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Chapter II

INTERNATIONAL TRADE AND FINANCE



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INTERNATIONAL TRADE AND FINANCE

A. International trade

1. **Global trade recovery: developing and transition economies play a major role**

Global trade increased significantly in 2003, after sluggish growth in 2002 and a slight contraction in 2001. Total merchandise exports grew by 15.5 per cent in current dollar prices. However, unlike the trade expansion of the second half of the 1990s, which was mainly the result of high export volumes, the growth rate in 2003 was characterized by a surge in the unit value of exports (denominated in dollars). This concerned manufactures as well as commodities, and put an end to the downward trend in prices that had begun in 1995. One important reason for these price increases was the depreciation of the dollar vis-à-vis other major currencies. By contrast, total export volume expanded at the more modest pace of 4.9 per cent, compared to the average annual growth rate of the 1990s of 6 per cent, approximately three times the world's average GDP growth in that decade (fig. 2.1). The ratio of export growth to GDP growth fell to the more moderate pre-1990 levels, before trade liberalization and integration processes in developing countries ac-

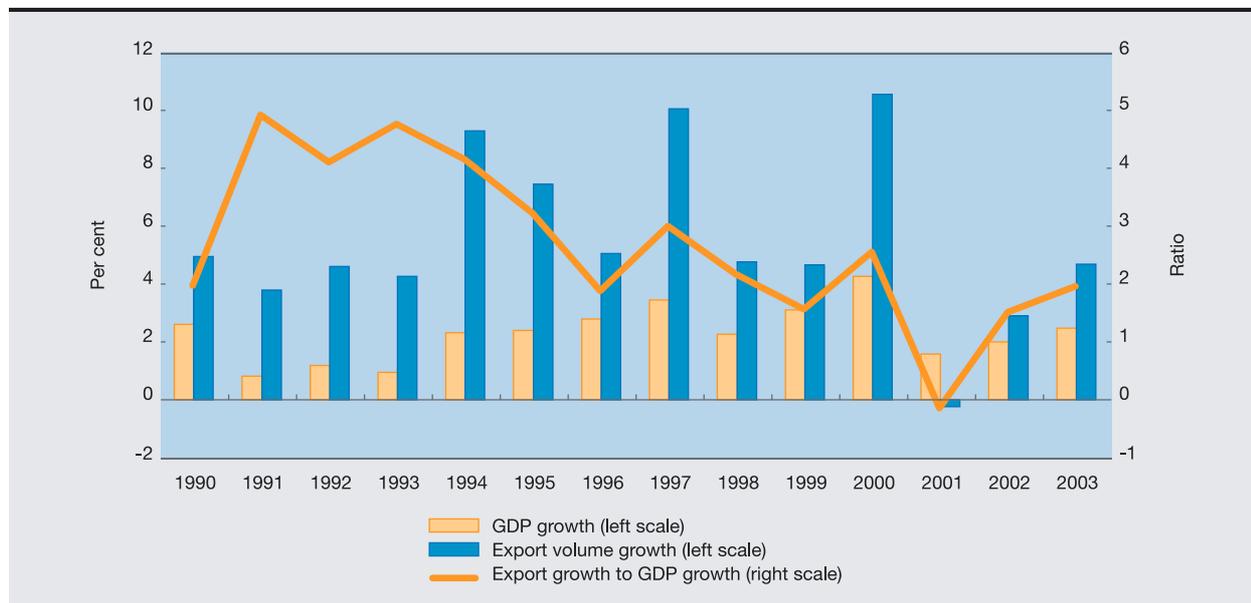
celerated world trade growth in relation to that of world GDP (*TDR 2003*: 44–49).

Not only was growth in export volume in 2003 slower than in the 1990s, but the origins have also changed. Between 1990 and 2000, developed countries accounted for most of the world's export growth. This was not due to exports rising faster in developed than in developing countries (actually the converse was true, as can be seen in table 2.1), but to the fact that, on average, 70 per cent of total exports originated in developed countries (including intra-EU trade), and only 25 per cent in developing countries during the 1990s. By contrast, the recovery of world trade in 2002 and 2003 was propelled mainly by developing countries: developed countries accounted for about 21 per cent of the increase in the volume of exports in 2003, developing countries for 66 per cent, and transition economies for 12 per cent. This shift is attributable not only to sluggish exports in most developed countries and regions but also to rapid expansion of export volumes in some developing regions (especially East and South Asia) and in the transition economies of Central and Eastern Europe and the Commonwealth of Independent States (CIS).

Figure 2.1

WORLD GDP AND EXPORT VOLUME GROWTH, 1990–2003

(Annual growth rates and ratio of export growth to GDP growth)



Source: UNCTAD secretariat calculations, based on WTO, *International Trade Statistics* database.

The contribution of developed and developing countries to growth of world imports by volume was more balanced, at around 40 per cent and 50 per cent, respectively, in 2002–2003; transition economies accounted for the remaining 10 per cent. Imports in developed countries remained more dynamic than exports, due to the persistent growth of United States imports. Even with a lower growth rate of imports, the extra imports by developed countries have a significant impact on world trade. For instance, even though United States imports increased by 8.8 per cent in 2003, compared to 40 per cent for Chinese imports, the expansion of imports in absolute value terms was almost the same for the two countries: \$105 billion in United States compared to \$118 billion in China (WTO, 2004a).

Weak export dynamism in developed countries in recent years has been partly the result of weak GDP growth. In Western Europe, faltering domestic demand within the region explains the low growth of export volumes between 2001 and

2003, since intraregional trade accounts for approximately two thirds of the region's exports. In the United States, the economic downturn in 2001, together with the global slowdown of growth, affected both imports and exports (fig. 2.2). In 2002 and 2003, that country's imports recovered much faster than exports, fuelled by an expansionary economic policy and a strengthening of the dollar until 2002. During the recent recovery, the geographical structure of United States imports changed significantly: imports from China continued to grow – by 52 per cent in current value between 2001 and 2003 – while those from Japan and the ASEAN countries contracted, leaving total imports from Asia almost unchanged. The share of Canada and Mexico in United States imports decreased, while that of the EU increased (USITC, 2004). As for exports, these began to recover in the last quarter of 2003, favoured by the real depreciation of the dollar. So far, however, this has not contained the United States widening trade deficit, equivalent to 5 percentage points of GDP in 2003, up from 2.4 points in 1997 and 4.6 in 2000 (see fig. 1.4).

Table 2.1

EXPORT AND IMPORT VOLUMES OF GOODS, BY REGION AND ECONOMIC GROUPING, 1990–2003

(Percentage change over previous year)

	Export volume				Import volume			
	1990–2000 ^a	2001	2002	2003	1990–2000 ^a	2001	2002	2003
World	6.0	-0.2	2.6	4.9	6.7	-0.2	2.7	6.0
Developed economies	5.3	-0.9	0.6	1.5	6.2	-1.3	1.4	3.5
<i>of which:</i>								
Japan	2.6	-9.5	7.9	4.9	5.3	-2.0	2.0	7.1
United States	6.7	-5.7	-4.1	2.7	9.1	-2.9	4.6	5.5
Western Europe	5.4	1.8	0.6	0.8	5.0	-0.4	-0.5	2.0
Developing economies	7.6	0.6	6.2	10.8	8.0	0.4	5.3	11.7
<i>of which:</i>								
Africa	3.4	2.2	0.8	7.5	4.2	6.1	2.0	7.9
Latin America	9.3	2.7	0.2	5.2	11.6	1.3	-7.5	2.3
West Asia	5.3	3.3	-5.0	3.3	3.2	7.6	2.7	1.2
East and South Asia	8.1	-0.8	10.5	14.0	7.8	-1.7	9.8	15.9
Transition economies	6.6	8.2	8.1	12.4	6.0	15.0	7.3	11.0

Source: UNCTAD secretariat calculations, based on IMF, *International Financial Statistics* database; WTO, *International Trade Statistics* database; ECLAC, *Statistical Yearbook for Latin America and the Caribbean* database; and Japan Customs and Tariff Bureau database.

^a Average.

Japan's trade surplus continued to grow in 2003, but at a much slower pace than in 2002. Import volumes picked up following an appreciation of the yen and improved domestic economic conditions. Although the United States remains Japan's largest trading partner, bilateral trade between these two countries declined. As Japan's manufacturing has been steadily moving to lower cost locations abroad, especially to China, many of the goods (mainly information technology and electronics products, automobiles and machinery) previously exported directly from Japan to the United States are now finalized and shipped to the United States by Japanese subsidiaries based in China. This would also explain why Japanese exports of capital and intermediate goods to other Asian countries, especially to China, have grown dramatically. In 2003, Japanese exports to China

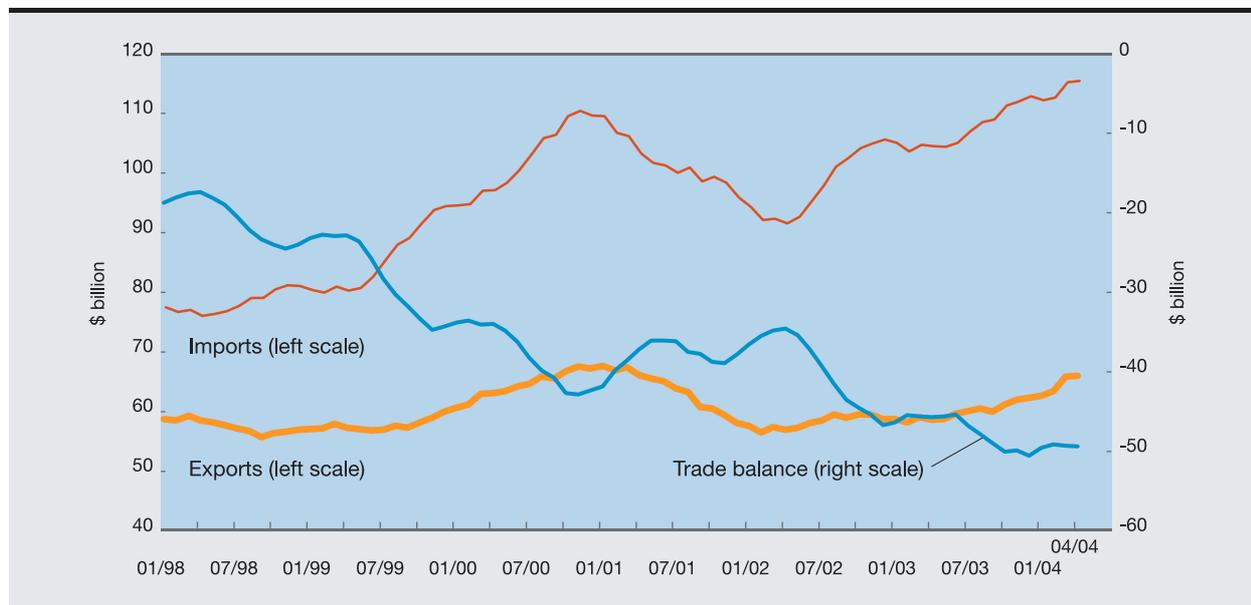
grew by 44 per cent in current dollar terms, much of the increase being driven by demand of intermediate products from Japanese subsidiaries that produce goods destined for both the Chinese market and for exports. As mentioned in chapter I, this expansion gave a major boost to Japan's economic recovery in 2003–2004.

