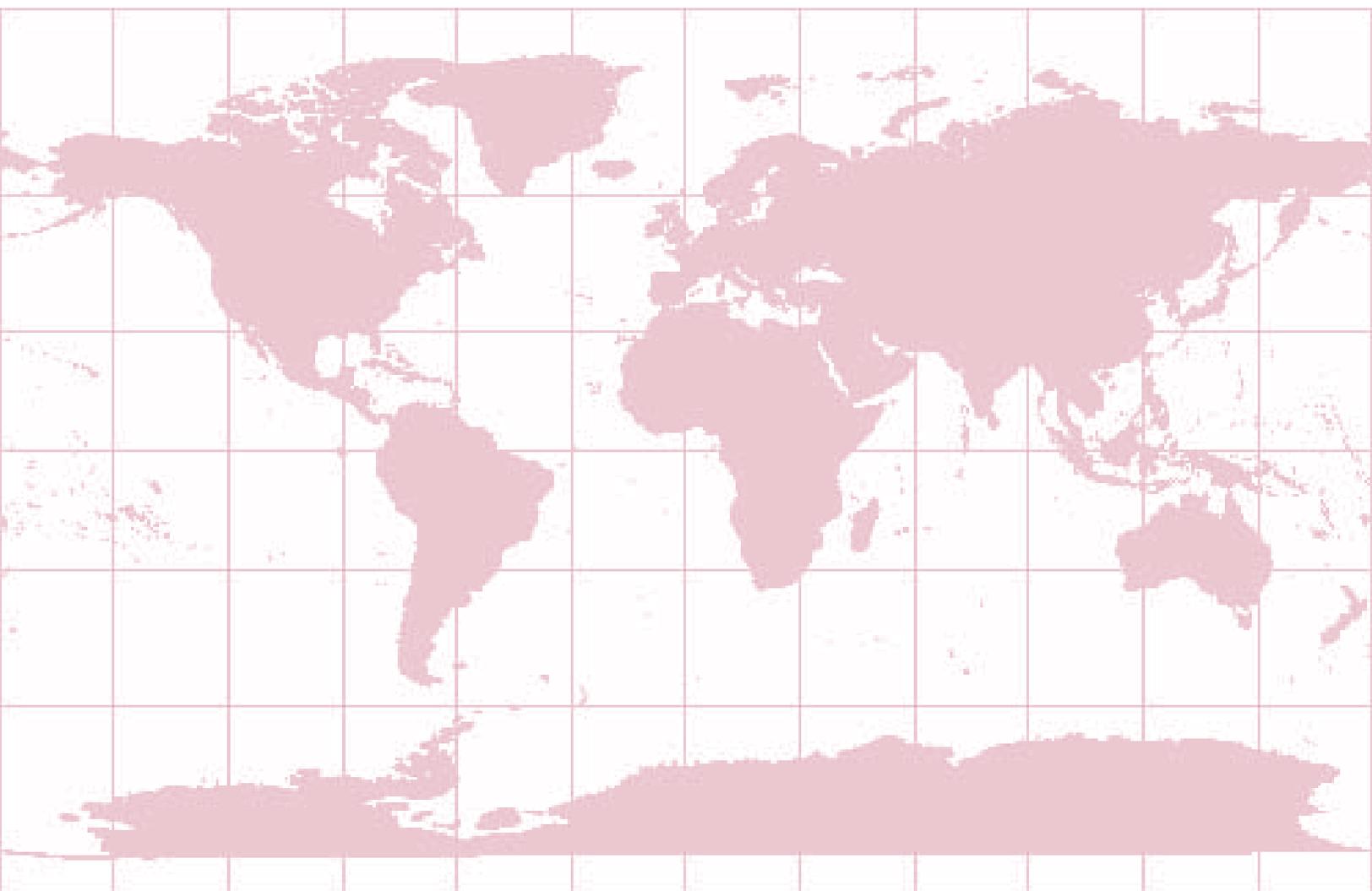


World Economic Situation and Prospects 2006



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Chapter I

Global outlook

Macroeconomic prospects for the world economy

Moderation of world economic growth expected

World economic growth slowed in the course of 2005 and is expected to continue at a moderate pace in the near term. World gross product (WGP) is projected to expand by about 3 per cent in 2006, thereby maintaining the pace estimated for 2005. This recent trend is noticeably below the exceptionally strong and broad-based expansion during 2004, yet still robust when compared with the longer-term trend (see table I.1). Part of the global slowdown has resulted from the maturing of the cyclical recovery in a number of economies from recessions in the early years of the new century and from the associated unwinding of the earlier policy stimuli (see box I.1). While varying in degree, several exogenous shocks, including a number of natural disasters and terrorist incidents, have also left their imprint on the current pace of growth in the world economy. Moreover, a number of downside risks could seriously affect world economic growth in the near future, particularly with oil prices even higher than currently anticipated, a disorderly unwinding of the macroeconomic imbalances of the major economies and a reversal in policy stances towards severe tightening of monetary policies.

Economic growth will remain notably stronger in developing than in developed economies, but both groups of countries will experience a slowdown from 2004. Developed economies are expected to grow at 2.4 per cent in 2005 and 2.5 per cent in 2006, down from 3.2 per cent in 2004, while growth in developing countries will slow from 6.6 in 2004 to about 5.7 per cent in 2005 and 2006. The still rather robust performance in the developing world relies in part on very strong and sustained growth in China and India. However, there has been less divergence in the growth performance among developing countries than in previous years of the decade. High commodity prices have been an important factor in spurring growth in many of the net exporters of oil and other primary commodities. The group of the least developed