

EXECUTIVE SUMMARY

The global economy grew by 3.2 per cent in 2005, down from growth of 4.0 per cent in 2004. Notwithstanding the slight deceleration, performance in 2005 was remarkable in view of an increasingly adverse economic environment, led by high and volatile oil prices, widening current account imbalances and a softening of global trade. Economic growth in 2005 was driven essentially by the strong performance of China and the United States of America. The growth rate of ESCAP developing countries decelerated moderately, by about 1 percentage point, in 2005 owing largely to high oil and commodity prices and the global slowdown in trade.

The rise in oil and other commodity prices did, however, increase inflation in 2005 relative to 2004, although the increase in prices throughout the region remained mild by historical standards. Economies adjusted well to the higher oil and commodity prices, some attenuating the effects of those prices by continuing to subsidize petroleum products and others by pre-emptively tightening monetary policy, and these measures served to dampen inflationary expectations. Prospects for the ESCAP region for 2006 indicate that output growth should maintain its current momentum while price pressures are likely to abate somewhat despite continuing high energy and commodity prices.

The principal policy issues and challenges facing the region over the next 12 months are concerned with the course of oil prices, the threat of global external payment imbalances unwinding precipitously, the impact of higher interest rates and the potential for the avian influenza to develop into a human pandemic. Longer-term issues relate to the ongoing challenge of poverty reduction, utilizing the benefits of home remittances to simultaneously improve social indicators and macroeconomic fundamentals, and re-energizing the trade liberalization agenda following the Sixth World Trade Organization Ministerial Conference, held in Hong Kong, China, in December 2005.

Oil prices

Oil prices have doubled since the beginning of 2004 and have trebled since 2002 as global demand has exceeded limited supplies, especially of petroleum products. Despite the high prices of oil there has been no sign yet of a major global economic slowdown. Notwithstanding these factors, the Asian and Pacific region, which is highly dependent on oil, remains vulnerable to any significant increase in oil prices in 2006. ESCAP forecasts assume that oil prices in 2006 will be similar to those prevailing in 2005, i.e., in the \$50-\$55 range. However, net oil-importing countries need to take steps to prepare for the risk of a large increase in oil prices both to mitigate the adverse social impact of such prices as well as to counter their negative macroeconomic effects.

In this regard, streamlining the existing system of subsidies is clearly warranted, particularly when the subsidies do not reach the intended groups. In view of the fiscal burden on Governments, subsidies on fuel types that are not widely used by the poor could be phased out. Within the region, the least developed countries in particular face significant vulnerabilities as a result of rising oil prices. These countries have little access to alternative sources of financing to cushion a temporary increase in balance of payments deficits caused by high oil prices. Therefore, international financial institutions need to provide, or

arrange, financial assistance for these countries as was done in the 1970s through the oil facility of the International Monetary Fund. Net oil exporters of the region, for example in Central Asia, also need to adjust to rising income from oil. The focus should be on efficiently managing the oil windfalls without jeopardizing short-term macroeconomic stability, as there is likely to be pressure on real exchange rates to appreciate.

Both oil-importing and -exporting countries should take steps to develop a longer-term policy response to reduce their dependency on oil, improve energy efficiency and promote energy conservation. Rationalization of energy pricing, greater public awareness of alternative energy options, improved regulations to ensure a minimum level of energy efficiency and fiscal incentives to reduce energy consumption are some of the measures that have already proven to be effective in various settings. Their wider application should be promoted as a matter of priority in the region.

External payment imbalances

The widening imbalances in the external accounts of major economies in the world pose a major risk for the economy of the Asian and Pacific region in 2006. A rapid unwinding of these imbalances could create large upheavals in the international financial markets and cause significant exchange rate instability not merely involving the dollar but perhaps several currencies in the region. Such a phenomenon would, in turn, have a negative impact on the regional economy by making consumers and investors more risk averse, tempting them to divert more savings into real estate and precious metals than is currently the case. However, there is only limited scope for action to address this problem at the national level.

An appropriate policy approach would be to view current account imbalances as a reflection of a structural mismatch between domestic savings and investment. Those countries with excess savings over investments tend to run current account surpluses. The opposite is true for low-saving countries. Remedying the imbalances therefore would require higher investment in the surplus countries and higher savings in deficit countries, the United States in particular.