In developing economies, trade volume recovered in 2003, albeit with varying intensity in different regions. East and South Asia experienced the most rapid growth of both imports and exports, continuing their strong growth trend of recent years, except for a slight contraction in 2001. Intraregional trade expanded at an even higher rate, growing more than sixfold over the last three decades. At present, 35 per cent of East Asian exports go to other economies in the region, com-

Figure 2.2

MONTHLY EXPORTS AND IMPORTS OF GOODS AND TRADE BALANCE IN THE UNITED STATES, 1998–2004

(Billions of dollars, 6-month moving averages)



Source: UNCTAD secretariat calculations, based on United States International Trade Commission (USITC), *Interactive Tariff and Trade DataWeb*.

pared to less than 24 per cent in 1985 (United Nations, 2004). This massive increase in intraregional trade has been partly due to higher import demand from within the region, notably from China, but also to a reorganization of production processes into regional production networks, which have resulted in increased trade flows of industrial supplies and intermediate goods. These are produced in the more industrialized countries in the region such as the Republic of Korea and Singapore, and are finalized in countries with low-cost labour, mostly China (*TDR 2002*, chapter III).

The expansion of East Asian trade has occurred together with a substantial change in the destinations of exports. Deeper production-sharing practices within the region have contributed substantially to the rise of intraregional trade flows. In particular, China's emergence as a major production site for labour-intensive stages of production and assembly has exerted a huge impact on such flows, both within Asia and between Asia and the rest of the world. Goods that were

previously processed and exported by other Asian countries are now finalized in China for export. This phenomenon explains, in large part, the increasing bilateral trade imbalances between China and its major trading partners; China has recorded growing trade surpluses with North America and Europe, while widening its trade deficit with the rest of Asia. At the same time, the rapid growth of industrial activity in China is increasing its demand for energy and industrial raw materials, which it imports from other developing countries and transition economies. Consequently, China is playing a fundamental role in international commodity markets, as further discussed in the next subsection.

West Asia (excluding Iraq) saw a large growth of exports in terms of volume and value. Oil-exporting countries benefited from significant increases in oil prices. In 2003, they were, on average, 15.8 per cent above their 2002 level (table 2.2), and rose at a similar rate in the first half of 2004. Furthermore, oil exports of several West

Asian countries expanded significantly in volume during 2003, due to the strong global demand and to the fact that they had to compensate for sharp cuts in supply from Iraq, Nigeria and Venezuela. Imports also registered a significant increase, but much slower than exports, thus enlarging the oil-exporters' external surplus. The largest non-oil-exporting country in the region, Turkey, also experienced strong growth in exports, mainly to Western Europe, but imports grew even faster due to an overvalued lira.

In Africa, both exports and imports rose by almost 8 per cent each in volume, and 22 per cent and 17 per cent respectively in value. Much of the export expansion came from a few oil exporters: Algeria, Angola, Egypt, the Libyan Arab Jamahiriya and Nigeria accounted for almost 60 per cent of the growth in regional export value. However, several other countries in the region also saw higher exports: 23 out of 53 countries recorded an increase in exports of more than 15 per cent, and only six experienced a contraction (WTO, 2004a). This could be attributed largely to higher commodity prices (especially oil, mining and agricultural raw materials) and to improvements in the supply side, with greater crop production in several countries.

Trade in Latin America has been recovering slowly from its downturn of 2001 and 2002, but the situation differs by country and subregion. Between 2001 and 2003, a halt of the buoyant trade growth experienced in Mexico during the nineties, had a major impact on regional figures, since that country accounts for roughly 45 per cent of Latin American exports and 50 per cent of its imports. Due to the United States slowdown and persistent appreciation of the Mexican peso, exports of manufactures were down, and only picked up in 2004, in a delayed reaction to the recovery of United States imports. In 2003, Latin American export growth was mainly due to the solid performance of the Southern Common Market (MERCOSUR) and some Andean countries.

In MERCOSUR, real exchange rate depreciations in previous years and price increases of some important export products restored the profitability of tradables in manufactures and primary commodities, and attracted investments towards them. Moreover, the introduction of new agricul-

tural techniques lowered costs and permitted an expansion of the planted area and of exports, particularly of soybeans. In 2003, the value of exports rose significantly in Argentina (15 per cent), Uruguay (17 per cent), Brazil (21 per cent) and Paraguay (36 per cent) (ECLAC, 2004a). In Brazil, exports have been increasing steadily in volume and value terms following the devaluation: they grew by more than 50 per cent between 1999 and 2003. In several Andean countries, exports grew as a result of several large investments in hydrocarbons and mining, undertaken mainly by transnational corporations (TNCs) as part of their long-term strategies; in these cases, the real exchange rate or other short-term considerations played a minor role. In Bolivia and Ecuador, new pipelines substantially expanded the capacity for transportation of oil and gas, and have already enabled an increase in production and exports. In Chile and Peru, the completion of investment projects in copper- and gold-mines along with rising commodity prices boosted mineral exports in the second half of 2003 and the first quarter of 2004. The increased supply capacity in Latin American primary production matched dynamic demand, especially from China. This country became an important market for Brazil (more than 6 per cent of its total exports), Argentina, Chile, Costa Rica and Peru (around 9 per cent of these countries' exports) in 2003. But even when Chinese demand was not directed at Latin American countries, it nevertheless contributed to the increase in commodity prices, thereby indirectly having a favourable impact on the region's export revenues (see subsection 2 below).

The external trade of the transition economies, which has been very dynamic for more than a decade, was not interrupted even by the 2001 global slowdown. In 2003, both imports and exports expanded by 27 per cent at current values, with almost all countries increasing their exports and imports by more than 20 per cent (WTO, 2004a). For the Central and Eastern European countries (CEECs) that acceded to the EU in May 2004, expectations related to accession prompted an ongoing process of relocation of production and generated additional trade flows between these countries and the EU. This process did not lose momentum even during the period of quasi-stagnation of trade and GDP in Western Europe, mainly the euro area, that began in 2001 (table 2.1).

Table 2.2

WORLD PRIMARY COMMODITY PRICES, 1998–2003						
<i>(Percentage change over previous year)</i>						
<i>Commodity group</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>
All commodities^a	-13.1	-13.9	2.0	-2.9	-2.0	8.1
Food and tropical beverages	-14.9	-18.5	1.0	0.0	-2.0	1.0
<i>Tropical beverages</i>	-17.3	-20.9	-13.2	-22.0	8.7	6.0
Coffee	-28.5	-23.2	-16.2	-28.5	0.0	3.2
Cocoa	3.7	-32.1	-22.2	22.7	63.3	-1.3
Tea	4.3	-7.0	6.8	-20.2	-9.5	8.4
<i>Food</i>	-14.1	-18.3	5.3	5.0	-4.0	0.0
Sugar	-21.2	-30.0	30.5	5.6	-20.3	2.9
Beef	-7.0	6.1	5.7	10.0	-0.3	0.5
Maize ^b	-15.0	-11.1	-3.0	1.2	10.5	7.2
Wheat	-19.9	-10.9	3.5	9.2	16.2	-0.7
Rice	1.3	-18.6	-18.1	-15.2	11.0	4.2
Bananas	-3.1	-9.9	-2.3	38.8	-9.6	-28.8
Vegetable oilseeds and oils	7.1	-23.3	-22.8	-8.5	26.2	17.1
Agricultural raw materials	-10.8	-10.3	1.9	-1.9	-6.7	17.5
Hides and skins ^b	-13.1	-5.9	11.2	5.5	-2.9	-16.8
Cotton	-8.3	-22.9	3.5	-20.9	-3.3	38.0
Tobacco	-5.5	-7.0	-3.3	-0.3	-8.2	-3.5
Rubber	-29.8	-12.6	7.9	-14.1	33.1	41.7
Tropical logs	-1.2	-7.2	3.8	6.3	-10.5	20.2
Minerals, ores and metals	-16.0	-1.8	12.0	-9.9	-1.8	12.1
Aluminium	-15.1	0.3	13.8	-6.8	-6.5	6.0
Phosphate rock	2.4	4.6	-0.4	-4.5	-3.3	-5.9
Iron ore	2.8	-9.2	2.6	4.5	-1.0	8.5
Tin	-1.9	-2.5	0.6	-17.5	-9.4	20.6
Copper	-27.3	-4.9	15.3	-13.0	-1.2	14.1
Nickel	-33.2	29.8	43.7	-31.2	13.9	42.2
Tungsten ore	-6.4	-9.3	12.1	45.5	-41.8	18.0
Lead	-15.3	-5.0	-9.7	4.9	-4.9	13.8
Zinc	-22.2	5.1	4.8	-21.5	-12.1	6.3
Crude petroleum	-31.8	38.7	55.6	-13.3	2.0	15.8

Source: UNCTAD, *Commodity Price Bulletin*, various issues.

^a Excluding crude petroleum.

^b These series have been revised from *TDR 2003*.

On the contrary, CEECs actually gained market shares inside the EU in 2003. The trade of CIS countries was no less dynamic in 2003, with higher values and volumes of imports and exports. In this group of countries, commodity exports (particularly oil and gas) have dominated.

World trade in services (transport, travel and other commercial services) grew by 12 per cent in 2003, twice as much as in 2002 (WTO, 2004b). As with trade in goods, however, much of this expansion seems to have been due to an increase in prices of some services. Moreover, transport

services accounted for the bulk of the expansion, while travel services (tourism) continued to be subdued. Transport services grew in 2003 in terms of both volume and value as a result of the global recovery of merchandise trade, which required increased shipments of commodities. Once again, the expansion of demand was driven, to a large extent, by China, and partly by the Iraq conflict. Costs of maritime transport increased sharply in 2003 and early 2004, ending the declining trend of previous years. An indication of the increased costs of freight is provided by the Baltic Dry Index: its average level climbed from 1,138 points in 2002 to 2,617 points in 2003 and 4,805 in January–May 2004.¹ A sustained demand of shipping transport services, especially from East Asia, resulted in a supply shortage following several years of relatively little shipbuilding and large-scale decommissioning of ships. Higher freight costs also reflected rising costs of insurance and fuel, in addition to increased costs of using older merchant ships (ECLAC, 2004b).

Travel services, measured by the number of international tourist arrivals, have not recovered from their 2001 downturn. After an annual increase of 4.2 per cent between 1990 and 2000, they declined in 2001 (by 0.5 per cent) and grew only by 2.7 per cent in 2002, before contracting again by 1.2 per cent in 2003 (World Tourism Organization, 2004). The fall in the number of arrivals in 2003 was concentrated in East and South-East Asia (by 11 per cent) and in North America (by 7 per cent). East and South-East Asia and Canada were severely hit by the outbreak of Severe Acute Respiratory Syndrome (SARS) during the second quarter, while security concerns discouraged arrivals to the United States, which fell for the third year in a row. Tourism in Europe stagnated (only Eastern Europe showed an increase), as a result of slow economic growth that hampered intraregional tourism, and of a strong euro. By contrast, in most developing regions, excluding East Asia, arrivals increased significantly in 2003. Tourism in Latin America and the Caribbean grew as a result of devaluations of their currencies (especially vis-à-vis the euro), a re-orientation of tourists from the United States to destinations seen as closer and safer, and the recovery of intraregional tourism. Intraregional travel has also been important in the Middle East (including Egypt), where arrivals expanded by 10 per cent.

