but, notwithstanding these, a consensus of official and private sector forecasts suggests that the American economy is still expected to grow by between 4.2 and 4.5 per cent in 2004 as a whole, i.e., significantly faster than in 2003. However, growth in the second half of 2004 is expected to be substantially weaker than in the first half. From the perspective of the region, what is of interest is how long the current soft patch might last and what implications it might have for the region.

The strength of the American economy in the first half of 2004 was the result of the large fiscal boost that it received in late 2003. This, combined with low interest rates, kept unemployment low and stimulated both corporate and household spending. In the latter, rising house prices have played a major role via their wealth effects. However, by mid-2004 the macroeconomic stimulus was starting to wane and nascent price pressures were beginning to emerge. In response, the Federal Reserve Board raised its benchmark federal funds rate three times. Given the size of the fiscal deficit, expectations of any extra federal budgetary stimulus are considered unrealistic for 2005.

Another factor that underpinned the economy in 2003 and part of 2004 was the equity markets. Of late, equity prices have been stagnant as GDP growth has not been converted into rising corporate earnings on a sustained basis. Moreover, the rather slow pace of job creation appears to have dented consumer confidence and rising oil prices have been a negative development. Thus, taking these various factors in combination the consensus of opinion now is for the American economy to decelerate in the second half of 2004 and into 2005 to an annual rate of 3.5 per cent.² Thus, as far as the ESCAP economies are concerned, the United States is unlikely to provide a significant stimulus to growth for the remainder of 2004 and, indeed, well into 2005.

A slower rate of GDP growth is not the only potential danger emanating from the United States with external repercussions. The emergence of large current account and fiscal deficits in the United States have weakened the dollar and, superimposed upon the low domestic saving rate, suggest that the American economy will be a significant user of global savings for some time to come. But a firmer trend in interest rates is bound to aggravate the servicing of both deficits and poses the risk of a disorderly adjustment if global financial markets have become overweighted with United States assets. In such a situation, all countries could be faced with significantly increased financial market and exchange rate volatility. It should, however, be emphasized that in the past, risks to the global economy originating in the United States have not always materialized. Nevertheless, there is agreement both in the United States and in multilateral bodies that the current macro-economic imbalances in the United States cannot be sustained indefinitely and will need to be dealt with somehow over the next 18 months.

***Current soft patch
in the United States
could be compounded
by the current account
and fiscal deficits***

The Japanese economy, too, exercises a major influence in the region. Its recent buoyancy has been an unexpected source of stimulus for several economies in the region, notably in East and South-East Asia. Although slowing somewhat in the second quarter of 2004, the Japanese economy is nevertheless on track to register its highest rate of growth for 14 years in 2004. From the perspective of the region, the question, however, is whether this acceleration in the growth rate is sustainable into 2005. The evidence at this stage is rather mixed. First, on the positive side, the current upturn appears to be more broadly based than previous ones, with growing evidence of a rise in household consumption, Japan's weakest link in reviving and sustaining growth over the last decade. Second, the corporate and financial sectors have undergone fairly extensive restructuring in that many firms have shed excess capacity while banks have made considerable progress in writing off non-performing loans and in recapitalizing of their balance sheets. As a result, corporate profitability has improved and banks are in a stronger position to support the recovery. This is reflected in rising business confidence. Third, deflationary pressures seem to be finally coming to an end. Indeed, analysts expect consumer price indices to start rising in mid-2005 after seven years of decline. This should have a further positive impact on corporate profits and consumer spending after a time lag.

² IMF, *United States: 2004 Article IV Consultation – Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion*, Country Report No. 04/230, July 2004.

***Rapid growth
in Japan in 2004
unlikely to be
maintained
in 2005***

At the same time, however, the export sector has been the primary driving force of Japanese growth, with sales to China especially buoyant in 2003 and early 2004. The United States has been another source of demand, particularly in the high-technology sector. Both economies are expected to slow in the months ahead, the United States more so than China. Anecdotal evidence suggests that a disproportionate share of new investment expenditure is being undertaken by firms in the export sectors while such expenditure remains sluggish in firms and sectors that have limited international exposure. In other words, corporate restructuring still has some way to go. Second, the enormous size of the fiscal deficit and of public debt remains an ongoing concern. Third, given Japan's high dependence on imported energy, the rise in oil prices represents a kind of tax on expenditure that could nip consumer spending growth in the bud.³

Broadly speaking, the present pace of recovery in Japan is regarded as being too fast even allowing for the fact that there was considerable slack in the Japanese economy in 2003 after years of low growth. Hence, the recovery is expected to ease in any event in the months ahead with the pace moving closer to Japan's long-term trend rate of growth of around 2.5 per cent per annum. Thus, both cyclical and structural factors will determine Japanese economic performance in 2005. But, whatever the proximate causes of any slowdown in Japan in 2005, the impact on the wider regional economy is not expected to be large in the short term.

***Continuing
lacklustre growth
in the EU***

Outside the region, the EU is finally showing signs of a moderate pickup in activity after little or no growth in 2002 and 2003. In the 12 euro zone countries, growth is picking up, especially in France, and is expected to strengthen further in 2005 even though the appreciation of the euro vis-à-vis the dollar has reduced relative euro zone competitiveness. However, high levels of euro zone unemployment at around 9.0 per cent continue to undermine consumer confidence and spending. This phenomenon, combined with slow progress in implementing structural reforms, for instance in Germany, suggests that a significant improvement in the GDP growth rate is unlikely in the short term.

Outside the euro zone, the older members of the EU, such as the United Kingdom of Great Britain and Northern Ireland and Sweden, continue to enjoy relatively buoyant growth, while the enlargement of the EU to 25 members since May 2004 presages, at the very least, a period of consolidation as the new members learn to grapple with the EU's political and economic decision-making arrangements before enjoying the benefits of an enlarged single market. In this context, the eligibility of the new entrants to the EU for membership in the euro and the reform of the Stability and Growth Pact raise complex issues that could delay the positive impact of the enlargement on trade and output growth for some time. Given these trends and given that even the enlarged EU of 25 accounts for under 15 per cent of exports from the

³ IMF, *Japan: 2004 Article IV Consultation – Staff Report: Staff Supplement; and Public Information Notice on the Executive Board Discussion*, Country Report No. 04/249, August 2004.

ESCAP region, its economic performance is unlikely to have a major bearing on growth in Asia and the Pacific in 2005.

Recent trends in international trade

The strong growth of the global economy in 2003 and 2004 was both reflected in and driven by strong growth in world trade (see table 2). Overall, global trade growth is expected to expand by 8.8 per cent in 2004 following growth of just over 5.0 per cent in 2003. At almost 15 per cent, developing countries will once again outpace developed countries in global trade growth. The ESCAP region is the main contributor to world trade growth with both exports and imports growing faster than world exports and imports.

A feature of globalization worthy of note has been that merchandise trade expanded at roughly twice the rate of merchandise production in the 1990s.⁴ The early years of the succeeding decade saw a marked slowdown in the rate of growth of merchandise trade – in 2001 it actually declined – but in 2004 the historical relationship between trade and output growth of the 1990s appears to have been restored. Moreover, there is evidence now that trade in services is growing rapidly to match trade in merchandise, with travel the fastest-growing category in the former but vulnerable to the rise in oil prices.