countries (LDCs), to which the United Nations pays special attention, has benefited from those favourable circumstances and its overall growth performance has been better than average. Nonetheless, not all countries in this group have been able to gain, as some were hurt rather than favoured by booming commodity prices, suffered from weather shocks adversely affecting agriculture or could not cope with the end of the Agreement on Textiles and Clothing (ATC) or continued to incur economic damage owing to relentless civil strife and conflict (see box I.2). In the outlook for the global economy, growth rates among these countries will vary discernibly owing to country-specific conditions as well as their different capacities in coping with high oil prices, expected exchange-rate realignments and shifts in global capital flows (see chapter IV for a detailed regional economic outlook).

After a slowdown in 2005, moderate growth is expected in 2006

Growth in most developing countries will be stronger than in developed countries

Table I.1.
Growth of world output, 1996-2006

Annual percentage change											
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 ^a	2006 ^b
World output ^c	3.4	3.7	2.4	3.2	4.0	1.4	1.8	2.6	4.0	3.2	3.3
<i>of which:</i>											
Developed economies	2.9	3.3	2.7	3.0	3.5	1.1	1.2	1.9	3.2	2.4	2.5
Economies in transition	-2.5	1.0	-3.2	4.0	8.3	5.7	5.1	7.1	7.7	6.0	5.9
Developing economies	5.9	5.4	1.9	3.6	5.6	2.4	3.6	4.9	6.6	5.7	5.6
<i>of which:</i>											
Least developed countries	5.5	5.1	4.6	5.3	4.8	5.9	6.2	6.5	6.7	6.8	6.6
<i>Memorandum items:</i>											
World trade	4.8	9.3	3.6	5.1	10.8	-0.9	3.0	6.4	11.0	7.1	7.2
World output growth with PPP-based weights	4.3	3.9	2.8	3.8	3.3	2.4	3.2	4.5	4.7	4.7	4.4

Source: Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA).

^a Partly estimated.

^b Forecasts, based in part on Project LINK, an international collaborative research group for econometric modelling, coordinated jointly by the Development Policy and Analysis Division of the United Nations Secretariat and the University of Toronto.

^c Calculated as a weighted average of individual country growth rates of gross domestic product (GDP), where weights are based on GDP in 2000 prices and exchange rates.