2. Commodity prices on the rise, mainly driven by expanding demand in China

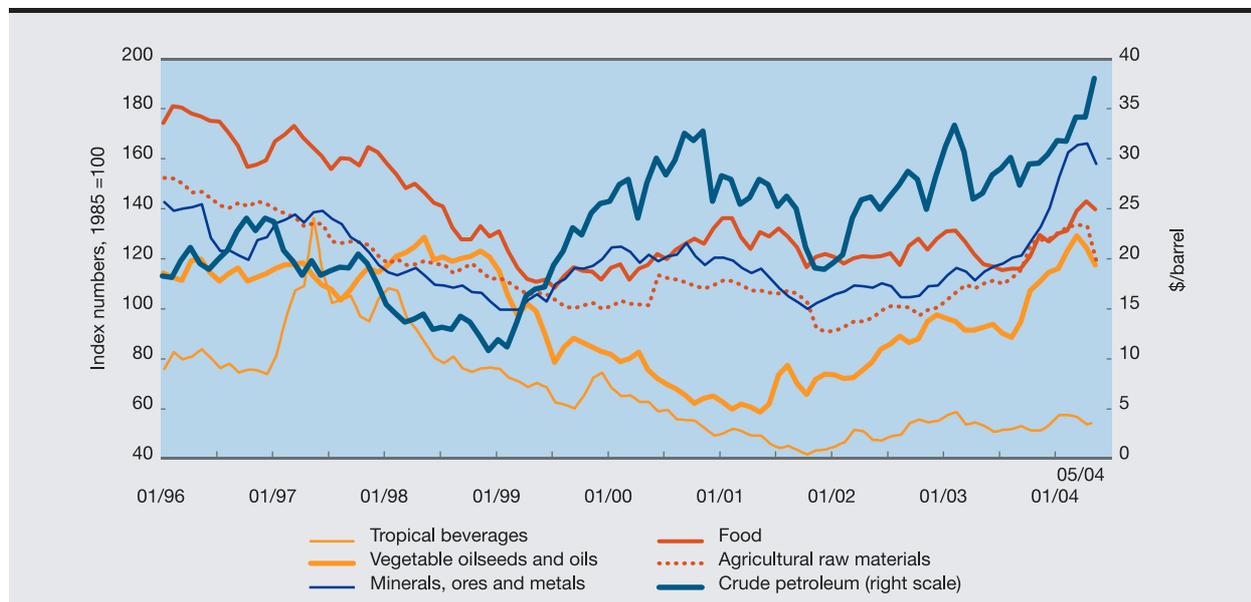
After a long period of decline, commodity prices in current dollar terms have been on the rise since 2002, and for some commodity groups they are approaching their levels of the previous peaks of 1996–1997. Prices have been increasing consistently for all commodity groups, the largest increases being in vegetable oilseeds and oils, agricultural raw materials and minerals, ores and metals groups (table 2.2). Price increases of food and tropical beverages were only very modest (fig. 2.3). For coffee and cotton, price increases have brought some relief to producers in developing countries that have been faced with a critical situation in recent years. However, for some other commodities, such as bananas, producers continue to suffer the negative consequences of an over-supplied market.

In general, recent commodity price increases can be explained by higher demand stemming from global economic recovery and, particularly from the rapidly expanding economic activity in Asian countries, especially China. In addition, supply has adjusted fairly slowly to the increased demand as a result of cutbacks in production that followed previous long-lasting price declines. However, there are some additional factors that may introduce a nuance to the classical supply-and-demand interpretation of a commodity price hike. While a cyclical commodity price upswing is undeniable, a closer look reveals that commodity price increases are not impressive enough to warrant alluding to a commodity boom or a bull market.

Along with commodity price indices, the unit value indices (in dollars) of manufactured goods exported by developed countries also increased by over 9 per cent in 2003 (UN/DESA, 2004). This implies that overall commodity terms of trade did not actually improve, and for some commodity groups they may even have considerably worsened. Likewise, it is important to take into account the impact of the depreciation of the United States dollar. As international commodity prices are usually quoted in that currency, movements in the dollar exchange rate are reflected in these prices.

Figure 2.3

**COMMODITY PRICE INDICES BY COMMODITY GROUP,
AND CRUDE PETROLEUM PRICE,^a 1996–2004**



Source: UNCTAD, *Commodity Price Bulletin*, various issues.

^a Crude petroleum, average of Dubai/Brent/Texas equally weighted (\$/barrel).

Typically, commodity prices move in the opposite direction to the dollar exchange rate. A depreciating dollar means that commodity prices rose much less or fell in terms of other major currencies. As a result, demand for commodities in consuming countries whose currencies are not pegged to the dollar has not fallen with the higher dollar prices, and might even have increased. For many large consumers, the surge in commodity prices has been matched by the sharp depreciation of the dollar in recent years. While the UNCTAD Combined Commodity Price Index in terms of current dollars increased by over 8 per cent in 2003, in terms of Special Drawing Rights (SDRs) it decreased by 1.3 per cent (fig. 2.4). Similarly, IMF (2004c) estimates of non-fuel primary commodity prices showed an increase of 7.1 per cent in terms of dollars in 2003, but a decline of 0.9 in terms of SDRs and of 10.6 per cent in euros.² Given these exchange rate movements, the export earnings of African commodity producers in the CFA zone have been negatively affected, as their currencies are pegged to the appreciating euro.

Additionally, the weak dollar, together with the low global interest rates, lifted international investors' demand for commodities. They have been more attracted by expectations of the higher returns that commodities could provide in comparison to other assets. Although this form of speculative investment normally focuses on precious metals, this time it has augmented demand for other metals as well, and even for some soft commodities. The role of these investment funds has thus added to the already considerable volatility of commodity markets, and it may negatively affect the prices of raw materials if international interest rates return to more normal levels. In fact, the upward trend in commodity prices seems to have stopped or even reversed in the second quarter of 2004, which may be partly the result of increasing expectations of higher interest rates. However, in the first half of 2004, commodity price indices remained significantly higher than in the same period of the previous year.

Once account is taken of the above-mentioned factors, which do not directly relate to

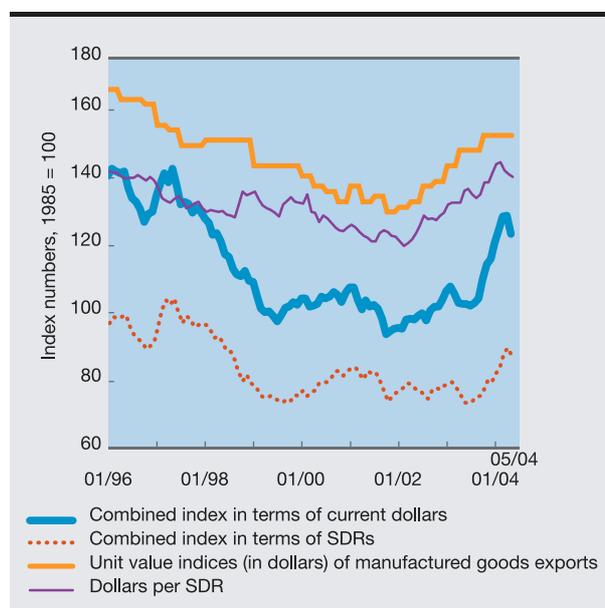
commodity supply-and-demand fundamentals, the major structural factor that has been pushing up world commodity prices in 2003 is the increasing demand from China. The continued rapid growth of the Chinese economy has necessitated increasing amounts of commodity inputs to meet its industrialization and development requirements. Consequently, in recent years, China has become the world's largest consumer of many commodities and, as Chinese production cannot cope with the pace of demand, it has also become an essential importer. Table 2.3 shows the magnitude of Chinese consumption growth in comparison with global consumption and with consumption growth in other countries for certain commodities. At the same time, as China is also the largest producer and major exporter of several commodities, it has become a key country in international commodity markets, with a critical influence on price levels.

Chinese upward pressure on prices is particularly important in agricultural raw materials and metals and minerals, but it has also been strongly felt in vegetable oilseeds and oils. In the case of soybeans, China's imports more than doubled at a time when they actually declined in the rest of the world. Since China accounts for more than one third of global soybean imports, this could explain why total world imports of soybeans registered an increase of nearly 17 per cent (United States Department of Agriculture, 2004). The increasing importance of China in the global market is partly a reflection of the changing food consumption patterns in the country, including the increased use of soybean residuals as animal feed for meat production. Booming Chinese soybean demand in 2003, combined with reduced production in the United States as a result of negative weather conditions and decreasing stocks, stimulated the agricultural sector in many South American countries, particularly in Argentina, Bolivia, Brazil and Paraguay.

In the raw materials sector, cotton and rubber are outstanding examples of the Chinese effect on demand and prices. Problems in the cotton market, in particular the negative effects of agricultural subsidies in developed countries on prices, have been high on the international agenda; four African cotton-producing countries (Benin, Burkina Faso, Chad and Mali) highlighted this issue at the WTO trade talks in Cancun in September 2003.

Figure 2.4

COMMODITY PRICE INDICES,^a UNIT VALUE INDICES OF DEVELOPED-COUNTRY MANUFACTURED EXPORTS AND EXCHANGE RATE, 1996–2004



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; and United Nations Statistics Division, *Monthly Bulletin of Statistics*, various issues.

^a In dollars and SDRs.

However, cotton prices rose considerably in 2003, thanks to increased global demand resulting from the previously low prices relative to competing fibres and to the dynamism of the Chinese textile industry that has encouraged a rapid increase in cotton mill consumption. Even though China is the largest cotton producer, it has had to import raw cotton in the last two years owing to the depletion of its own stocks due to poor weather conditions. China's raw cotton consumption in the 2002–2003 season increased by more than 12 per cent, representing over 30 per cent of total consumption, while demand from the rest of the world stagnated. Thus, thanks mainly to China's imports, global cotton imports grew by nearly 5 per cent, even though imports in other countries fell. Cotton import demand in China in the 2003–2004 season is expected to be about one fifth of world imports, up from only 1.6 per cent in 2001–2002 (International Cotton Advisory Committee, 2004).

Table 2.3

**GROWTH IN THE CONSUMPTION OF SELECTED PRIMARY COMMODITIES IN 2003:
CHINA AND THE REST OF THE WORLD**

(Percentage)

	Consumption growth			Contribution of China to global consumption growth	Share of China in global consumption
	China	Other countries	World		
Copper	9.6	1.0	2.6	67.4	19.5
Cotton	12.3	0.3	3.7	93.5	30.5
Natural rubber	11.1	3.6	4.9	39.2	18.5
Oil	11.1	1.5	2.1	34.4	7.0
Soybeans	32.3	0.9	4.9	84.9	16.3

Source: UNCTAD secretariat calculations, based on United States Department of Agriculture (USDA), *Oilseeds: World Markets and Trade*, April 2004; International Cotton Advisory Committee (ICAC), *La volatilité des prix sur le marché mondial du coton*, 2004; International Rubber Study Group, 2004; International Copper Study Group, *Copper Bulletin*, 2004; and International Energy Agency, *Oil Market Report*, May 2004.