Developing economies' trade growing more rapidly than the global pace

Table 2. World trade and prices,^a 1991-2004

	<i>Annual percentage changes</i>					
	<i>1991-2000</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004^b</i>
Trade in goods (volumes)	7.3	13.3	-0.4	3.5	5.5	9.1
Trade prices (in US dollars)						
Manufactures	-0.9	-5.6	-2.8	2.4	13.2	7.5
Oil	2.1	57.0	-13.8	2.5	15.8	28.9
Other commodities	-0.9	4.4	-4.1	0.6	7.1	16.8
Terms of trade						
Developed economies ^c	0.2	-3.1	0.3	1.1	1.3	-0.1
Developing economies	0.0	7.6	-3.1	0.6	0.0	3.2

Source: IMF, *World Economic Outlook, September 2004: The Global Demographic Transition* (Washington, IMF, 2004).

^a Goods only.

^b Forecast.

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

⁴ UNCTAD, *Trade and Development Report, 2004* (United Nations publication, Sales No. E.04.II.D.29).

Within the fastest-growing categories of merchandise, some subcategories play a more dynamic role than others. In this context, the most dynamic category relevant to the ESCAP region is trade in ICT equipment and software. Together, these subcategories expanded at twice the rate of total manufactured goods over the previous 12 years. Such phenomena indicate that global trade flows are not static; over relatively short periods of time they have experienced major structural shifts and have evolved in the face of changing technology and consumer tastes and preferences. It is for individual countries to remain alert to the changes occurring around them and to adapt to such changes through responsive policies and the provision of public goods such as market intelligence and logistical support. They also need to maintain and promote competitiveness in particular lines in order to keep market share through targeted R&D expenditures. These developments are of particular relevance to the countries likely to be affected by the ending of the Agreement on Textiles and Clothing on 1 January 2005.

Rapid shifts in trade patterns

An apposite illustration in this regard, for instance, is that the share of agricultural products in global trade has declined steadily over the last 15 years. This is so despite the fact that production of most agricultural commodities has increased in recent years. The relative decline in trade is partly the result of the very rapid growth in the trade of manufactured and semi-manufactured goods, principally components, and partly because demand for agricultural goods has risen more slowly in the last two decades. The recent example of wheat is illustrative of this change. World wheat production is estimated to have risen by over 9.5 per cent in 2003/04. However, according to FAO estimates global cereal trade is set to decline sharply in 2004/05 as much of the increased production will be locally consumed and preclude the need for cross-border sales and deliveries.⁵ An accompanying trend is that processed agricultural goods have risen in importance in world trade throughout the last 12 years, indicating that value is being added to commodities in the exporting countries rather than in the importing countries.

Moderate deceleration of trade likely in 2005

Overall, most observers expect to see a moderate deceleration in world trade growth in 2005 in volume terms. Import demand in the developed economies is likely to slow so significantly that growth within the developing economies may not be able to fully compensate. Yet world trade growth is still expected to be in the 7.0 to 8.0 range, close to its average growth in the 1990s. In the ESCAP region, China's import growth is set to continue at a fast pace, if not at quite the rate of the last two years, and to provide opportunities to economies in the region to maintain the momentum of intraregional trade.

⁵ FAO, *Food Outlook No. 3*, September 2004.

Commodities

After a long period of decline, commodity prices have been on the rise since 2002 (see table 3). Prices have increased for all commodity groups, the largest increases being in agricultural raw materials, such as vegetable oilseeds and oils, and various mineral ores and metals. Rising coffee and cotton prices have brought relief to some countries where producers have often faced ruin in the face of relentless long-term price declines. However, firmer commodity price trends appear to have bypassed some agricultural products, notably coffee and bananas, for which producers continue to grapple with the consequences of oversupply and weak demand.⁶

**Commodity prices
on a firmer trend
since 2002**

In general, recent trends in commodities can be explained by the rapid increase in demand that the economic recovery of the last two years has brought in its wake. The rise in demand has been most visible in the ESCAP region, particularly in China, and has come in the face of secular trends that have reduced supplies and led to a decline in stocks. To put matters in perspective, however, the current rise in commodity prices should take into account the recent depreciation of the dollar. As most internationally traded commodities are priced in dollars, the dollar exchange rate becomes an element in the way that prices behave. Thus, for instance, while the commodity price index has risen by nearly a fifth over the last two years in dollar terms, it has actually fallen in terms of the euro and has barely moved in terms of the yen.

Table 3. Indices of major commodity prices, 1996-2004

(1995 = 100)

	1996	1997	2000	2001	2002	2003	2004 April
Palm oil (Malaysia)	84.6	86.8	49.2	45.5	62.0	70.4	85.5
Rice (Thailand)	105.4	94.3	63.5	53.8	59.8	62.2	79.0
Rubber (Malaysia)	88.7	64.4	43.7	37.6	50.0	70.8	90.7
Sugar (US import price)	97.0	95.1	84.1	92.5	90.8	93.2	91.2
Tea (Sri Lanka)	126.5	134.5	119.9	117.0	113.3	119.2	..
Timber:							
Hardwood logs (Malaysia)	98.5	92.4	73.8	62.2	63.2	72.7	76.9
Hardwood sawnwood (Malaysia)	100.1	89.5	80.9	65.9	70.0	74.3	74.6
Softwood logs (United States)	105.3	95.6	93.3	81.4	75.3	75.1	99.6
Softwood sawnwood (United States)	103.1	97.8	94.7	94.0	90.8	94.5	112.7

Sources: IMF, *International Financial Statistics Yearbook 2002* (Washington, IMF, 2002); and *International Financial Statistics* (Washington, IMF, June 2004).

⁶ UNCTAD, *Trade and Development Report, 2004* (United Nations publication, Sales No. E.04.II.D.29).

***The China factor
in the commodity
markets***

A depreciating dollar means that commodity prices have risen or fallen much less in terms of other major currencies; hence, demand has not been greatly affected by the rise in dollar values in the EU or Japan. But it is also true that the greater part of the increase in demand has occurred in the ESCAP region, where exchange rates have either remained on a fixed parity with the dollar, for example, in China, or have stabilized against the dollar over the last 18 months or so, for example, in much of the rest of Asia. Thus, it is demand emanating from China in particular and from the region in general that has essentially driven commodity prices upward over the last two years.

The rapid growth of the Chinese economy has meant that China has become the world's largest consumer and importer of several commodities, many of them sourced from within the region. As such, it has become a key factor in the commodity markets with a critical influence on price levels. China's influence extends beyond the production and sale of the commodities themselves to shipping, freight rates and related services and its market power has been most evident in vegetable oilseeds and oils, soybeans, cotton and rubber. China's economic growth has also resulted in a massive increase in the demand for energy, particularly coal and oil. While China can satisfy most of its requirements of coal, increased domestic demand and lower exports from China have raised international coal prices. It is in oil that Chinese demand has had the greatest impact. China's oil needs have doubled in less than a decade and contributed to the tightness in supplies in 2004. As car ownership expands rapidly in China, the prospect for oil prices could be one of significant upward pressure in the next two or three years.

***Upward pressure
on oil prices***

But in oil, too, the depreciation of the dollar has played a part, providing an upward momentum to prices. At the beginning of 2004, OPEC was keeping prices in the upper part of the US\$ 22-28 per barrel range. By mid-2004 prices had risen significantly above this range and even though OPEC increased production, the unanticipated higher demand from China, aggravated by supply disruptions in Iraq and some degree of speculative activity in the futures market, sent prices soaring above US\$ 55 a barrel in October 2004. At this level, they represent a doubling of prices over the previous 18 months in dollar terms, and have raised concerns regarding their negative repercussions on the broader global economy, a topic discussed later in the chapter.