Box I.1

Major assumptions for the baseline global economic forecast for 2006

The United Nations global forecast is based on detailed information regarding trends in world commodity and financial markets, policy intentions and economic prospects in a large number of countries and on an analysis of global linkages, using the LINK world econometric modelling system. The baseline outlook depends on a number of assumptions regarding policies in the major economies and key commodity prices. The principal assumptions are as follows:

- The United States Federal Reserve is expected to raise the Federal Funds interest rate to 4.5 per cent in the first quarter of 2006 and maintain it at that level for the rest of the year. The European Central Bank (ECB) is assumed to keep interest rates unchanged in 2006, while the Bank of Japan (BoJ) is expected to maintain the policy interest rate at zero in 2006 and to become less stimulatory in terms of its quantitative target for monetary policy.
- The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements. In general, fiscal policy worldwide is expected to be less expansionary in 2006 than in the previous year, with the exception of a few economies.
- The price of Brent crude oil is expected to average \$59.00 per barrel in 2006, up from an estimated average of \$54.70 per barrel for 2005.
- The dollar is expected to depreciate slightly during 2006 to an average of \$1.22 per euro. The yen-dollar rate is expected to be around yen 110 per dollar in 2006.

Box I.2

Prospects for the least developed countries

The least developed countries (LDCs) have sustained robust growth rates, averaging more than 6 per cent per year since 2001. Growth performance varied widely within the group, however. The number of LDCs (only 41 out of 50 LDCs have data to monitor) that managed to register a per capita GDP growth of above 3 per cent increased from 15 in 2004 to 19 in 2005 and 18 in 2006. Meanwhile, 4 LDCs are expected to suffer a decline in per capita GDP in 2006, 5 countries fewer than in 2005. In 2005-2006, sustained high oil exports earnings and stronger public spending are expected to support strong GDP growth rates in a number of oil-exporting countries, such as Angola, Chad and the Sudan. Some other LDCs that export minerals and metals are also expected to see terms-of-trade gains.

In the majority of LDCs, however, economic growth depends mainly on agricultural production, which is vulnerable to weather conditions. Most LDCs enjoyed good harvests in 2005, with the exception of those adversely affected by drought, food shortages and related inflationary pressures. Lesotho, Malawi, Niger and Zambia were hardest hit by drought and food deficits. The competitiveness of the manufacturing sector in most LDCs is weak, and, with a few exceptions, this sector contributes little to export growth. The loss of trade preferences associated with the Agreement on Textiles and Clothing (ATC) in 2005 hit some LDCs, including Lesotho, Madagascar and Malawi, hard. Bangladesh is an exception, weathering the shock well and managing to expand textile production and exports. The most vulnerable LDCs are the net oil importers that suffer from high oil prices, do not gain from higher, non-oil, primary commodity prices and have limited access to external financing. Those and other adverse factors have constrained economic growth in countries such as the Central African Republic, Guinea, Guinea-Bissau and Togo.

Political stability and sound macroeconomic policies continue to be crucial for growth in the LDCs. Improved political and economic governance have directly contributed to sustained growth rates of above 5 per cent during the past three years in countries such as Cape Verde, Madagascar, Mozambique, Senegal, the United Republic of Tanzania and Zambia. Meanwhile, the ongoing civil conflicts in Côte d'Ivoire (which is not an LDC) and the Darfur region of the Sudan remain of great concern, not only because of the consequences for the inhabitants of those countries, but in view of the potentially destabilizing effects on neighbouring countries.

Many LDCs will continue to pursue relatively cautious monetary and fiscal policies. LDCs that experienced lower export earnings and higher import costs will have to rely on additional official development assistance (ODA) and debt-relief to avoid a major recession. The new plans announced by the European Union (EU) and G-8 in 2005 to substantially increase aid flows to Africa and to improve the coordination of bilateral aid programmes and policies of the member States, when fully implemented, are expected to enhance the prospects for many LDCs in the region to achieve the Millennium Development Goals (MDGs). The G-8 proposal to write off multilateral debt owed by heavily indebted poor countries (HIPC), if acted upon promptly, is also expected to facilitate long-term debt sustainability in many LDCs.