In the case of rubber, growing demand in China, the world's leading consumer country for this commodity (owing to the rapid expansion of the automotive industry) has driven up rubber prices. In 2003, China's natural rubber consumption grew by over 11 per cent, compared to the nearly 5 per cent increase at the global level, and represented 18.5 per cent of global consumption (table 2.3). China currently produces only about one third of its total annual consumption.

Similarly, the booming manufacturing and construction sectors in China have pushed up demand for metals and minerals, resulting in price peaks for some of them such as copper, iron ore and nickel, mostly driven by strong stainless steel consumption and production. In the case of copper, Chinese imports of refined copper have doubled in the past three years, accounting for more than 17 per cent of world imports in 2002. For the near future, even though there are some concerns about overheating of the Chinese economy, leading to capacity bottlenecks and the possibility of growth slowing down, Asian demand for commodities is expected to remain firm, with China playing the leading role followed, in time, by India. In fact, measures announced by the Chi-

nese Government to prevent overheating of the economy may be an additional factor explaining the weakening in the upward trend in commodity prices during the second quarter of 2004. A side-effect of China's high demand for commodities was found in the freight market, where prices exploded partly because of lack of ships, inefficiencies in Chinese ports and high oil prices.

The economic boom in China is also highly energy intensive; the resulting strong demand is therefore playing a fairly decisive role in global markets (particularly for coal and oil). Unlike other commodities, for coal the impact on the global market arises mainly on the export side. As both the largest producer and consumer of coal in the world, China can reasonably satisfy most of its own coal needs. However, strong coal consumption in the domestic market has been reducing the amount of coal available for export, thereby pushing up world coal prices. In the oil sector, the weight of oil in the fuel-energy mix in China is relatively limited due to the importance of coal and the comparatively low use of road transportation and individual automobiles. As a consequence, China's share in world oil demand is fairly low, accounting for only 7 per cent of total demand

(table 2.3). Nevertheless, China's growth in demand for oil has doubled in the last decade, which is one of the main reasons for the current tight oil markets. As a result of escalating industry needs and increasing automobile use, China has overtaken Japan to become the second largest oil-consuming country in the world. With net oil imports increasing by 33.4 per cent in 2003, China was responsible for over one third of the growth of global oil demand (IEA, various).

Crude petroleum prices have been growing steadily since May 2003 and during the first half of 2004, reaching, in nominal terms, a record level since the beginning of the 1990s. Apart from growing demand, prompted by China and by the global economic recovery, the oil market is vulnerable to uncertainties surrounding the possibility of supply disruptions, even though the market is not in a structural deficit position and supply could be expanded. One major reason for the tightness is geopolitical tensions in the Middle East, and particularly in Iraq. Although in other important producers, like Nigeria and Venezuela, oil production has recovered after serious cuts in early 2003 due to internal conflicts, these precedents have added to uncertainty in oil markets. In addition, the low level of oil reserves in consuming countries, mainly in the United States, combined with a cold winter and the actions of speculators, increased the pressure on the demand side. Last, but not least, OPEC tried to prevent a decline in prices, even though it increased its production in order to compensate for the reduction or suspension of exports from Iraq, Nigeria and Venezuela in the first half of 2003. This policy of high prices is mainly favouring the production and exports of non-OPEC oil-producing countries, such as the Russian Federation, where oil production is more costly.

Once again, the depreciation of the dollar has had a major influence on oil prices, as OPEC calculates in dollars but has to take into account the increasing costs of its imports from the non-dollar areas. At the beginning of 2004, OPEC was keeping prices in the upper part of the \$22–\$28/barrel band established in 2000, and even exceeding it. For the second quarter of 2004, it announced a reduction in quotas based on expectations of oversupply in a season of relatively low demand (a previous reduction came into effect in November 2003). However, considering that prices were

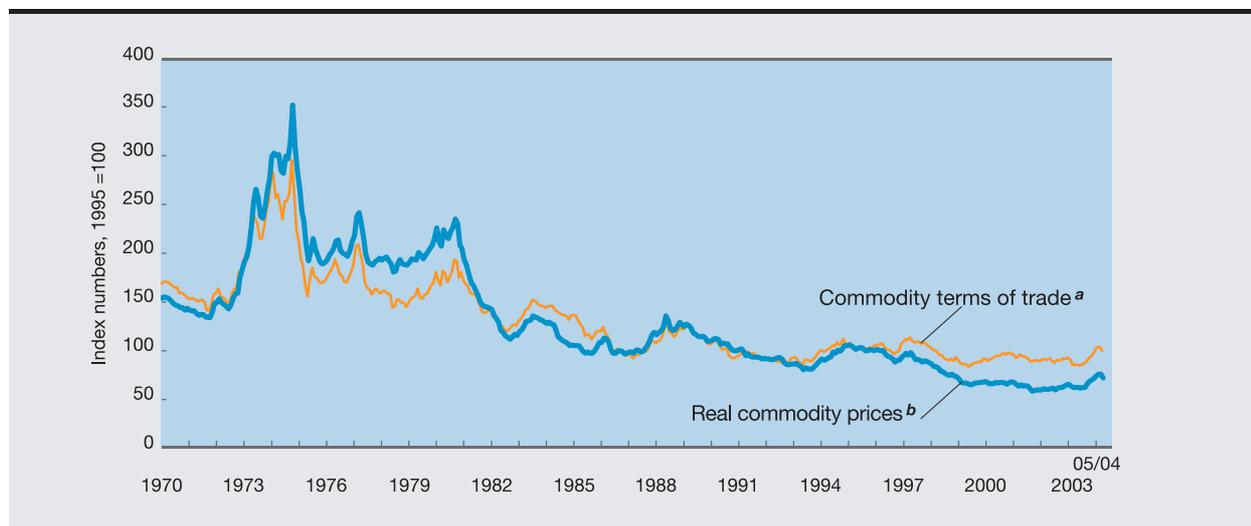
much higher than expected in the second quarter of 2004, a formal increase of OPEC production was decided in June 2004, effective as of 1 July (two million barrels/day) and 1 August (a supplementary 500,000 barrels/day). It is important to note that OPEC as a whole has been producing above its official target in recent months.

The sustained increase in oil price has raised concerns worldwide about the negative repercussions this may have on global economic recovery.³ Particularly hard hit are the many developing countries that are highly dependent on oil imports and normally more energy-intensive than developed countries. On the other hand, for oil producers it means higher real income, which can create growing demand for exports from the rest of the world. So far, the dangers stemming from higher oil prices should not be overestimated as long as higher import prices in developed countries do not translate into accelerating inflation and restrictive actions of the major central banks.

Despite the recent commodity price increases described above, viewed over a longer term perspective, and in real terms, they still remain at very low levels and considerably below their levels of the 1970s and early 1980s. This is the case for commodity producers in developing countries as well as for commodity consumers in the developed economies. From the point of view of commodity producers, the result of deflating commodity prices by the unit value indices of manufacturing exports of developed countries (in dollar terms) is usually considered as an approximation of commodity terms of trade. Figure 2.5 shows that the commodity terms of trade have continued their deteriorating trend in the long term. On the other hand, from the point of view of commodity consumers, it confirms that the real value of commodities obtained by deflating their prices with the consumer price index (CPI) of developed countries (using the CPI of the United States as a proxy) is now significantly lower than that of a quarter of a century ago. A clear example is that of oil: the recent dramatic increases in oil prices have provoked much debate, particularly as they reached record levels in current dollar terms. Figure 2.6 shows that in real terms, the oil price for consumers in developed countries is still relatively low compared to the levels recorded at the time of previous sharp oil price hikes in the 1970s.

Figure 2.5

**COMMODITY TERMS OF TRADE AND REAL COMMODITY PRICES,
EXCLUDING PETROLEUM, 1970–2004**

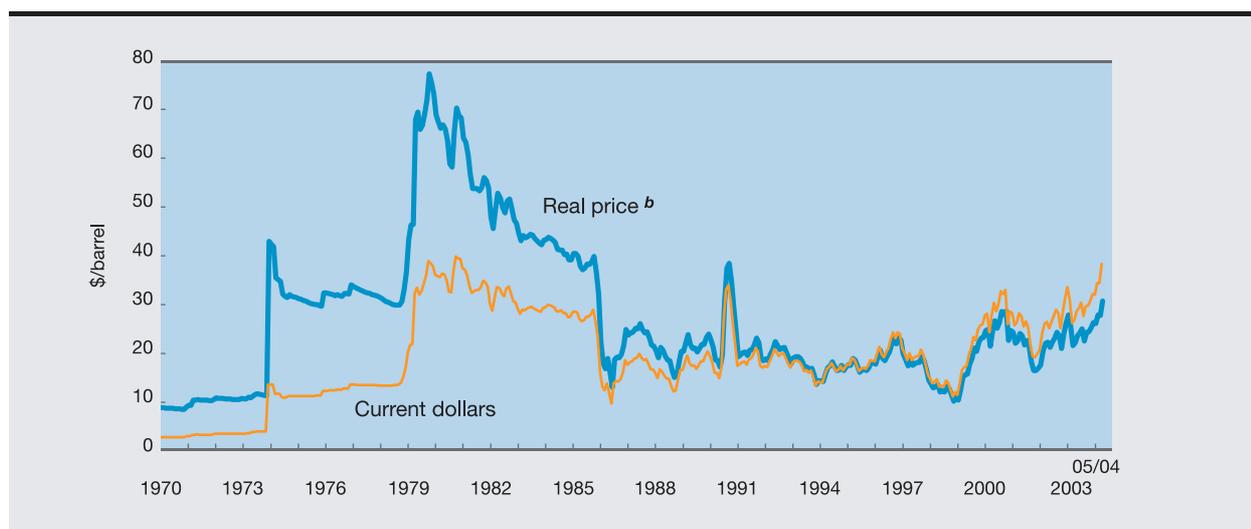


Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; United Nations Statistics Division, *Monthly Bulletin of Statistics*, various issues; and IMF, *International Financial Statistics* database.

- a** Combined index of commodity prices in terms of current dollars deflated by unit value indices of manufactured goods exports of developed countries.
- b** Combined index of commodity prices in terms of current dollars deflated by United States CPI.

Figure 2.6

CRUDE PETROLEUM PRICES,^a NOMINAL AND REAL, 1970–2004



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Bulletin*, various issues; and IMF, *International Financial Statistics* database.

- a** Crude petroleum, average of Dubai/Brent/Texas equally weighted (\$/barrel).
- b** Deflated by United States CPI (1995 = 100).

Table 2.4

	1980– 2003	1980– 1985	1986– 1990	1991– 1995	1996– 2003
EXPORT VOLUME, PURCHASING POWER OF EXPORTS AND TERMS OF TRADE OF DEVELOPING COUNTRIES, 1980–2003					
<i>(Average annual percentage change)</i>					
All developing countries					
Volume indices of exports	10.1	2.1	16.6	14.7	5.3
Terms of trade	-1.3	-3.9	-0.7	0.3	0.5
Purchasing power of exports ^a	8.7	-2.2	15.9	15.2	5.9
Non-oil exporters					
Volume indices of exports	11.9	8.3	18.4	16.5	6.6
Terms of trade	-0.5	-2.8	-0.8	0.9	-0.7
Purchasing power of exports ^a	11.3	4.7	16.7	17.5	5.8
Major exporters of manufactures					
Volume indices of exports	13.7	10.3	21.1	18.6	7.3
Terms of trade	-0.2	-1.5	0.6	0.5	-1.2
Purchasing power of exports ^a	13.5	9.8	22.0	19.3	6.1

Source: UNCTAD, *Handbook of Statistics*, various issues; and table 2.1.