The firmer trend in commodity prices witnessed over the last two years has helped the economies of commodity-producing and -exporting countries in the region by boosting export earnings. In the case of agricultural commodities, it has also bolstered farm incomes, which have stimulated overall demand and output growth and helped in the fight against poverty. But that being the case and viewed from a longer-term perspective, commodity prices in real terms continue to remain at historically low levels, considerably below their levels of 20 years ago. This has meant that over the last two decades the terms of trade of commodity producers have deteriorated. It has also meant that rising production and exports have not been translated into rising incomes and prosperity for the producers, exacerbating the

financial and social distress of commodity producers across the region that began more than a decade ago.

Thus, while rising commodity prices have undoubtedly helped commodity-producing countries in terms of higher exports and lower current account deficits, they have had only a minimal impact on the underlying financial and social problems of the commodity producers in these countries. Such producers often tend to operate on a small scale and have little, if any, financial strength either to diversify their production or to invest in value-adding facilities. This factor has played a major role in the continuation of rural poverty in the region.

***Commodity prices
still below their level
of the early 1980s
in real terms***

Financial market developments

Large current account imbalances continue to characterize the global economy. The United States deficit is estimated to exceed US\$ 570 billion or more than 5.0 per cent of GDP in 2004 and to remain at this level in 2005. Smaller current account deficits are run by the United Kingdom, Italy, Spain and Australia among the developed countries and by some of the newer members of the EU from Eastern Europe. A number of developing countries, principally in Latin America and Africa, will also run current account deficits in 2004 and beyond. Current account surpluses are found principally in Asia but also in parts of Europe (mainly Germany, Switzerland and Norway).

Since the mid-1990s, the American deficit has more than tripled in percentage points of GDP, with Japan and developing countries in Asia accounting for the bulk of the corresponding surpluses. In the United States, strong demand growth and the high value of the dollar widened the deficits in the late 1990s. Since the beginning of 2002 the deficit has continued to widen despite the weakening of the dollar.

By definition, the marked rise in United States external borrowing needs since the mid-1990s has been associated with a growing gap between American investment and saving. Before the last downturn, saving by households fell and investment as a proportion of GDP increased. These two factors drove the current account deficit up, in spite of a sharp improvement in the fiscal accounts. Following the recession, the picture changed as investment was cut back and business saving rose. Nevertheless, United States foreign borrowing continued to increase as a large public sector deficit emerged. The persistence of the American deficit and its vulnerability to shifts in foreign investor sentiment is a major source of uncertainty in the global economy today.⁷

***Funding the
United States current
account and fiscal
deficits is a major
cause of uncertainty
in the financial
markets ...***

A lower dollar, as is beginning to happen, would obviously contribute to reducing the United States current account deficit. However, the speed of any adjustment depends on relative trade elasticities, which suggest that the

⁷ BIS, *74th Annual Report, 1 April 2003–31 March 2004* (Basel, BIS, 2004).

**... as is the dollar
exchange rate**

adjustment could take a considerable time. Moreover an adjustment of the dollar exchange rate is bound to have implications beyond the United States, especially in the ESCAP region. As the dollar falls, other currencies must rise against it. Thus far, it is primarily the euro that has appreciated. In the ESCAP region, the Chinese yuan renminbi, Hong Kong, China, dollar and Malaysian ringgit maintain a fixed parity with the dollar. Other currencies, not linked to the dollar, have only appreciated marginally against it over the past 18 months. The Japanese yen has remained virtually unchanged during this period.

Many economies in the ESCAP region and elsewhere have relied on American import demand as an important driver of growth; a sizeable fall in the dollar might choke off this source of growth. In addition, a fall in the dollar could also push up inflation in the United States, possibly leading to higher American and global interest rates. For now, these scenarios lie in the realm of speculation. Nonetheless, the world has to find ways to accommodate the United States current account deficit, accumulate dollar-denominated assets in the process and deal as well as possible with a gradual decline in the dollar exchange rate that reduces the value of those assets over time. The adjustment of the current global imbalances thus poses a major challenge from the perspective of both global and regional financial markets.

Although interest rates have begun to firm in recent months, their very low levels over the past two years have encouraged the growth of a variety of alternative investment vehicles. Precious metals and real estate, especially housing, have been among the most-favoured investment modes as the equity and bond markets have barely moved in 2004 after rising significantly in 2003. These alternative investment modes have generated significant capital gains and kept consumer spending high.

**Dangers of
hedge funds**

The growth of alternative investments merits closer attention. Other than real estate and precious metals, where borrowed funds also play a role but where the amplitude of price fluctuations is limited, these have been primarily in the form of highly leveraged vehicles, such as hedge funds, usually involving a small group of wealthy individuals prepared to trade high risk for high returns on their investments. But the inherent risks of leveraging and the rather esoteric nature of the uses to which some hedge funds are being put, including oil futures, strongly suggest that financial market operators need to beef up their risk-evaluation systems and thus counter the threat of a major potential upheaval in the financial markets. Such an upheaval could come as a result of excessive risk taking by an individual fund, causing, in turn, disproportionate price volatility in the securities and commodity markets over much of the world, and conceivably lead to a prolonged, and more systemic, withdrawal of liquidity from these markets. It is worth stressing that hedge funds remain essentially unregulated and their risk profiles largely unknown from a regulatory perspective.⁸

⁸ "How hedge funds are destabilizing the markets", *Financial Times*, 28 September 2004.

Along with the emergence of global imbalances, a factor worthy of note is that developing economies in the ESCAP region have become net capital exporters since 2000, a phenomenon that has raised questions and concerns for both capital market participants and policy makers. Prior to 1997, the year of the crisis, inflows to ESCAP developing countries were the norm and there was a significant differential between, say, United States and ESCAP developing country interest rates. Inflows took the form primarily of FDI through much of the 1990s, supported in the last few years before the crisis by portfolio flows and bank loans. Since 1998-1999, while FDI has remained largely stable, the retrenchment of bank lending as interest rates have converged has led to the phenomenon of capital outflows from ESCAP developing countries. The process has been intensified of late with the accumulation of reserves by developing ESCAP countries in making Asia a large net capital exporter over the previous six years (see table 4).

**Developing
ESCAP economies
net exporters of
capital since 2000**

Table 4. Net capital flows^a of developing countries and developing Asia, 1997-2005

(Billions of US dollars)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total									
Net private capital flows ^b	195.0	70.5	88.1	46.6	47.8	61.2	120.4	81.6	47.5
Net private direct investment	144.9	155.0	173.4	177.1	191.2	143.5	147.6	166.9	175.2
Net private portfolio flows	63.3	41.9	66.6	16.1	-91.3	-99.6	-11.0	-21.3	-23.4
Net other private capital flows	-13.2	-126.4	-151.8	-146.6	-52.0	17.3	-16.2	-64.0	-104.4
Net official flows	34.6	49.7	6.5	-27.7	15.7	1.7	-24.8	-31.0	-42.1
Changes in reserves ^c	-103.8	-33.9	-92.5	-115.6	-113.2	-197.1	-367.0	-350.1	-291.2
Emerging Asia^d									
Net private capital flows ^{b, e}	37.6	-52.2	8.6	-4.5	9.6	25.4	52.8	79.8	8.6
Net private direct investment	56.5	56.1	66.4	67.4	60.5	53.8	70.0	77.2	77.5
Net private portfolio flows	6.7	8.1	56.1	19.8	-56.9	-59.6	5.5	12.0	-1.8
Net other private capital flows ^e	-25.5	-116.4	-113.9	-91.7	6.0	31.2	-22.8	-9.4	-67.1
Net official flows	22.6	17.9	2.2	4.5	-1.8	-1.8	-16.3	-6.9	-8.8
Changes in reserves ^c	-36.4	-52.7	-87.2	-60.9	-90.9	-158.4	-234.2	-232.6	-158.0

Source: IMF, *World Economic Outlook, September 2004: The Global Demographic Transition* (Washington, IMF, 2004).