Economic growth is an important, though not sufficient, condition for reducing poverty. Leaving aside issues of redressing income inequality within countries, one (admittedly crude) rule of thumb is that developing countries should try and achieve a growth rate of gross domestic product (GDP) per capita of at least 3 per cent per year in order to make a substantial contribution to the international goals set for poverty reduction. On average, developing countries are expected to do better than that. In the outlook, the per capita income of developing countries will grow by about 4 per cent in 2005 and 2006. Not all countries, however, are expected to perform that well. As shown in table I.2 and figure I.1, about half (51) of the 107 developing countries for which data were available managed to register per capita growth above 3 per cent in 2005, 19 reached the benchmark, but the rest (36) did not. Only two dropped out of the category of countries with adequate growth rates as compared

A large number of developing countries can attain a per capita GDP growth rate of 3 per cent or higher

Table I.2.

Frequency of high and low growth of per capita output, 2003-2006

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2003	2004	2005 ^a	2006 ^b	2003	2004	2005 ^a	2006 ^b
		Number of countries							
World	159	34	14	14	9	64	89	83	88
<i>of which:</i>									
Developed economies	33	4	0	0	0	10	18	14	14
Economies in transition	19	0	0	0	0	14	17	18	19
Developing countries	107	30	14	14	9	40	54	51	55
<i>of which:</i>									
Africa	51	17	10	8	6	18	20	22	25
East Asia	13	1	1	2	1	6	11	9	11
South Asia	6	0	0	1	0	5	5	5	5
Western Asia	13	4	1	1	1	7	8	6	5
Latin America	24	8	2	2	1	4	10	9	9
<i>Memorandum items:</i>									
Least developed countries	41	15	9	9	4	14	15	19	18
Sub-Saharan Africa ^c	44	17	10	8	6	13	15	18	18
Landlocked developing countries	26	7	3	4	1	9	11	12	14
Small island developing States	17	7	3	4	2	5	7	7	7
	Share^d	Percentage of world population							
Developed economies	15.5	0.5	0.0	0.0	0.0	1.4	7.9	2.2	2.2
Economies in transition	5.6	0.0	0.0	0.0	0.0	4.6	5.2	5.1	5.2
Developing countries	78.9	9.3	1.8	2.2	1.2	59.3	68.0	62.6	68.5
<i>of which:</i>									
Africa	13.2	2.9	1.2	1.2	0.8	5.6	7.2	7.2	10.9
East Asia	31.0	0.1	0.0	0.1	0.0	28.0	30.5	28.3	30.3
South Asia	23.4	0.0	0.0	0.4	0.0	23.3	23.4	23.5	23.6
Western Asia	2.8	0.9	0.3	0.4	0.4	1.6	1.8	1.4	1.6
Latin America	8.5	5.5	0.2	0.2	0.0	0.8	5.1	2.2	2.2
<i>Memorandum items:</i>									
Least developed countries	10.7	2.8	1.2	1.8	0.6	5.5	6.8	8.1	8.0
Sub-Saharan Africa ^c	8.2	2.9	1.2	1.2	0.8	2.3	3.7	5.7	5.6
Landlocked developing countries	4.9	2.0	0.6	1.0	0.2	1.1	2.6	2.7	2.9
Small island developing States	0.8	0.4	0.2	0.3	0.0	0.1	0.3	0.4	0.4

Source: UN/DESA, including population estimates and projections from *World Population Prospects: The 2000 Revision, vol. I, Comprehensive Tables and corrigendum* (United Nations publication, Sales No. E.01.XIII.8 and Corr. 1).