^a The value index of exports deflated by the import unit value index.

Developing countries as a whole experienced a deterioration in their terms of trade between 1980 and 2003, by an average rate of 1.3 per cent per annum (table 2.4). Consequently, although their export volumes rose strongly, the purchasing power of those exports increased much less. The sharpest decline in the terms of trade occurred in the first half of the 1980s which, combined with very slow growth in export volumes, implied a fall in the purchasing power of exports during this period. In the subsequent periods between 1986 and 2003, the terms of trade stabilized, and hence the volume and purchasing power of exports rose broadly in parallel.

If the major oil-exporting countries are excluded, the decline in the terms of trade between 1980 and 2003, on average, has been smaller. But as with the group of developing countries as a whole, the terms of trade of the non-oil exporters declined for all the sub-periods shown in the ta-

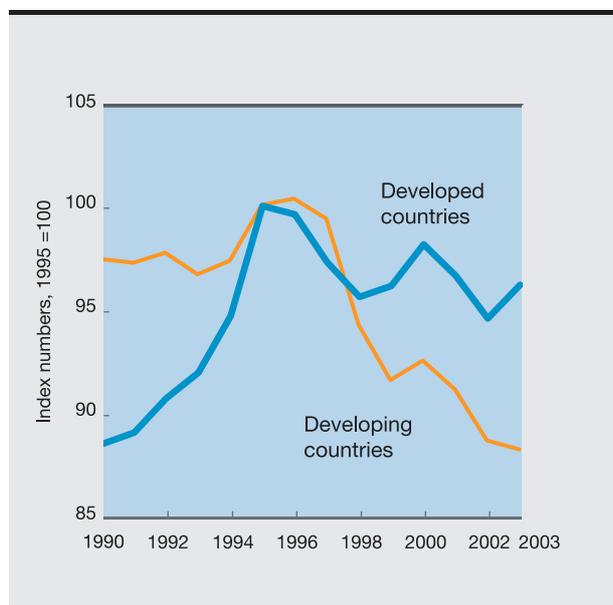
ble except for the first half of the 1990s. Consequently, the growth in the purchasing power of exports has almost constantly been below that of export volumes. Nevertheless, as discussed above, world market prices for a number of commodities have been increasing over the past two years.

In this context, the report of the meeting of eminent persons on the impact of commodity problems on the development of commodity-dependent countries, organized by UNCTAD in 2003, offers a wide range of actions that can improve conditions in commodity markets (UNCTAD, 2003). A particularly important action would be diversification into those products for which global market demand is likely to remain strong for a number of years.

The decline in the terms of trade during the period 1996–2003 was strongest for those developing countries for which manufactures have been

Figure 2.7

PRICES OF UNITED STATES IMPORTS OF MANUFACTURES, BY ORIGIN, 1990–2003



Source: UNCTAD secretariat calculations, based on United States Bureau of Labor Statistics database.

the main source of export earnings. This indicates that the manufactures exported by developing countries may have acquired features in world markets that had traditionally been associated with

primary commodities, namely a secular downward trend in the terms of trade and the dilemma of fallacy of composition (*TDR 2002*, chapter IV). Indeed, looking at the evolution of the level of index numbers for major exporters of manufactures over the entire sample period, it was highest in terms of export volumes and lowest for the terms of trade in the most recent years of the sample period (i.e. between 2000 and 2003). The evolution of the price index of United States' imports of manufactures also shows a strong and positive correlation between the evolution of prices and the level of per capita income of exporting countries. Moreover, it shows that, compared to imports from developed countries, the decline in prices of United States imports from developing countries has been strong over the past five years, and that prices are now at their lowest level since 1990 (fig. 2.7)

Summing up, the decline in the terms of trade continues to be a problem for exporters of primary commodities, even though sustained import demand from China may prolong the recent price increase for some commodities. But it appears that it is increasingly becoming a problem for developing-country exporters of manufactures as well. Indeed, as discussed in *TDR 2002* (chapter IV, section B), evidence shows that the degree of deterioration in the terms of trade for developing countries' manufactures vis-à-vis those of developed countries reflects the level of technology embodied in their manufactured exports.

B. Capital flows and finance

1. Capital flows from developing to developed countries

Since 1999, developing and transition economies have experienced sizeable and growing surpluses in the current account of their balance of payments. This is primarily the result of persistent surpluses in their trade of goods and services (\$240 billion in 2003) and rising current transfers (\$90 billion in 2003, almost twice their 1999 value), while the deficit in net income payments (\$122 billion in 2003) increased at a slower pace due to declining international interest rates. As a counterpart to their current account surplus, they recorded a net export of capital of more than \$200 billion to the rest of the world in 2003. Thus they further increased their net export of capital to developed countries by 45 per cent from the already high level of 2002 (table 2.5).

East Asia and West Asia continued to have the highest current account surpluses, and some large Latin American countries also registered surpluses. Transition economies as a group had a moderate surplus, though this was concentrated in the members of the Commonwealth of Independent States (CIS), while EU acceding countries continued to receive net capital inflows to finance their current account deficit of \$32 billion (IMF, 2004c).

Despite this large overall net capital outflow from the developing to the developed countries, the fact that there was an increase in “net private

capital flows” to developing countries, from \$13 billion in 2002 to \$83 billion in 2003 (table 2.5) was interpreted by many international observers as a positive sign for the developing countries’ growth prospects. The World Bank, for example, suggested that “this increase in private capital inflows offers significant opportunities for developing countries to invest in infrastructure and facilitate trade finance to foster a self-reinforcing cycle of sustained capital flows, economic growth and poverty reduction.” (World Bank, 2004)

Since the net private capital inflows (in bonds, equities and other capital flows) into developing countries were more than offset by their net accumulation of foreign currency reserves – resulting in total net outflows of \$200 billion – this interpretation is misleading. In order to properly assess the role of overall capital flows to developing countries, outflows in terms of rising reserves have to be taken into account. For example, a large proportion of the private gross capital inflows into China has been attracted by expectations of a revaluation of the Chinese currency, despite low interest rates in China. These inflows have, to a large extent, been bought up by the Chinese central bank and invested, at higher interest rates, in United States Treasury bonds, thereby financing the United States budget deficit, but not real investment within China.

But the accumulation of reserves not only puts the figure for net private capital flows in perspective, it also hints at the fact that many national policy-makers were concerned that the

Table 2.5

**NET CAPITAL FLOWS AND THE CURRENT ACCOUNT:
DEVELOPING AND TRANSITION ECONOMIES, 1996–2003**

(Billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	2003
Developing economies								
Private capital flows	200.1	139.5	45.6	59.7	23.9	27.3	12.9	82.9
Private direct investment	100.7	126.5	129.7	145.6	149.7	161.4	112.0	102.5
Private portfolio investment	83.8	39.8	33.1	64.7	8.5	-86.3	-91.1	-78.1
Other private capital flows ^a	15.6	-26.8	-117.3	-150.5	-134.4	-47.9	-8.0	58.3
Official flows	-16.0	42.6	36.8	8.3	-13.8	23.0	11.6	2.7
Change in reserves ^b	-86.0	-90.2	-32.5	-79.7	-96.6	-108.3	-170.6	-320.9
Current account balance	-79.4	-51.8	-23.5	43.6	114.3	70.3	136.2	199.5
Africa								
Private capital flows	9.1	4.0	9.1	11.8	1.1	6.5	7.2	9.5
Private direct investment	3.6	7.9	6.9	9.8	8.2	23.9	12.3	14.3
Private portfolio investment	2.8	7.0	3.7	8.3	-2.2	-8.8	-0.7	1.8
Other private capital flows ^a	2.7	-10.9	-1.6	-6.3	-4.9	-8.5	-4.4	-6.6
Official flows	-3.0	3.3	4.7	3.5	3.1	1.9	4.2	4.1
Change in reserves ^b	-6.7	-11.2	2.7	-3.4	-13.2	-12.5	-7.6	-14.4
Current account balance	-5.5	-6.5	-19.5	-15.9	5.4	-1.5	-7.4	-3.9
Sub-Saharan Africa								
Private capital flows	6.9	0.7	8.1	10.3	1.5	3.5	6.1	7.6
Official flows	-2.7	4.4	5.2	4.0	4.0	3.0	5.6	5.3
Change in reserves ^b	-4.0	-6.2	1.6	-3.8	-6.5	-2.4	-3.2	-5.7
Current account balance	-6.3	-9.3	-17.8	-15.3	-2.5	-9.3	-12.5	-12.0
East and South Asia								
Private capital flows	118.6	34.0	-50.6	2.7	-4.2	10.1	24.8	84.3
Private direct investment	53.4	56.5	56.1	66.4	67.4	60.5	53.1	49.3
Private portfolio investment	32.0	6.3	8.4	56.6	20.1	-54.4	-57.6	-58.4
Other private capital flows ^a	33.1	-28.8	-115.0	-120.2	-91.7	4.0	29.3	93.4
Official flows	-13.2	25.2	17.5	1.8	4.0	-2.0	-1.9	-8.6
Change in reserves ^b	-46.1	-35.9	-52.6	-87.1	-60.8	-90.7	-157.8	-245.3
Current account balance	-40.8	15.3	113.8	106.5	86.8	90.1	131.7	148.3
China and India								
Private capital flows	48.4	37.9	-4.6	10.3	13.8	43.0	44.7	101.8
Official flows	2.3	1.5	5.6	7.0	-0.5	0.9	2.4	5.7
Change in reserves ^b	-34.4	-40.5	-9.1	-14.6	-16.6	-56.0	-94.3	-148.6
Current account balance	1.2	33.9	24.6	12.4	15.4	16.7	40.2	32.6
First-tier NIEs								
Private capital flows	11.5	-14.8	-23.5	18.5	10.1	-16.2	-10.1	-10.9
Official flows	-11.3	11.2	-3.6	-19.9	-6.9	-7.8	-7.4	-13.7
Change in reserves ^b	-8.8	-7.6	-31.9	-55.9	-43.1	-28.8	-44.4	-75.9
Current account balance	-2.2	6.1	64.9	58.4	41.4	52.0	63.6	86.5
West Asia^c								
Private capital flows	2.0	9.6	8.4	-7.9	-24.9	-16.3	-27.6	-22.9
Private direct investment	4.1	5.2	5.1	3.9	7.7	8.1	6.9	8.9
Private portfolio investment	1.0	-2.7	-6.2	-4.5	-12.3	-15.8	-19.0	-24.3
Other private capital flows ^a	-3.1	7.2	9.5	-7.3	-20.4	-8.6	-15.4	-7.4
Official flows	7.4	6.7	5.2	6.6	-11.0	-3.2	-5.4	-11.0
Change in reserves ^b	-18.0	-16.6	10.3	-0.2	-27.4	-10.6	-3.1	-25.6
Current account balance	6.0	6.3	-26.6	10.0	68.9	36.3	27.6	51.5

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Table 2.5 (concluded)

**NET CAPITAL FLOWS AND THE CURRENT ACCOUNT:
DEVELOPING AND TRANSITION ECONOMIES, 1996–2003**

(Billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	2003
Latin America and the Caribbean								
Private capital flows	70.4	91.9	78.6	53.2	51.9	26.9	8.5	11.8
Private direct investment	39.6	56.9	61.5	65.5	66.4	68.9	39.6	30.0
Private portfolio investment	47.9	29.2	27.2	4.4	2.9	-7.2	-13.7	2.9
Other private capital flows ^a	-17.1	5.8	-10.1	-16.6	-17.4	-34.7	-17.4	-21.1
Official flows	-7.2	7.3	9.5	-3.4	-9.9	26.3	14.6	18.2
Change in reserves ^b	-15.2	-26.5	7.2	11.1	4.8	5.4	-2.0	-35.5
Current account balance	-39.1	-66.8	-91.2	-57.0	-47.0	-54.5	-15.8	3.8
Transition economies								
Private capital flows	17.7	38.1	31.8	26.9	18.3	-6.7	34.1	48.3
Private direct investment	15.3	17.5	23.3	25.6	25.3	27.7	27.3	16.8
Private portfolio investment	1.2	23.0	5.3	1.3	-2.4	-9.4	-7.5	-9.4
Other private capital flows ^a	1.2	-2.4	3.3	-0.1	-4.6	-24.9	14.3	41.0
Official flows	10.9	5.7	10.5	-1.9	-0.7	2.8	-8.3	-9.9
Change in reserves ^b	-5.2	-13.9	-2.1	-13.0	-20.3	-5.2	-25.4	-43.0
Current account balance	-16.0	-29.0	-27.9	-4.8	14.6	17.8	9.6	7.8

Source: UNCTAD secretariat calculations, based on IMF, *World Economic Outlook*, April 2004.