In view of the widespread negative implications that an abrupt and large-scale unwinding of global current account imbalances would have if Governments depend on financial markets alone, a concerted multilateral response is certainly needed. Rather than trying to correct imbalances that may lead to sharp contractions in the wider global or regional economies, a more effective solution would be to strive for a balanced, medium-term approach, with exchange rate adjustments effected over a period, within an agreed regional framework, for example.

Impact of higher interest rates

An important issue with which economies in the region would have to deal in 2006 is the potentially adverse impact on growth of tighter fiscal and monetary policies. For a number of years, many countries have been following a policy of fiscal consolidation, with a view to reducing the growing burden of public debt and providing more opportunities for private investment activity. Inflationary pressures induced by higher oil prices have resulted in a tightening of monetary policy, with interest rates generally rising across countries in the region, although some countries are notable exceptions.

Reinforcing the effects of long-term fiscal consolidation, especially in countries where it is being brought about through cuts in government expenditure rather than through improved tax revenues, are higher interest rates. They are bound to adversely affect the pace of economic activity. A particular danger exists in those economies where low interest rates have fuelled strong growth in debt-financed private consumption and have created asset bubbles in real estate and in stock markets.

In this regard, higher interest rates should prove less deleterious for economic growth than cuts in government spending, especially in the poorer developing countries where government development expenditure is often the key to the pace of development. However, in the richer developing countries where real interest rates are already high, a further significant increase could trigger a hard landing of the economy through a sharp decline in asset prices. Thus, the policy challenge is to mix fiscal and monetary policies judiciously so as to ensure steady growth in output over the next 12 to 18 months. Most investors value policy predictability; Governments should therefore develop medium-term scenarios for GDP growth, inflation and budgetary and balance-of-payments outcomes through a process of consultation with all relevant stakeholders.

Avian influenza

From December 2003 to the beginning of February 2006, 161 people in the region have been infected with avian influenza and 86 of them died. No vaccine is currently available to protect humans from avian influenza. The number of people who might die in a possible global pandemic if the highly pathogenic avian influenza becomes transmissible between humans range from an estimated 5 million to 150 million people worldwide. Should such a pandemic occur, it would inevitably cause massive disruptions to everyday life through overloaded health-care systems, widespread quarantines and travel restrictions, among others. As a conservative estimate, the loss in GDP globally from such a pandemic could amount to \$200 billion in a single quarter and in the worst case scenario could plunge the global economy into recession.

Given these risks, there is an urgent need for collective preparedness in the region involving the stockpiling of medical supplies and the taking of joint action on possible control measures, such as travel restrictions, to prevent the spread of the disease if a pandemic occurs. It is also important from the standpoint of cost-effectiveness to concentrate resources and action on controlling the disease at its source before it develops into a more rapidly spreading contagion.

The ongoing challenges of poverty and inequality

Although the Asian and Pacific region has been growing faster than most regions of the world for two decades or more, the eradication of extreme poverty remains its most important challenge. In tackling the problem of poverty it is important to remember that rapid growth remains the surest route to reducing both income poverty and non-income poverty. Rapid economic growth provides opportunities for employment in both the formal and informal sectors of an economy. It also generates resources for the public sector whereby issues of non-income poverty, such as insufficient or poor-quality public goods (education, health, transport and housing), can be meaningfully addressed.

However, rapid economic growth alone may not be enough. In countries where poverty is widespread, jobs and income growth alone do not seem to make a positive impact on non-income poverty. In such cases, the Governments concerned need to intervene in order to make the growth process more equitable by significantly expanding the provision of, and access to, public goods, particularly for and by the poor.

Remittances

Remittances sent to their families by migrants and temporary workers on contract abroad have greatly helped to raise the standard of living of some of the poorest sections of society in countries in South Asia, South-East Asia and the Pacific. Governments in these and other countries with high levels of underemployment and with limited opportunities for employment in the formal sector could follow the example set by the Philippines and systematically promote the temporary export of workers as a part of their national development and poverty-reduction strategies.

Countries facing general labour shortages or lacking workers with specific skills should consider allowing migrants to work legally in their economies. Such a policy approach would have a positive impact on the unemployment problem in many countries of the region and lead to a better utilization of skills across different subregions.