^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. This table includes Hong Kong, China; Israel; the Republic of Korea; Singapore; and Taiwan Province of China.

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

^c A minus sign indicates an increase.

^d Consists of developing Asia and the newly industrializing Asian economies.

^e Excluding the effects of the recapitalization of two large commercial banks in China with foreign reserves of the Bank of China (US\$ 45 billion), net private capital flows to emerging Asia in 2003 were US\$ 97.8 billion while net other private capital flows to the region amounted to US\$ 22.2 billion.

The massive increase in reserves in the ESCAP region, although providing insurance against a future debt crisis and, perhaps, minimizing the likelihood of one occurring in the first place, nonetheless has its own complications. For instance, it can and has led to a build-up of excess domestic liquidity in several economies and has created quasi-fiscal costs as central banks have sought to sterilize this increase in liquidity seeping into the domestic banking systems. An increase in liquidity and low interest rates have been the progenitors of asset bubbles in the past; at the very least they make risk assessment and risk management by the financial system more problematic. There is also the question of opportunity costs as the reserve-holding countries, in general, currently earn less on their reserves than what they pay out on their foreign loans. There are accordingly arguments both in favour of and against accumulating large foreign exchange reserves, and judgements as to where benefits outweigh costs are not easy.

The accumulation of foreign exchange reserves in the region

In increasingly globalized financial markets, global events and factors, such as the bursting of the ITC equity bubble, the rapid rise of China as a trading power, the large size of global external imbalances arising from the growing external and fiscal deficit of the United States and the large increase in liquidity available in most ESCAP economies, are bound to have major effects on the domestic economies of ESCAP developing countries via changes in exchange rates, in trading links and in the relative competitiveness and profitability of individual enterprises. As ESCAP developing countries become more mainstream in the global economy, capital allocation mechanisms and decisions will inevitably take on an international perspective. In this regard, as more ESCAP developing countries move from managed to floating exchange rates and as they gradually free up the balance-of-payments capital accounts, erring on the side of caution, in terms of large foreign exchange reserves, seems appropriate at least for the foreseeable future, at the minimum until regional financial supervisory mechanisms are developed to handle acute problems of liquidity, such as those evident in the 1997 Asian crisis. Nevertheless, the emergence of several ESCAP developing countries as net capital exporters, given their levels of development and need for financial resources for many years in the future, raises significant policy issues for the countries concerned as well as for the region as a whole.

Prospects for the ESCAP region

Slackening of output growth expected in the region in 2005

As mentioned elsewhere, developing ESCAP economies were largely unaffected by the rising price of oil and the end of the low-interest environment up to mid-2004. Some slackening in the pace of output growth is expected in the second half of 2004 but is likely to be modest. Overall, GDP growth is expected to be some 0.6 percentage points higher at 6.8 per cent in 2004 than earlier estimates for ESCAP developing economies. However, inflation is expected to pick up in response to the higher oil prices but only marginally so for the time being. Current estimates suggest that the average pickup in inflation in 2004 will be around 0.5 percentage points to an annual rate of 4.0 per cent for ESCAP developing economies. Prospects for 2005 indicate a slowdown in GDP growth to around 6.2 per cent, with inflation rising by another 0.5 percentage points to 4.0 per cent for this group of

economies (see table 5). GDP growth and inflation numbers are based on the presumption that average oil prices will be around US\$ 38 a barrel in 2005, the average level prevailing in 2003.

Table 5. Rates of economic growth and inflation of selected developing economies and North and Central Asian economies of the ESCAP region, 2002-2005

(Percentage)

	Real GDP				Inflation ^a			
	2002	2003	2004 ^b	2005 ^c	2002	2003	2004 ^b	2005 ^c
Developing economies of the ESCAP region^d	5.8	6.2	6.8	6.2	5.5	3.5	4.0	4.0
South and South-West Asia^e	5.2	7.0	6.3	6.0	14.5	10.0	7.6	7.1
Bangladesh	4.4	5.3	5.5	5.2	2.8	4.4	5.8	6.8
India	4.0	8.1	6.0	6.8	4.1	3.9	5.0	4.0
Iran (Islamic Republic of)	7.5	6.7	6.4	5.2	15.8	15.6	15.1	14.4
Pakistan	3.1	5.1	6.4	6.6	3.5	3.1	4.6	5.0
Turkey	7.9	5.8	7.0	4.5	45.0	25.3	11.2	11.4
South-East Asia	4.3	4.7	6.2	5.3	4.5	3.2	4.1	4.0
Indonesia	4.3	4.5	4.7	4.9	11.9	6.6	6.4	6.2
Malaysia	4.1	5.3	6.5	5.7	1.8	1.1	1.5	2.3
Philippines	4.4	4.5	5.5	5.2	3.1	3.1	5.6	5.2
Singapore	2.2	1.1	8.3	4.3	-0.4	0.5	1.7	1.5
Thailand	5.4	6.8	6.5	6.0	0.7	1.8	2.8	2.6
Viet Nam	7.1	7.3	7.2	7.3	3.9	3.1	7.8	6.4
East and North-East Asia	6.6	6.1	7.2	6.7	0.1	1.4	3.2	3.4
China	8.0	9.1	9.0	8.8	-0.8	1.2	4.1	4.5
Hong Kong, China	1.9	3.2	6.6	4.7	-3.1	-2.5	-0.2	0.8
Republic of Korea	7.0	3.1	5.2	4.6	2.7	3.6	3.5	3.0
Taiwan Province of China	3.6	3.2	5.7	4.8	-0.2	-0.3	1.2	1.5
North and Central Asia	5.4	7.7	7.2	6.2	15.0	12.8	10.2	9.2
Kazakhstan	9.8	9.2	9.3	8.5	5.9	6.4	6.7	6.7
Kyrgyzstan	0.0	6.7	5.3	5.2	2.1	3.1	4.0	3.8
Russian Federation	4.7	7.3	7.1	6.1	15.8	13.6	10.7	9.6
Turkmenistan	21.2	23.1	10.5	8.2	10.6	6.5	9.0	8.0
Uzbekistan	4.2	4.4	3.0	3.0	24.2	13.1	8.3	8.5
Developed economies of the ESCAP region	0.1	2.5	4.3	2.4	-0.6	-0.1	0.1	0.5

Sources: ESCAP, based on IMF, *International Financial Statistics*, vol. LVII, No. 6 (Washington, IMF, June 2004); ADB, *Key Indicators of Developing Asian and Pacific Countries 2004* (Manila, ADB, 2004) and *Asian Development Outlook 2004 Update* (Manila, ADB, 2004); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2004), various issues; web site of the Inter-State Statistical Committee of the Commonwealth of Independent States, < www.cisstat.com >, 24 September 2004; and national sources.

^a Changes in the consumer price index.

^b Estimate.

^c Forecast/target.

^d Based on data for 38 developing economies representing more than 95 per cent of the population of the region (including the Central Asian republics); GDP figures at market prices in United States dollars in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates.

^e The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2004/05 = 2004 for India and the Islamic Republic of Iran; and fiscal year 2003/04 = 2004 for Bangladesh, Nepal and Pakistan.

With the exception of China, where domestic consumption and investment have been the main drivers of growth over the past two years, the resilience of ESCAP developing economies is essentially built around exports, within and outside the ESCAP region (see table 6). Domestic demand emanating from both household consumption and corporate investment expenditure and driven by low interest rates has played a supportive role. East and South-East Asia have benefited from a strong revival in the ICT sector that began in 2003 and has continued into 2004, embracing a much wider range of goods now. Higher oil prices have boosted oil-producing economies and added to regional import demand without harming oil-importing economies. The stronger commodity prices, especially of agricultural products, have increased exports and simultaneously raised rural incomes, thus providing a fillip to domestic demand. Corporations have responded to the increased demand by improving capacity utilization and committing greater resources to investment in improving competitiveness, such as new products in household electronics.