Note: It should be noted that IMF data underlying this table have been substantially revised in 2004. On the basis of IMF data published in spring 2003, the net private capital inflow to developing countries in the United Nations definition amounted to \$51.8 billion in 2002. The difference is due in part to the new inclusion of Hong Kong (China) in the aggregate data for 2004, in part by substantial revision of the figure for portfolio investment for other East Asian countries.

a "Other private capital flows" comprises other long- and short-term net investment flows, including private borrowing and residuals not covered under other items; due to limitations in data coverage such residuals may also include some net official flows.

b A minus sign in the lines for change in reserves indicates an increase.

c Including Israel and Egypt, excluding Turkey.

effects of such inflows on the exchange rate would destabilize their economies. This concern is reflected in the decision of some developing countries' monetary authorities to purchase foreign currency to prevent the inflows from triggering an appreciation of their national currencies, as this would have hurt their competitiveness in world markets. Furthermore, private capital is not going primarily to countries that are in need of financing for infrastructure development; rather, it is going mainly to those countries that, at present, do not need foreign capital to finance investment, e.g. China – which has lately shown that as much as 40 per cent of its GDP can be used to finance investment without having to depend on outside capital. In these countries, the national authori-

ties' problem is not a lack of investment, but an excess of it, leading to an overheating of the economy.

2. Regional developments

Changes in net capital flows, including the accumulation of foreign reserves, have differed markedly across regions and countries. In 2003, both the amount of private capital inflows to developing economies and the increase of those flows were concentrated in a few regions and countries. East and South Asia, especially China

and India, were the main recipients of net private capital flows to developing economies, accounting for almost all the increase in such flows (table 2.5). Developing Asia and the newly industrializing Asian economies continued to increase their large external surpluses, from \$132 billion to \$148 billion, due to their favourably competitive position and a pick-up of growth in the United States. Moreover, the main component of the increase in net private capital flows into this region was not foreign direct investment (FDI), which actually fell slightly, but "other private capital flows", which include credit and short-term capital flows. A significant proportion of this increase, however, consisted of speculative investment, based on expectations of a revaluation of the regional currencies. Consequently, governments in the region absorbed a large share of these inflows to prevent a real appreciation of their currencies and a loss of competitiveness.

Recent currency depreciations in many Latin American countries have enabled those countries to increase their competitive position, thus reducing their reliance on external capital to finance their development. The region managed to stage a modest economic recovery in 2003, while at the same time turning the current account from a deficit of \$15.8 billion into a surplus of \$3.8 billion (table 2.5) – the first surplus in decades. Much of this was the result of external surpluses in Argentina, Brazil and Venezuela, while countries such as Chile, Ecuador and Mexico reduced their current account deficits. However, even if this recovery increases the room for manoeuvre in policy-making, many of these countries still have to resort to international financial markets for refinancing or restructuring the payments of the principal of their external debt. As a result, they are still exposed to the risk of a tightening of the conditions governing access to those markets, even if those operations do not involve net capital movements.

In Brazil and Argentina, the nominal devaluations in 1999 and 2002 contributed to major improvements in competitiveness. Inflationary pressures have been kept in check by low levels of domestic demand in Brazil and by substantial excess capacity in Argentina. Manufacturing exports have picked up, while the improved competitiveness of domestic firms has promoted import

substitution. In Venezuela, high oil prices and low domestic demand led to another year of a huge current account surplus in 2003.

Argentina's improved competitive position allowed the country to stage a strong economic recovery, with an annual GDP growth rate of almost 9 per cent, without running into new current account deficits. This performance is all the more remarkable since many economists had warned that the current lack of access to global capital markets, due to pending negotiations on restructuring the country's foreign debt, would seriously hinder growth prospects. In fact, the only relevant gross capital inflows were debt arrears from the public and private sectors (\$10.6 and \$2 billion respectively), while the Government made net payments on non-defaulted debt and the private sector continued to export capital, albeit to a much lesser extent than in 2001 and 2002. Approximately half of the \$8 billion current account surplus was used to accumulate international reserves, following the national authorities' goal of maintaining the real exchange rate at a competitive level and reducing the economy's vulnerability to external shocks (INDEC, 2004).

The situation in Brazil has not been quite as positive. The positive effects of the devaluation on exports, combined with the negative impact of slow economic growth on imports, led to a current account surplus of \$4 billion. FDI fell sharply in 2002 and 2003, and short-term private capital flows displayed high volatility, with successive phases of net outflows and inflows since mid-2002. During much of 2003, there was an accumulation of international reserves through financing by the IMF and by short-term private capital inflows that were attracted by high interest rates. In response, the Government, in an attempt to avoid appreciation of the exchange rate, recycled the capital to the United States at very low yields; at the same time it had to pay the difference between the low United States yield and the high interest on the public debt issued in order to sterilize the monetary effects of accumulated reserves.

In Venezuela, the Government introduced strict exchange controls so as to restrain the massive capital outflows from the private sector, which totalled almost \$10 billion per year in 2001 and 2002

(Banco Central de Venezuela, 2004). At the same time, it re-established a fixed exchange rate regime. As a result, the external surplus, fuelled by high oil revenues, led to a rapid accumulation of international reserves.

In Africa, the reduction of the current account deficit has been due to rising prices in commodity markets – especially oil – rather than the result of improved competitiveness. Modest GDP growth, compared to other regions, meant that imports grew slower than exports. The current account deficit for Africa as a whole therefore narrowed, from \$7.4 billion to \$3.9 billion. For sub-Saharan Africa, the current account deficit fell only slightly (table 2.5). Capital inflows, both official and private, thus remained almost stagnant, at a low level. The most important capital inflow was FDI, much of which was concentrated, as in 2002, in the oil sector of relatively few countries (Algeria, Angola, Chad and Nigeria). In South Africa, where short-term inflows were attracted by high domestic interest rates, the Government and central bank opted for intervention in the currency market, in order to restrain the appreciation of the rand due to the inflow of hot money.

In the Russian Federation and the transition economies of Central and Eastern Europe, conditions continued to diverge markedly. Rising oil prices and export volumes in the Russian Federation increased the current account surplus by almost a third, to \$39.5 billion, while the financing requirements of Central and Eastern Europe rose by almost half, to \$31.7 billion (or 3.9 per cent of the region's GDP). Bosnia and Herzegovina, Croatia, The former Yugoslav Republic of Macedonia, Serbia and Montenegro, and the Baltic countries, in particular, had to rely heavily on foreign finance. Estonia's current account deficit rose to 13.7 per cent of GDP, thereby remaining above 10 per cent for the second year in a row. Some of the larger EU acceding countries also continued to experience large current account deficits, running at 5.5 per cent of GDP in Hungary and 6.5 per cent in the Czech Republic (IMF, 2004c).

As in the Russian Federation and parts of Africa, West Asian oil producers benefited from rising oil prices and accelerating global economic growth, which increased global oil demand and

boosted that region's exports. As a group, these countries almost doubled their current account surplus, from \$27.6 billion to \$51.5 billion (table 2.5). Since the improvement in the balance-of-payments position in the region stemmed mainly from oil revenues, the largest oil exporters – Saudi Arabia, Kuwait, Qatar and the United Arab Emirates – recorded the biggest increases. As a result, there was a large net export of capital from the region.

3. Large build-up of reserves

Developing countries in all the regions have increased their reserve holdings by huge amounts. Their purchase of foreign currency reached a net value of \$320.9 billion, with the largest purchases made by Asian countries. China bought \$117.1 billion and India \$31.7 billion. The Russian Federation came third with purchases of \$27.2 billion, followed by Brazil with \$11.5 billion and Malaysia with a little more than \$10 billion. Turkey, Indonesia and Mexico also bought significant amounts (IMF, 2004a).

This unprecedented accumulation of reserves is part of an attempt by developing countries to adapt to the continuing volatility of private international capital flows. The most recent volatility in 2003 and 2004 has been partly due to increased speculation about a sharp devaluation of the dollar. Since 2002, confidence in the dollar among international investors has been faltering due to the persistently high current account deficit of the United States. As investors began shifting part of their portfolios from United States assets into assets of other – developed, developing or transition – economies, many currencies came under pressure to appreciate.

Monetary authorities in countries with a de facto or formal fixed exchange rate vis-à-vis the dollar were confronted with the decision to either sterilize the net inflows or to abandon their unilateral fixing of the exchange rate. Those countries that decided to maintain their fixed exchange rate regimes consequently accumulated substantial dollar reserves. The most widely debated case is that of China, which has been keeping its currency, the yuan (renminbi), within a narrow band of

around 8.28 yuan to the dollar after the 1994 devaluation. Here, investors' distaste for United States assets, amplified by their appetite for Chinese assets, led to an enormous increase in gross foreign private capital flows into China. Speculation of an imminent appreciation of the yuan further augmented the capital flows by adding a stream of "hot", speculative money. This prompted the Chinese central bank to buy large quantities of dollars to defend its currency peg. Malaysia and Hong Kong (China), which belong to the small group of economies in Asia that have a fixed exchange rate pegged to the dollar, also bought United States assets, mainly Treasury bonds, in large quantities (box 2.1).

But even a number of countries that do not have a formal currency peg felt obliged to intervene in the foreign-exchange market to prevent an excessive appreciation of their currency. Hardly any developing country today has a truly free-floating currency. Instead, most of them have attempted to dampen excessive volatility in their exchange rate on the one hand, and to keep their exchange rate at a rather competitive level, on the other. With the dollar depreciating, monetary authorities in all countries, with or without a formal exchange rate arrangement, have been in a similar position. True, "dirty floaters" have not felt as obliged to buy foreign reserves as the official "peggers", but, nevertheless, many of them have considered some form of intervention necessary to avoid being adversely affected by a currency appreciation.