The WTO agenda

The previously mentioned Sixth WTO Ministerial Conference concluded with the adoption of a wide-ranging ministerial declaration. While the declaration puts the Doha round back on track, an issue of fundamental importance is whether it holds the promise that the Doha round will ultimately correct the development deficit of the Uruguay round. A key challenge facing ESCAP members and associate members over the next year will be finding ways to reinvigorate the Doha development agenda.

ESCAP developing countries are likely to be challenged in the months ahead to make concessions of a commercial value so that developed countries will remain committed to the development process. Thus, the trade-dependent countries of the region need to determine ways to harness the traditional reciprocity dynamics of WTO to move forward on their market access expectations. At the same time, a jump-start will be needed to open up the service sector. Efforts to do so by some increasingly dynamic service exporters in this region would be worthy of further support by other developing countries in Asia and the Pacific.

Emerging issues of unemployment in the region: rising to the challenges

The number of people unemployed in East Asia increased from 4 million in 1992 to 9 million in 2002, while the number in South-East Asia and the Pacific increased from 5.5 million to 14.6 million in the same period. Total unemployment in South Asia increased by 7 million over the same period. Unemployment is highly concentrated among youth throughout the region. However, among

children between the ages of 5 and 14, sadly too many are employed. The region harbours an estimated 127 million or 52 per cent of the world's 246 million working children. As for underemployment, the problem is even more widespread than unemployment, particularly in rural areas.

Jobless growth

There are two major reasons for high unemployment and underemployment. First, the rate of growth of the labour force is high. Second, the pace of job creation has not kept up with that growth. In addition demand for labour has been declining owing to technological changes and the considerable downsizing that has occurred in public sector employment following privatization in some countries. There is widespread concern that many countries in the region are achieving high output growth at the expense of employment creation. The charge of jobless growth is being made, particularly in rapidly growing economies where the rate of unemployment has recently tended to rise.

Working poor

A large number of those employed in countries in the region earn paltry wages. The share of the working poor measured in terms of those earning less than \$2 a day (defined in terms of purchasing power parity) in total employment in 2003 was 88 per cent in South Asia, 59 per cent in South-East Asia and 49 per cent in East Asia. Data indicate that the vast majority of such people earn wages that are just above the \$1 a day poverty line. As a result, the likelihood of the working poor sliding into extreme poverty because of internal or external shocks is very high.

Improving the functioning of labour markets is of vital importance in tackling the problem of unemployment. In the formal sector, the region's labour markets are excessively rigid. The low level of education among workers and the mismatch of educational attainment and the skills demanded by the private sector are major causes of unemployment.

Youth unemployment

Compulsory education up to a reasonable age could help to address the complex problem of child labour. Educational reforms in countries where female unemployment is high or the female participation rate is low may break this vicious circle by providing a more conducive socio-cultural environment in which women could receive an education. This would improve their productivity and help in eliminating wage and employment discrimination against women. Enhancing the employability of youth, but not children, should be a key component of labour-market policies and educational reforms.

Policy responses

Striking the right balance between high growth and employment creation requires measures to improve the productivity of workers in niche industries while focusing on sectors where the majority of labour is concentrated, giving particular emphasis to capacity-building. In agriculture, land reform, extension services, the provision of credit, crop diversification and rural infrastructural development would

obviously play a critical role in this respect. Improved marketing facilities and cooperative organizations could also be effective instruments in advancing rural employment.

In both rural and urban areas the development of micro- and small- and medium-sized enterprises has the greatest potential for generating employment and this process needs to be facilitated by providing business with a conducive environment, in particular by reducing entry costs, by providing institutional support, by building capacity and by implementing the principles of good governance.

In this regard, employers also need to display better corporate responsibility by providing opportunities for the training and retraining of workers, collaborating with the public sector in enabling unemployed youth to obtain training and by ensuring workplace safety and the welfare of employees.

International migration could play a valuable supporting role in stabilizing the labour markets of both labour-importing and -exporting countries. In this respect, the organized flow of persons under a global framework such as Mode 4 of the WTO General Agreement on Trade in Services could create tangible benefits for all the countries concerned.