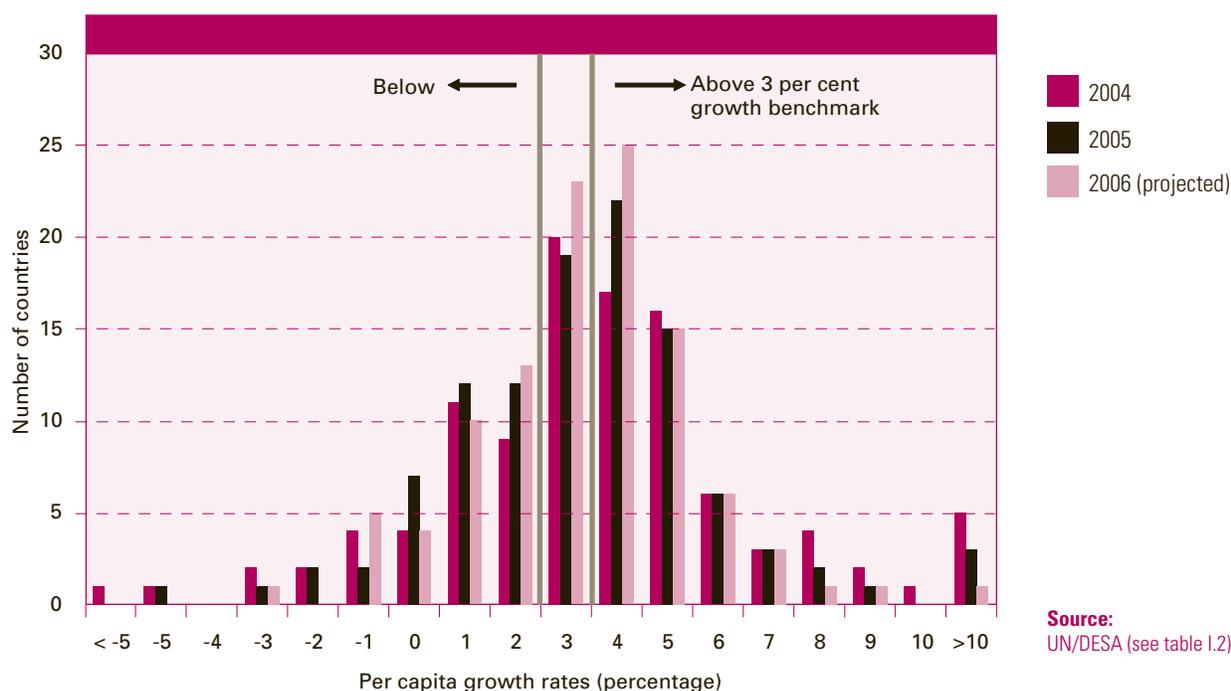
a Partly estimated.

b Forecast, based in part on Project LINK.

c Sub-Saharan Africa, excluding Nigeria and South Africa.

d Percentage of world population for 2000.

Figure I.1.
Distribution of per capita GDP growth among developing countries



Source:
UN/DESA (see table I.2).

with 2004 when the world economy witnessed the most broad-based expansion (in the sense of benefiting most countries) in decades. At the other extreme, there are 14 countries whose per capita GDP declined in 2005. Overall, the distribution of per capita GDP growth rates across developing countries in 2005 remained similar to that of 2004 (see figure I.1). Thus, while a large number of countries have registered satisfactory growth, others remain below the benchmark from the perspective of achieving the internationally agreed poverty reduction goals.

In *developed countries*, the deceleration of growth in the economy of the *United States of America* during 2005 is expected to continue into 2006, as it is increasingly challenged by a number of structural macroeconomic weaknesses. These include the extremely low (and even negative) household savings rate and the large and growing external deficit and associated indebtedness. The probability of a cooling down of buoyant house prices, sustained high prices of energy and rising interest rates constitute important downside risks. The *Canadian* economy is expected to grow at a pace near its potential, aided by high commodity export prices and relatively flexible monetary policies. The growth outlook for *Western Europe* remains lacklustre, particularly for Germany, Italy and the Netherlands. The fall of the euro against the United States dollar in the past year, low interest rates and favourable corporate finances provide some potential for positive impulses to growth. Investment rates, however, are stagnant and uncertainty remains over public finances and, in particular, over the trade-off between the needs for more fiscal stimulus during the present economic cycle and more fiscal savings to cope with future rising costs of pension and social security schemes. Further fiscal tightening could halt the weak recovery that is under way. Structural weaknesses in the labour market also remain unresolved. In contrast, growth of the economies of the *new European Union members* is expected to strengthen as a result of stronger exports and