During 2003, the Indian monetary authorities, for example, increased their foreign currency holdings by 46 per cent to prevent short-term speculative inflows from jeopardizing their economic policy goals. In Brazil, the central bank bought dollars in order to keep the real from excessive appreciation, because a loss of competitiveness would have hurt economic recovery in South America's largest economy. In the Russian Federation, the central bank saw in the strong rouble a threat to that part of the economy that is not oil dependent, and also bought dollars in large quantities.

The fear that excessive capital inflows could lead to an overvaluation of developing countries' currencies was not unfounded. Following stabi-

lization policies in the early 1990s, many countries had experienced an overvaluation of their currencies that harmed domestic industries, hurt the international competitiveness of their export-oriented industries and diminished their ability to earn the foreign currency necessary to finance the imports needed for pursuing a balanced growth path. Keeping the exchange rates stable at a convenient level is seen as a strategy that gives them the long-term ability to finance imports of capital goods and consumer goods when faced with volatile capital flows.

The exchange rate stabilization strategy also reflects lessons drawn from the experiences of the currency crises in East and South-East Asia and Latin America, which painfully drew the attention of developing countries to the risks of an overvalued exchange rate and of an over-reliance on foreign capital to finance the resulting current account deficits. While the Asian crisis only hit countries that had some kind of fixed or rigid exchange rate, the capital flight from Brazil in the run-up to the Brazilian presidential elections in 2002 – that was controlled only with a large IMF loan package – has shown that even countries with a flexible exchange rate regime are not immune from currency and financial crises, as long as they depend on a constant inflow of foreign capital to finance their current account deficit or external debt repayments.

However, in some of the countries that have accumulated reserves over the past two years to prevent overvaluation, their unilateral attempts to cope with excessive capital inflows has led to problems in stabilizing the domestic economy. While most countries have succeeded, to a large extent, in sterilizing the inflows, China recently has had problems keeping an investment and credit boom under control. The boom was fuelled by the Government's expansionary policy combined with a liquidity increase resulting from capital inflows and consequent purchases of dollars.

Other countries have been faced with rising fiscal costs stemming from their attempts to sterilize the consequences of their immense purchases of reserves. As mentioned above, buying foreign reserves in the foreign exchange market leads to an increase in liquidity in the domestic money market. In order to reduce the liquidity, central

Box 2.1**ASIA'S SAVINGS AND THE UNITED STATES' EXTERNAL DEFICIT**

Given the large trade imbalance between the United States and Asia and the enormous accumulation of United States bonds by Asia's investors and central banks, it has been suggested that the fate of the United States economy is in the hands of Asian investors. According to this argument, if Asia were to stop financing that country's current account deficit, the results could be dramatic: the demand for United States bonds would collapse, the dollar would depreciate, interest rates would soar and the economy would suffer a slowdown. It is further contended that developing Asian countries such as China would then finally have the possibility to use the capital they had exported to the United States in recent years for investment and consumption at home. However, closer inspection shows that these arguments are disputable.

What would happen to Asia if it decided to no longer finance the United States' external deficit?

At present, the United States imports more goods from Asia than it exports to the region. This is only possible because Asian investors (both private investors and central banks) are willing to purchase United States assets in exchange for the goods they export to that country. If this were to slow down, demand in the United States for Asian products would fall, and the price of United States assets relative to Asian assets (that is, the exchange rate of the dollar vis-à-vis the Asian currencies) would also decline. This would affect Asian exporters: their sales prices and volumes would come under pressure. Asian producers for the domestic market would also be hurt as imports into Asia would become relatively cheaper, leading to greater consumption of imported rather than domestically produced goods. Together, these two mechanisms would lead to a falling Asian surplus in its trade (and current account) balance with the United States, which would reflect a diminished net capital flow from Asia to the United States.

In the unlikely event that Asian investors decided to sell existing dollar assets and import American goods from the receipts, while not selling any of their products against fresh United States assets ("repatriating their savings"), the dollar would have to depreciate to an extent that would turn Asian current accounts into deficit. This would reverse the net capital flow from Asia to the United States. As this might imply a further dollar depreciation, the adverse effects on Asian firms would be dramatic.

Thus Asia cannot profit from a "repatriation" of its foreign capital investments. An appreciation of the major Asian currencies – yen, won or yuan – against the dollar would slow down export expansion and dampen profits and economic growth. Only if national economic policy managed to stimulate domestic demand by cutting interest rates, and thereby stabilizing overall monetary conditions, would the Asian countries be able to remain on their high and stable growth path. However, this might prove difficult, since interest rates are very low and a significant proportion of private investment in Asia, particularly in developing countries such as China, is in the export-oriented sector, which would be hurt by an appreciation of the local currency against the dollar. In Asia, if government policies failed to restructure their economies by replacing United States demand for their goods by domestic demand, the region's overall GDP growth would slow down, albeit not as much as its export growth. Moreover, there would be a "net inflow of capital" from the United States only if GDP in these Asian countries were to fall short of what is used up domestically for consumption and investment at the new exchange rate of their currencies to the dollar.

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Box 2.1 (continued)***What would happen to the dollar if the Asian central banks stopped buying United States Treasury bonds?***

Recently, Asian countries have experienced large current account surpluses and large gross capital inflows from abroad. The central banks have kept their exchange rates constant by buying United States Treasury bonds, but they have also started to diversify their foreign-exchange reserve holdings. If they were to completely stop buying United States assets, and there were no private Asian investors willing to invest in United States assets, the effect would be much the same as described above: there would be a gap between the goods that United States consumers can buy and the goods and assets they can sell at the current exchange rate. Therefore, the only possible adjustment would be a depreciation of the dollar. Again, this would hurt Asian exporters and undermine economic growth in the region.

However, it is unclear how much the dollar in this case would really depreciate. A significant share of the gross private capital inflows into Asia at present is probably “hot money” from investors betting on an imminent appreciation. If the currencies actually did appreciate, this pressure could ease. This might be the case especially for China, whose former overall trade surplus dipped into deficit at the beginning of 2004.

What would happen if Asian central banks diversified their dollar bonds into different assets?

Risk considerations might induce Asian central banks to sell United States bonds and to buy other assets, such as European bonds. As long as private investors did not counteract this shift in investments, such a move would increase the demand for European assets at the expense of United States assets. If, at the same time, Asian central banks tried to prevent their own currencies from appreciating against the dollar, as they have done over most of the past two years, the only possible adjustment would be in the exchange rate of the euro. The euro would then appreciate against both the dollar and the Asian currencies, while the exchange rate of the dollar vis-à-vis Asian currencies would remain unaltered.

Would a fall in the exchange rate of the dollar vis-à-vis Asian currencies hurt the United States?

This question is not easy to answer. However, some theoretical considerations and historical experience suggest that the effects will be far from dramatic, and completely different from what developing countries experienced when their currencies depreciated sharply.

Since United States companies, governments (state and federal) and households are not highly indebted in yen or yuan, a fall in the value of the dollar would not increase their debt service. Consequently their net wealth would not decline and neither would their financing costs increase. Hence, the depreciation would not directly slow down the United States economy.

Further, there is no direct link between the willingness of foreigners to hold United States Treasury bonds and higher domestic interest rates in the United States. An appreciation of the Chinese cur-

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Box 2.1 (concluded)

rency, for example, would significantly reduce investors' expectations of short-term gains, thus leading to a redirection of the flow of some of the short-term funds from China to the United States. This would compensate, at least in part, for the reduced holdings of United States Treasury bonds by foreign investors. Additionally, since investors in the United States usually hold a certain proportion of their gross wealth in foreign assets (denominated in foreign currency), their (net) dollar wealth would increase with the depreciation. This in turn would increase the demand for United States assets (both bonds and stocks). If the drop in demand for United States Treasury bonds from the foreign central banks were bigger than the increase in domestic demand for these bonds, the interest rate might rise. However, the additional demand for equities would put upward pressure on stock prices, thereby counteracting the negative effect of the rising bond yields on companies' investment plans.

Even more important, any interest rate movement as a reaction to a shift in foreign and household demand for United States bonds would be compensated by a shift in the portfolios of financial intermediaries and in the behaviour of the United States' central bank, the Federal Reserve. In the medium and long term, the price of bonds, and thus the long-term interest rate, is determined by the central bank's short-term policy rate and expectations of changes in that rate. The Federal Reserve fixes the short-term interbank interest rate by providing unlimited amounts of liquidity to the federal funds market if it wants to keep the federal fund rate close to its target rate. If domestic banks perceive the current and expected future short-term interest rates as being too low relative to the long-term interest rate, they will borrow from the Federal Reserve in the federal funds market and buy longer running Treasury bonds. This increases the price for this type of Treasury bond, thus lowering the long-term interest rate.

Thus, as long as the dollar depreciation does not provoke a change in the Federal Reserve's monetary policy stance, or changed expectations of banks about the future course of the Federal Reserve's monetary policy, long-term interest rates will not be affected by the change in the rest of the world's willingness to buy Treasury bonds.

Of course, the assumption of the Federal Reserve's monetary policy and corresponding expectations remaining unaffected by a depreciation of the dollar may not be justified. A huge currency appreciation in Asian countries could, theoretically, force the central bank to act. A strong depreciation of the real effective exchange rate of the dollar would dramatically increase the international competitiveness of United States exporting firms. Demand and prices for their products would increase, both through stronger export demand and import substitution. After a certain time lag, this would result in an increase in the profitability of the sector producing tradable goods and a pick-up in investment. At the same time, consumer prices would start to rise due to increased import prices. If the Federal Reserve's monetary policy were to remain unchanged, overall monetary conditions that reflect effects of interest rates and the exchange rate would in fact loosen. Consequently, in order to keep the economy on the targeted growth path, the Federal Reserve would have to react to a depreciation of the dollar by increasing nominal interest rates.

However, this would not necessarily hurt overall United States growth. With the tradable sector booming, production would merely shift from the non-tradable to the tradable sector, without necessarily having a negative impact on GDP growth. However, the composition of growth would alter: with rising import prices, consumer prices would increase and real wages fall. A slower growth in consumption demand would be the consequence. At the same time, export demand would increase.

banks regularly issue stabilization bonds against domestic money. However, if the domestic interest rate is higher than the rate on United States Treasury bonds (which has been the case for most developing countries, but not for China), the monetary authority has to pay the bond-holders more than it can get from recycling the reserves in United States Treasury bonds. The resulting costs then have to be borne by the developing country's general budget, and consequently by the taxpayer. In the spring of 2004, the Republic of Korea, which has also been heavily intervening in the foreign-exchange market, had currency stabilization bonds worth more than 30 trillion won (\$27 billion) outstanding. Brazil and South Africa had to face high costs of sterilizing their increased reserves.

While the accumulation of reserves by developing countries slowed slightly in the first months of 2004 compared to late 2003, the basic trend of heavy interventions in the foreign-exchange market and corresponding sterilization has remained intact in 2004. Compared to both the long-term historical average as well as the corresponding figures from the same months in 2003, most developing countries continued to accumulate foreign reserves at a rapid pace. However, with the recovery in the United States gaining hold – and thus that country's assets becoming more attractive for private investors – and the increase in the long-term United States interest rate, the flow of speculative money to developing countries decreased somewhat in the second quarter of 2004. This alleviated the need of developing countries to counteract these inflows with foreign currency purchases. This is a further indication that in most countries, reserves have recently been accumulated as a bulwark against volatile capital flows, and not to set aside resources to pay future imports.