Table 6. Rate of growth of exports and imports of selected ESCAP economies, 2001-2004

(Percentage)

	2001		2002		2003		2004 ^a	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Bangladesh	2.6	0.1	-5.1	-12.9	16.2	21.4	32.3	5.2
China	-2.0	8.4	22.1	21.3	34.6	39.7	49.7	29.0
Hong Kong, China	-6.0	-5.6	5.5	3.2	11.8	11.8	8.5	16.2
India	6.1	15.0	12.0	13.6	21.5	24.3	21.9	16.0
Indonesia	-9.3	-7.6	1.5	1.1	6.7	4.0	15.4	22.6
Iran (Islamic Republic of)	-7.6	0.1	-7.4	24.1	37.4	41.8	9.7	19.4
Malaysia	-10.1	-10.8	5.9	8.4	30.5	24.4	22.8	15.5
Pakistan	3.8	-5.2	7.4	10.6	19.1	37.9	17.2	36.8
Philippines	-15.9	-4.2	9.5	7.2	23.5	32.8	13.1	20.7
Republic of Korea	-12.8	-12.1	7.8	7.8	20.7	22.8	17.4	16.8
Russian Federation	-19.9	9.0	29.9	23.4	24.2	38.5	18.9	17.1
Singapore	-11.8	-13.8	2.8	0.4	15.2	9.9	22.2	27.3
Taiwan Province of China	-17.2	-23.4	6.3	4.9	10.4	13.1	25.7	35.6
Thailand	-5.6	0.2	5.7	4.3	17.0	17.1	18.3	26.8
Turkey	12.8	-24.1	11.9	23.7	30.0	34.3	31.3	46.6
Viet Nam	3.7	3.7	11.1	21.8	28.0	30.2	15.0	11.7
Memo:								
United States	-5.3	-4.7	-5.2	1.9	4.4	8.6	14.2	13.1
Japan	-15.6	-8.0	3.3	-3.4	13.8	13.6	16.6	14.5
European Union	0.6	-1.8	6.2	3.6	17.9	19.5	12.9	17.8

Sources: IMF, *Direction of Trade Statistics* (CD-ROM), September 2004; and national sources.

^a Data for January-May 2004, except for Taiwan Province of China, in which case the data refer to January-June 2004.

The sharp rise in oil prices has inevitably added to import spending. As a result, the current account balance of ESCAP developing economies, while remaining in surplus, is expected to narrow by around 1.5 percentage points of GDP between 2004 and 2005 according to some estimates (table 7). In fact, there is now a perceptible risk that in the second half of 2004 and in 2005 the overall external environment could well be significantly weaker if there is a simultaneous slowdown in China, the United States and Japan. In that event, the external situation could reduce export growth and narrow the current account balance further. However, given the accumulation of large foreign exchange reserves over the last few years, this should not impact on overall levels of activity in the region for some time.

Table 7. Current account balance as a percentage of GDP of selected developing economies and North and Central Asian economies of the ESCAP region, 2001-2004

	2001	2002	2003	2004 ^a
South and South-West Asia				
Bangladesh	-2.2	0.5	0.6	0.3
India	0.4	0.9	0.5	0.9
Iran (Islamic Republic of)	7.0	3.1	1.5	4.4
Pakistan	0.5	3.7	4.9	1.9
Turkey	2.3	-0.8	-2.9	-4.1
South-East Asia				
Indonesia	4.8	4.5	3.7	2.8
Malaysia	8.3	8.5	13.0	10.3
Philippines	1.8	5.6	4.2	3.0
Singapore	18.7	21.4	30.9	24.7
Thailand	5.4	5.5	5.6	3.5
Viet Nam	2.1	-1.7	-4.8	-4.4
East and North-East Asia				
China	1.5	2.8	3.2	1.4
Hong Kong, China	6.1	7.9	10.3	9.3
Republic of Korea	1.7	1.0	2.0	3.6
Taiwan Province of China	6.4	9.1	10.2	6.7
North and Central Asia				
Kazakhstan	-5.2	-2.9	-0.2	0.2
Kyrgyzstan	-3.4	-5.3	-2.7	-3.5
Russian Federation	11.0	8.4	8.3	8.4
Turkmenistan ^b	-2.5	3.5	4.1	3.5
Uzbekistan	-1.0	1.2	8.9	8.2

Sources: ESCAP, based on IMF, *International Financial Statistics*, vol. LVII, No. 6 (Washington, IMF, June 2004); ADB, *Key Indicators of Developing Asian and Pacific Countries 2004* (Manila, ADB, 2004) and *Asian Development Outlook 2004 Update* (Manila, ADB, 2004); and Economist Intelligence Unit, *Country Reports and Country Forecasts* (London, 2004), various issues.

^a Estimate.

^b At official exchange rates.

This broad assessment is nevertheless subject to two caveats: one, given the prevailing uncertainty regarding the future course of oil prices, the forecasts are prone to a somewhat higher margin of error than, say, a year ago; and, two, the different ESCAP subregions and, indeed, individual ESCAP economies are likely to respond very differently to the challenges of maintaining the present growth momentum in the coming months. These differences are highlighted in the succeeding paragraphs.

South and South-West Asia

South Asian prospects remain positive despite adverse natural developments

Good weather resulted in a strong agricultural performance in South Asia in 2003. Buoyant farm incomes fed into strong growth in both manufacturing and services and gave the subregion, in particular India, one of its best growth outcomes of recent years. Less favourable weather in 2004 in the north-west of India and north Pakistan and floods in Bangladesh have undermined domestic output growth for 2004, which will also now have to absorb the higher costs of oil from both the cost and demand sides. In 2005, should the global economy experience a loss of momentum, exports from the subregion, too, would be adversely affected. Overall GDP growth is thus expected to be 0.7 percentage points down from 2003 but nevertheless higher than estimates made earlier in the year for 2004. Prospects for 2005 indicate that growth should continue at, or very close to, its current pace. In India, in particular, growth has become more broad-based and on the evidence of the first two quarters of 2004 the loss of momentum following the below-average rainfall in the north-west of the country is expected to be minimal.

All the economies in this subregion have benefited in recent years from structural reform programmes that have sought to stabilize and improve macroeconomic fundamentals and provide production incentives for both agriculture and manufacturing on a sustained basis. However, success in this regard has been uneven. There has been substantial progress on the external front with stable exchange rates, high reserves and improved current account positions. On the domestic side, progress has been less substantial. Fiscal consolidation has made limited headway and with interest rates now moving up the effect on the budget of a higher burden of debt servicing could be a matter of some concern. Rising inflation is another concern as it may necessitate further monetary tightening in the near future. Also, the ending of the Agreement on Textiles and Clothing (the erstwhile Multifibre Arrangement) in January 2005 will pose a major challenge.

South-East Asia

Growth to ease in South-East Asia in 2005

By contrast, growth in South-East Asia in 2004 is likely to exceed both 2003 growth and estimates made earlier in the year. All economies, with the exception of Thailand, improved upon or matched 2003 performance, with Singapore expected to experience the sharpest rebound, from just over 1.0 per cent GDP growth in 2003 to over 8.0 per cent in 2004. Moderate inflationary pressures have emerged in recent months with the higher oil prices but the effect on output growth has been minimal, except in Thailand. Higher inflation and firmer interest rates have had a negative impact on the

stock markets in the subregion – regarded as bellwethers of business confidence – but this phenomenon is not expected to spill over into lower investment expenditures in the economies for some time. It is worth noting that while high commodity prices have boosted several economies in the subregion, with Indonesia, Malaysia and Viet Nam benefiting from the higher prices, the use of oil price subsidization in Indonesia is likely to pose a very difficult fiscal problem before too long.

As in the past, a strong performance in manufacturing and in manufactured goods exports has contributed to the impressive GDP growth in the subregion. Demand from China and the United States has been supported by domestic demand for manufactured goods, especially cars and household electronics and housing. While these factors are, by and large, expected to continue into 2005, a simultaneous slowdown in China and the United States could trigger a slowdown or even a reversal of the current buoyancy in corporate investment expenditures. In addition, a rise in interest rates could slow consumer spending in the area of household electronics purchased on credit. Prospects for 2005 accordingly point to an easing of the collective GDP growth rate of the subregion of around 1.0 per cent. In this context, it is worth stressing that Indonesia, for the reasons given above, the Philippines and Thailand are the most vulnerable to high oil prices in the months ahead; hence, in the subregion as a whole much depends upon the future course of oil prices.

East and North-East Asia

This subregion is expected to post stronger growth in 2004 than in 2003 even though China, the largest economy, is expected to experience a slight slowdown during 2004. The slight diminution in China's growth rate in 2004 has been more than offset by faster growth in the other economies, principally the Republic of Korea and Taiwan Province of China, on the basis of their strong trading performance. In common with the other subregions of ESCAP, inflation has picked up in 2004 and is expected to rise further in 2005. On the external side, the current account surplus is expected to narrow in both 2004 and 2005 on the back of higher oil prices.

***“Soft” or “hard”
landing in China?***

Prospects for the subregion are intimately bound up with the impact of measures that the Chinese Government is currently taking to slow down the economy in 2005 and whether, as a result, China's economy experiences a “soft” or a “hard” landing in the coming months. A soft landing is one in which the economy decelerates gradually to its trend rate of growth while a hard landing is one in which the economy decelerates sharply to below its trend rate of growth for a period of time. The Chinese authorities have already tightened credit policy and are restricting land to cool investment as ample liquidity and low interest rates have triggered a massive investment boom in the economy. Such measures are, however, likely to act after a time lag and there has been a reluctance to raise interest rates until recently. The consensus of opinion is that China's economy should decelerate gradually to a more sustainable pace in 2005 and beyond and would thus provide ample policy space for countries and economies in the subregion, and indeed

in the wider ESCAP region, to adjust. Alternative scenarios for China's economy are discussed more fully later in the chapter.

North and Central Asia

Oil prices dominate the Central Asian economies

Data up to mid-2004 indicate that this subregion will enjoy another year of buoyant growth in 2004, although marginally slower than the pace attained in 2003. Price pressures will abate, while the current account balance will widen somewhat as imports grow faster than exports. This holds true for the subregion, with the exception of Kazakhstan and the Russian Federation, two economies that are large producers and exporters of oil and gas. Prospects for 2005 in the subregion are for a continuation of current trends with the probability of a moderation in output growth as oil and other commodity prices ease in the months ahead.

The energy sector has been the main driver of growth over much of the subregion, accounting for approximately one third of GDP and over one half of exports in Kazakhstan and the Russian Federation. However, a backlog of investment in pipeline and port capacity and more generally in energy infrastructure puts a limit on growth in this sector, at least in the short term. In addition, despite reforms in recent years, the non-oil sectors of the economy are not yet a viable alternative source of growth. A major issue of concern in this subregion, which the current phase of high oil prices has served to mask, is the slow progress in the economies in diversifying away from a dependence on oil and gas and a few other commodities. This limits the possibilities for more broad-based growth once the current phase of high energy prices draws to a close.

Developed countries

Robust growth in the developed economies

Japan's prospects have been discussed elsewhere in the chapter. As far as Australia and New Zealand are concerned, although higher prices of oil are likely to have a dampening effect on output growth, the forecast for 2004 is for continuing robust growth underpinned by buoyant domestic demand and high commodity prices. Despite strong fiscal positions, policy has been tightened in both countries in the face of a build-up of price pressures in recent months and additional measures are expected if oil prices remain high. In that event, there is likely to be a modest slowdown in 2005 in both countries, with the likelihood of a sharper slowdown in New Zealand. The current account deficit has remained uncomfortably large in both countries and whereas it has tended to narrow in Australia in 2004 it has widened slightly in New Zealand. The high oil price will thus pose a bigger challenge for New Zealand in 2005 than for Australia.

Policy issues

Near term

Broadly speaking, the global economy is on track to show strong growth in 2004 despite a deceleration expected in the second half of the year. This

unexpected out-turn, given the rising oil prices, suggests that most economies in the region are not immediately faced with difficult policy dilemmas, other than the need to fine-tune monetary policy with the objective of pre-empting the risk of inflation building up in the months ahead and to keep the growth momentum intact as far as possible. This is far from being an easy task, but with inflation and interest rates at historically low levels the room for policy manoeuvre for most Governments is adequate and drastic interventions are not indicated in the short run in most economies. There is nevertheless a need to avoid complacency and, as stressed in previous issues of the *Bulletin* and *Survey*, to continue to give due attention to the longer-term challenges of development, some of which are discussed later.

Against this overall background, the first question with significant policy connotations in the region is whether the projected slowdown in the global economy expected by most Governments and international and regional multilateral bodies in 2005 will prove to be only a brief hiatus in a longer-term upswing of the global economy or whether it might presage the onset of a longer period of adjustment aggravated by oil prices that remain chronically high into the foreseeable future. Higher oil prices, in turn, risk higher inflation and higher interest rates. The second question has to do with the future course of oil prices. Here, there is a degree of uncertainty that might of itself feed back negatively into business and personal spending decisions. Finally, given China's central and growing influence on regional economic prospects, the question whether it can successfully manage a moderation of what is considered, within and outside China, to be an unsustainably fast growth rate will loom large in the judgements that policy makers might be faced with in the near-term future. It should, however, be recognized that none of the issues outlined above are directly amenable to policy action at the national level in the region; they simply represent the environment within which national Governments will have to operate in the months ahead.

***Is the current
slowdown mainly
cyclical?***

Prior to the sharp convulsions in the oil markets that began in mid-2004, there was widespread confidence that the global recovery that began in 2003 would be sustained and, indeed, even gather strength, in 2004 and beyond. This optimistic view tended, on the whole, to ignore the ongoing conflict in Iraq and the uncomfortably large size of global current account imbalances. Optimism was based on the perception that the Iraq conflict that had begun in 2003 had failed to act as more than an irritant to overall consumer and business confidence. It had failed, moreover, to affect the oil markets seriously. This is no longer the case. The problem of global imbalances meanwhile had bedevilled the world economy for three years or more without acting as a visible drag on levels of activity in either the developed or developing economies. It was thus not unreasonable to assume that significant upheavals from the latter source could be avoided in 2004 and 2005 if the dollar depreciated gradually.

By mid-2004, however, evidence emerged that both the United States and Japanese economies were slowing down. In the United States, to the current account deficit had been added an equally large fiscal deficit. There

was a new realization that the low interest rate environment was likely to end sooner rather than later and, when it happened, how would holders of household and corporate debt in the United States react? Could the dollar exchange rate depreciate rapidly in 2005? In Japan, the recovery to date had been mainly export-driven; with slowing growth in China and the United States, how long could the recovery be sustained? On the domestic side, deflationary pressures were stubbornly persistent, domestic demand remained fragile and corporate and financial sector restructuring was far from complete. And, looming large behind these potential difficulties lies Japan's massive public sector debt and how fiscal consolidation might impact upon the Japanese economy and private consumption demand. The broad conclusion is that the global upswing was far from being durable even before oil prices rose sharply in mid-2004. It had a number of fragile components, any one of which could fall prey to a significant outside shock, such as a prolonged period of high oil prices.