However, there are some exceptions to this general trend, mainly in countries concerned about the medium- and long-term debt sustainability. In Brazil, for example, such concerns led to outflows of short-term capital and increased the cost of external financing; as a result, the Government decided to use international reserves to make debt repayments to the IMF in December 2003 and the first quarter of 2004, and to avoid an excessive depreciation of the real. New purchases of foreign assets by Brazil's central bank would thus at

least partly be interpreted as an attempt to rebuild those diminished reserves in order to prepare for new speculative outflows of private capital or impending debt repayments.

4. *Financing conditions*

The improved balance-of-payments situation of many developing countries has reinforced the fall in the risk premiums of their sovereign bonds. In early 2004, the yield spread on Brazilian bonds fell below 500 basis points for the first time since 1998, down from more than 2,000 basis points in early 2003. The risk premium on Turkish bonds more than halved, to around 300 basis points. Even for the Russian Federation, which defaulted on its debt in 1998, the yield spread fell to roughly 200 basis points. EU acceding countries gained from the prospect of joining the European Economic and Monetary Union (EMU): Hungarian and Polish risk spreads fell to historic lows of around 50 basis points and slightly below 100 basis points respectively (fig. 2.8).

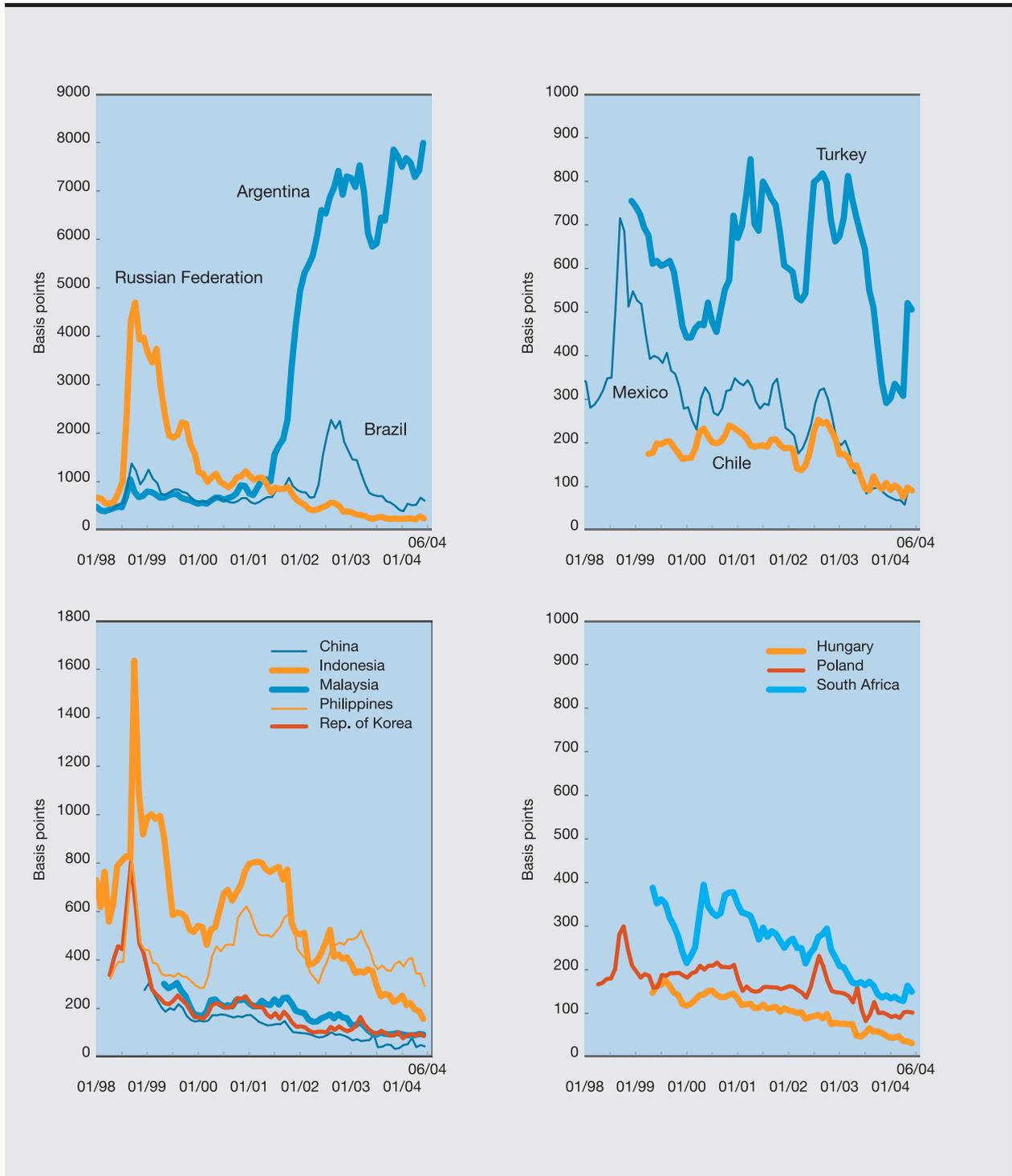
Among the internationally traded developing-country bonds, only Argentinean debt still carries a risk spread of several thousand basis points; this is not surprising, given that the restructuring of its sovereign debt is an issue that is yet to be resolved. However, as Argentina is not borrowing on the international market, the risk premium has little relevance for its domestic economy. Domestic financing conditions in local currency are favourable: short-term real interbank rates are slightly negative and 30-day nominal prime lending rates are at around 10 per cent.

However, the fall in international risk premiums needs to be viewed along with the prospect of increasing interest rates in the United States, as this might reverse Latin American countries ability to refinance their outstanding debt and reduce their interest burdens. In 2003, net interest payments made by Latin American countries fell by \$0.5 billion, to \$52.1 billion, the lowest level since 1997 (IMF, 2004c). However, the prospect of a tightening of international interest rates may reverse the fall in the risk premiums, as seems to have occurred in Brazil in the second quarter of 2004.

Figure 2.8

YIELD SPREADS OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKET BONDS,^a 1998–2004

(Basis points^b)



Source: Thomson Financial Datastream.

^a Differential between the yield on a representative bond issued by the borrowing country and those of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.

^b One basis point equals 0.01 per cent.

5. *Calm year for financial markets, no major currency crises*

Another positive side-effect of the extensive intervention of developing countries' central banks in foreign-exchange markets has been the calm in the global currency market. After Argentina's default and devaluation in late 2001 and early 2002, which also pulled neighbouring Uruguay into crisis, and the financial market scare in the run-up to the Brazilian presidential elections in 2002, 2003 was a remarkably calm year for international financial markets. This development was also reflected in a drop in net official lending to the developing countries. While in 2002 the IMF approved a record loan to Brazil to prevent the looming crisis getting out of control, countries sought less IMF support in 2003: its net credit and loans fell from \$13.4 billion in 2002 to \$1.8 billion. This explains the significant fall in net official capital flows to the developing economies, from \$11.6 billion in 2002 to only \$2.7 billion in 2003 (IMF, 2004c).

Even more encouraging is the fact that, worldwide, demand for emergency loans has abated. In all regions other than Latin America, net lending from the IMF has even been negative. The Russian Federation managed to pay back \$1.9 billion in net terms thanks to its high oil revenues. In Latin America, the single IMF loan of \$5.2 billion to Brazil accounted for almost all of the region's net capital receipts from the Fund.

However, even though the IMF's net lending has declined significantly, several countries rely on new IMF disbursements in order to pay for previous IMF loans. This is the case for Argentina, which is still struggling with international creditors to come to an agreement on how to restructure its defaulted debt. Uruguay managed to restructure its foreign debt, with strong IMF involvement, in May 2003, while Bolivia, Brazil and Ecuador are under close IMF supervision as they continue to have large outstanding positions with the Fund. Thus, the IMF continues to play a significant role in some countries, and the problems of debt crises remain unsolved, even in regions where, overall, economic conditions have recently improved.

6. *FDI to developing and transition economies declines*

Although FDI remains the major source of foreign financing in developing countries, their net FDI flows (inflows minus outflows) declined to \$102.5 billion in 2003 from \$112 billion in 2002 – the lowest level since 1996, and roughly \$60 billion lower than the peak in 2001 (table 2.5). This development seems to be part of a more general trend linked to the reduction of cross-border merger and acquisition (M&A) operations since 2001.⁴ Economic slowdown and financial constraints faced by transnational corporations (TNCs) – due to over indebtedness and declining stock values – are the main reasons for the fall in M&As.

In the developing and transition economies, the picture differs from region to region. In East and South Asia, net FDI flows remained roughly at their 2002 level: some \$50 billion, and were highly concentrated in China (including Hong Kong, China). The region's continued success in attracting FDI is partly related to the reorganization of production processes through the development of regional production networks, and partly to its low labour costs and expanding domestic market, which attracted FDI from developed countries outside the region. Net FDI flows for Central and Eastern European countries (CEECs) declined. As in East Asia, a significant share of FDI to these countries is part of the geographical restructuring of production processes, but also the EU acceding countries are becoming attractive locations for FDI seeking access to the larger EU market.

In Latin America and the Caribbean, too, FDI continued to fall in 2003. Prolonged economic stagnation discouraged FDI targeting host-country markets. The termination of privatization processes in several countries was also a major reason for the decline in FDI inflows. Export-oriented FDI showed a mixed picture: the Andean countries (particularly Chile, Colombia, Ecuador, Peru and Venezuela) continued to attract FDI in natural resources (especially mining and hydrocarbons), but Mexico, where the assembly industry oriented to the United States market stagnated, saw a decline in FDI inflows. On the other hand, FDI outflows from the region rose.

A significant proportion of FDI flows to the CIS and West Asia also went to natural-resource extraction. These investments (essentially in oil and gas) seem to be relatively disconnected from local economic conditions, responding, instead, to the long-term strategies of TNCs. In Africa, FDI flows slumped from an exceptional peak of \$24 billion in 2001 to about \$12 billion in 2002, which

appears to be a return to the normal trend considering the size of FDI flows during the period 1997–2000. Net FDI flows during 2003 are estimated to have amounted to about \$14 billion. In all, FDI flows to the region are concentrated in a few countries, and in the extractive sectors of oil and minerals, with total flows in any particular year reflecting new investments in these sectors. ■

Notes

- 1 In early June 2004, this index had fallen to 3,282 points, after reaching a peak of 5,681 points in February (Bloomberg, 2004).
- 2 The HWWA (Hamburg Institute of International Economics) Index, which tracks world prices of commodities from the perspective of industrialized countries, shows an increase of 14.3 per cent on a dollar basis and a decrease of 4.2 on a euro basis (http://www.hwwa.de/indikatoren/idsp_rohstoffindex.html, accessed June 2004).
- 3 See, for instance, a recent study of the International Energy Agency (IEA, 2004).
- 4 The continuing low value and number of cross-border M&As, which had been the main drivers of global FDI flows since the late 1980s, contributed significantly to this performance. For a discussion of FDI flows in 2003 see UNCTAD (2004).

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