The problem of rising oil prices

As at 15 October 2004 oil prices exceeded US\$ 55 a barrel, double what they were in nominal terms two years previously and over 65 per cent more than in January 2004. In October 2004 futures prices implied an average price of around US\$ 37 a barrel in 2004 or about US\$ 8 more than in 2003. According to IMF, an average increase of this magnitude would reduce world output by approximately 0.25 per cent.⁹ Thus, while oil prices in real terms are still well below the levels they reached in the oil shocks of 1973 and 1981, their high levels in 2004 are almost certainly going to affect global growth in due course. Many causes on both the demand and supply sides can be adduced to explain the rise in oil prices: the massive increase in Chinese demand in 2004 is one and low stocks of crude and refined products are another. The Iraq conflict has now become an ongoing source of uncertainty and, taking advantage of the situation, speculative activity in the futures market driven by hedge funds has affected oil prices.

How long might this phase of supply-demand imbalance last? A precise answer is difficult, if not impossible, but the following might provide some useful clues. Analytically, the most relevant way to look at oil prices is as a tax on producers and consumers alike. In the short run, demand for oil is not very price-elastic so that even a doubling of prices does not change consumption much. The challenge for policy makers is how best to deal with the ensuing situation in which high oil prices are instrumental in both lowering output and increasing inflation: should they counter the lower output or fight higher inflation? If nominal interest rates remain unchanged, the rise in inflation lowers real interest rates, resulting in an implicit policy easing. While this should neutralize the risk of output reduction, it risks raising inflation further. Thus, until some way is found to stabilize oil prices monetary policy has to confront such policy dilemmas, such as raising interest rates in an otherwise weakening economy. Oil prices are likely to remain high until these competing policy objectives are aligned and reduce the pressure on available supplies from the demand side, or, alternatively, some new source of supplies can be tapped. In other words, there

⁹ IMF, *World Economic Outlook, September 2004: The Global Demographic Transition* (Washington, IMF, 2004).

is no effective way of dealing with high oil prices in the short term and/or by national policy initiatives alone, other than the standard prescriptions of conservation and energy-saving exhortations. Superficially at least, there appears to be a theoretical case for Governments in the ESCAP region to cooperate to create an oil reserve along the lines of the United States Strategic Petroleum Reserve, whose practical modalities are worth investigating.

China's economy has played a major role in driving and sustaining growth in the ESCAP region over the last two years. China has emerged as a production base for the region's exports to the rest of the world and as a final export market. Indeed, soaring domestic demand – both consumption and investment fuelled by low interest rates and the easy availability of credit – has stimulated strong import growth. Imports are currently projected to reach an extraordinary US\$ 512 billion in 2004, a rise of US\$ 230 billion over the last three years.¹⁰ A crucial concern both within and outside China is that despite recent indications of moderation in the fast pace of investment, a soft landing of the economy to a more sustainable growth path is not yet ensured. The overinvestment in certain sectors and low interest rates might take time to respond to the measures taken so far. In the meantime, inflationary pressures have emerged in the economy despite flat or declining prices in particular sectors of activity. This phenomenon has raised concerns that a substantial range of investments might prove uneconomic if there were to be a rapid slowdown of the economy, thus burdening the financial system with new non-performing loans and creating new sources of social tension if significant numbers of workers were then laid off in the months ahead.

It is very early to say whether China will have a soft or hard landing in 2005. A gradual and probably marginal slowdown is generally expected over the next 12-18 months. The pace at which the Chinese economy decelerates will have a major impact on commodity prices and on regional suppliers of finished goods and equipment. In a soft landing, the economy should decelerate to trend after a period of very rapid growth. In a hard landing, the deceleration would be sharper and more prolonged with adverse effects on the regional economy. Some analysts believe that a hard landing might flush out excess capacity more quickly, leading to a more pronounced rebound thereafter. But this might affect commodity prices more severely and affect the regional economy in a more profound way. It is worth noting that the momentum of growth in the Chinese economy was largely unchanged up to September 2004.

One clear lesson from the past is that while central banks cannot prevent oil prices from giving a one-off boost to inflation they must prevent them from feeding into higher wages and prices. The cyclical position of the economy will play a critical role in the conduct of monetary policy: the less slack there is in an economy the bigger the risk that oil prices will feed quickly into higher prices. Hence, in economies operating at close to potential the case for a pre-emptive tightening of monetary policy, in the face of a sharp rise in oil prices, is very strong. This would involve difficult

The role of the Chinese economy

Benefits of inflation targeting

¹⁰ "IMF concludes 2004 Article IV Consultation with the People's Republic of China", available at web site < www.imf.org/external/np/sec/pn/2004/pn-0499.htm > , 27 August 2004.

judgements between controlling inflation and preserving the momentum of output growth, but on the basis of past experience inflation is undoubtedly the greater danger. In addition, it would be useful for Governments and central banks to have clarity of purpose with respect to inflation. Inflation targeting is one solution and could be brought into play in the current low inflationary environment so that market participants are aware of the future direction and pace of interest rate changes.

What are the central policy messages for Governments in the region? First, oil prices have risen far beyond the level of any working assumptions that might have been made by Governments in the region earlier in the year. Furthermore, they are likely to remain under upward pressure for some time. They thus pose a threat to inflation and the uncertainty of their future course is likely to discourage investors from making significant commitments in the months ahead. Two, there is a distinct risk of the external environment, i.e., demand from China, Japan and the United States, deteriorating in unison in the months ahead. Some weakening of momentum was already taking place in two of the three economies prior to the recent upheavals in the oil markets; the latter have made the likelihood of a simultaneous, albeit marginal, slowdown more rather than less probable. Three, a weakening external environment, varying inflationary pressures in the region and a depreciating dollar would together pose a major challenge to maintaining growth and macroeconomic and exchange rate stability in the months ahead. Governments would thus need to assess their individual positions vis-à-vis inflation, growth, capacity utilization and their own fiscal situation before deciding upon the most appropriate course of action. In the short term, the risks of inflation outweigh the other risks as inflation left untreated can acquire its own momentum and do severe damage to the economy. Furthermore, inflation has a tendency to affect the poorer sections of society more severely than the rich. On social grounds, therefore, the need to tackle incipient inflationary pressure is paramount.

Addressing the supply side of oil

In this regard, it is the case that several Governments in the region subsidize prices of oil products. Should oil prices remain high for some time this will pose an impossible fiscal burden on them.¹¹ There is a case, therefore, for re-examining the system of subsidization, to better target the subsidies and to endeavour to phase them out over a defined time-span. Subsidies, while socially more equitable, tend to encourage overuse of the subsidized product and, hence, usually prove to be unsustainable in the long run.

As mentioned elsewhere, action is also needed to address the supply side of the oil question. While little can be done to increase supplies in the short term, Governments in the region should look into the practical aspects of maintaining higher stocks of both crude and finished products and examine whether the main oil importers in the region could take more cooperative action in this area. At least some of the volatility in oil prices might be reduced as a result.

¹¹ "Fuel subsidies begin to take toll in Asia", *Asian Wall Street Journal*, 5 October 2004.

Long-term development policy issues

The challenge posed by the ending of textile quotas

Tackling the Millennium Development Goals remains the major long-term development challenge, but, simultaneously, near-term policy issues such as those outlined above have to be tackled on a day-to-day basis by all Governments in the region and such issues often succeed in dominating the agendas of most Governments in the region. However, preoccupation with them should not come at the cost of neglecting the longer-term development challenges. One central challenge in that context is how to manage the myriad issues that globalization poses. An immediate issue in that context, for instance, will be the ending of export quotas when the Multifibre Arrangement expires at the end of 2004. The ending of the quotas for clothing and apparel exports represents a major challenge for a number of economies in the region, mainly in South Asia. In Bangladesh, such exports make up 75 per cent of total exports, while in Sri Lanka they account for close to 50 per cent. In Pakistan they represent just over a fifth of total exports. Outside South Asia such exports are proportionately less important, the highest being Viet Nam with around 15 per cent of its total exports consisting of clothing and apparel. While large shifts in trading patterns are not expected to happen overnight and countries have had several years to prepare for this event, the ending of the quota system means that such economies could well lose out to stronger competitors, mainly China and India, in international markets over the medium term. UNCTAD takes a more optimistic view based on the facts that (a) China's transitional arrangements following WTO membership will not end until 2016 (indeed, United States textile and clothing companies are already urging the United States Government to keep Chinese clothing and apparel exports to the United States subject to quota restrictions) and (b) shifts in supply-demand relationships only tend to occur gradually (hence, countries like Bangladesh and, indeed, other least developed countries involved in garment exports are unlikely to face immediate pressure to find new markets, etc).

The Governments of these countries nevertheless need to redouble their efforts towards strengthening their respective textile and garment industries. Even a gradual loss of international market share could have severe social consequences through a loss of jobs. Whether it is worthwhile to preserve the textile industry, or enhance competitiveness in other manufacturing or service activities, can only be judged by the Governments and business people of the countries concerned. What is important from a policy perspective is that given the importance of the textile sector for Governments to provide the needed logistical and technical support to assist those engaged in clothing and apparel production in supplying their markets competitively. More generally, these countries should remain committed to the trade liberalization agenda whether at WTO or at the regional and subregional levels and not to seek to delay the implementation of the Agreement on Textiles and Clothing.

Similar issues will arise as the transitional arrangements that form an essential component both of the multilateral trade liberalization agenda of WTO and in the various regional and bilateral FTAs recently concluded by

ESCAP economies draw to a close. Building, enhancing and sustaining the international competitiveness of ESCAP economies, whether in manufacturing, agriculture or services, is thus both a vital long-term development challenge as well as a major near-term policy issue for Governments in the region. Meeting it would require not merely a supportive policy environment at the macroeconomic level but also an ongoing programme of investment in both physical and social infrastructure.

***The importance
of social
infrastructure***

The importance of good physical infrastructure, such as transport facilities, ports, electricity, water, etc., is well known and does not require reiteration here. With regard to social infrastructure, much neglected in the past, its importance is now increasingly recognized within the broad rubric of governance. Social infrastructure is not merely the efficient operation of key institutions of governance, such as the legal system, the financial sector and education and health delivery agencies, but an underlying “social contract” that defines relations between the individual and the community and between the citizens and the State. The absence of such a social contract can gravely undermine the public good; equally, its presence can significantly reduce the need for more formal and quasi-legalistic arrangements that often do not work at all, or work poorly, in practice in most developing economies. The poor, for example, reduce their vulnerabilities not through insurance mechanisms but through the access that they have to the informal institutions of the larger community.

As highlighted in the *Bulletin 2003/04*, the primary objective of development is to reduce poverty and initiate sustained improvements in the living conditions of the people. It is the central responsibility of all Governments in the region to focus upon attaining this objective. However, the route taken in reaching this objective can vary from country to country depending upon its initial conditions, its resource endowments, its recent development experience, its trading links and the effectiveness of its governance in providing an appropriate framework of laws, regulations and institutions to promote development, underpinned by an effective social contract as discussed above. All these elements taken together determine, when viewed from the current perspective, a country’s ability to achieve sustainable improvements in the standards of living of its citizens while grappling with the forces of globalization.

It is well recognized that raising the productivity of investment, both public and private, is the key to successful long-term development. Some countries get both the levels and the composition of investment right and achieve high rates of economic growth. Other countries invest too much through the public sector and crowd out private investment. Yet others invest too little through the public sector – a problem manifested in poor educational facilities, poor infrastructure and poor public institutions generally – an approach that reduces the efficiency of overall investment in the economy and reduces its long-term growth potential. While the paucity of public resources is driving many countries to involve the private sector in the provision of public services, at root is the choice of what is best left to public provision and what is best provided by the private sector, in other words, what are the respective

spheres for individuals, markets and communities, including the State, and how best to guarantee both efficiency and equity in society.

Beginning with the 1980s but gathering pace since the 1990s, there has been an attempt to withdraw the State from activities where previously the public interest was seen to be equated with public ownership. With globalization and technology altering traditional distinctions between the public and private sectors, a new consensus is needed to redraw the lines between the public and private sectors and, indeed, to look again at the public sector itself. Agreeing on where markets have an enhanced role and where market failure has to be tackled seriously is therefore a critical prerequisite for fashioning such a consensus. To argue without qualification that the only kind of reform that is worth pursuing is some form of privatization of public enterprise negates the possibility of a proper debate on how a reformed public sector might contribute to the greater achievement of efficiency and equity in society, outcomes that are universally desired.

In the above context, it is worth stressing that markets are best regarded as a means and not as ends in themselves. There is no question that markets are good at efficiently creating productive assets but it is also true that they are less good at guaranteeing fairness. If the profit motive is the only incentive, public goods will rarely be provided by markets and, unless corrective measures are taken, markets will tend to widen inequality of access to public goods, like education and health, and lead eventually to greater social inequality, a recipe for chronic instability in society. It is worth remembering that any given economic system is not a discrete sphere of human activity. It is a reflection of the prevailing value system. Economic structures, in turn, generate values and outcomes that help to shape the social and political consensus. If these structures result in ever-widening inequalities, in the poor provision of public services and in a general lack of fairness, the implicit social contract will eventually break down, leading to endemic instability in society.

***Better balance
between the public
and private sectors***

Linkages between investment and productivity growth have been viewed through the lens of international competitiveness in recent years. Competitiveness can be applied at both the enterprise and the national levels. Not all countries can simultaneously improve competitiveness relative to other countries. Competitiveness is determined by both real and monetary factors. It may increase as a result of greater investment in productive assets or it may increase through a slower rise in unit labour costs, from an effective exchange rate depreciation or, more usually, from a combination of all three. The role that Governments can play in maintaining and enhancing competitiveness is either as a provider of public goods and social infrastructure or as an enabler of the process. In the latter case, Governments need to look beyond the provision of macroeconomic stability to overcoming the impediments traditionally identified – such as properly-functioning capital markets – to encourage innovation and investment in technology by enterprises. Whether particular activities are carried out in the public or private sector is less important than that they are performed efficiently and effectively.

Successful development is thus a multifaceted phenomenon. Achieving high rates of economic growth and high average per capita incomes is merely one part of the story; its obverse is social stability, which can only be achieved if the benefits of growth are shared equitably through the public provision of public services. Decentralization has often been cited as almost a panacea to this end. But decentralization raises its own complex issues and the choices involved are not easy. In the final analysis, Governments must rely not only upon their own judgement but equally upon the contribution that informed citizens can make in this regard. Development interventions should thus be viewed not only from the narrow perspective of output growth but also in terms of their impact on the social infrastructure. Social infrastructure does not exist in a vacuum; indeed, the nature and extent of interactions between individuals and society and between State institutions and citizens hold the key to the long-term development prospects of society.¹²

¹² M. Woolcock and Deepa Narayan, "Social capital: implications for development theory, research and policy", *World Bank Research Observer*, vol. 15, No. 2, August 2000.