Moderate deceleration is expected to continue in the United States; Japan's modest recovery is sustained

increased long-term investment. The *Japanese* economic expansion is expected to continue, as the prolonged adjustment in excess capacity and employment by many firms has come to fruition, with the benefits gradually spreading to the household sector. Progress continues in corporate financial restructuring, but dealing with the large public debt remains a major challenge. *Australia* and *New Zealand* continue to witness moderate growth, with the former economy being held back because of a sharp cooling of the housing boom, and in the latter, traded goods production suffering because of the appreciation of the domestic currency.

Growth in the transition economies remains robust

Among the *economies in transition*, growth in the group of *Commonwealth of Independent States* (CIS) is expected to remain robust. It is benefiting from higher commodity prices, in particular for oil, gas and metals, and domestic demand expansion owing to rising real wages and expansionary policies. In the Russian Federation, rising production costs, the continued real appreciation of the ruble, and inadequate investment levels give cause for concern about growth prospects. Institutional and structural weaknesses and the need to reduce dependence on oil and primary commodities will continue to constitute key policy challenges for the region as a whole. Growth in *South-eastern Europe* is expected to remain strong, but to decelerate somewhat. More restrictive macroeconomic policies, to stave off an expected overheating of these economies, may marginally affect private consumption. Investment growth will nevertheless remain dynamic as a result of continued FDI inflows directed to both new investments and the recapitalization of privatized State enterprises, the modernization of existing firms and ongoing public infrastructure projects.

The outlook for Africa is optimistic, although subject to some risks

Among the *developing countries*, the growth outlook for *Africa* remains optimistic, though subject to both economic and political risks. GDP growth is expected to remain at around 5 per cent (for the continent as a whole, as well as for sub-Saharan Africa, excluding Nigeria and South Africa). This upward trend is supported by a strong expansion of oil and non-oil primary exports and by robust domestic demand in many countries in the region. Not all have seen an equal amount of welfare gains as civil and political conflicts have lessened growth in a number of countries in the region. Growth is also slower among net oil importers and some agricultural exporters (see also box I.2). Economic growth in *East Asia* remains strong in the outlook, although the downside risks have increased, particularly in view of higher oil prices. Meanwhile, China continues to see a strong economic expansion driven by exports and investment. Import demand, though, has decelerated significantly. The renewed outbreak of avian influenza will pose certain risks for some countries in the region. In *South Asia*, only a marginal slowdown is expected for 2006. The agricultural sector has benefited from normal monsoon rains in 2005, and the growth in industrial production and in the service sector has remained strong, particularly in the textiles and ready-made garment (RMG) sector, especially in India, Pakistan, Sri Lanka and Bangladesh. The major impediment to growth in the region continues to be higher oil prices. Growth in *Western Asia* is expected to maintain its robust pace into 2006, based on the expectation that oil prices remain high and oil production stays at roughly existing levels, close to full capacity. Many of the oil-importing countries in the region have benefited from spillover effects via trade, tourism and financial flows from the region's oil exporters. The region remains, however, extremely vulnerable on the security and political fronts and subject to potential disruptions to the oil industry's infrastructure. Growth in *Latin America and the Caribbean* is expected to slow down modestly in 2006. Many economies, particularly those in South America, continue to gain from higher commodity prices and strong external demand. Mexico and Central American countries face increasing pressure in their manufacturing sectors from international competitors. The economies of the region remain vulnerable to any worsening of external conditions.

China and India will sustain a strong growth

Stabilizing international economic environment for developing countries

Higher commodity prices and greater availability of foreign capital have benefited many developing countries. The international economic environment, however, is expected to become more challenging in the near future. The key risks in the outlook are associated with persistently high oil prices and large global imbalances. High oil prices affect developing countries in diverse ways. A disorderly adjustment of global imbalances could significantly worsen the external conditions facing many developing countries (see below, as well as chapters II and III, for a more detailed look at international trade and finance).

Growth of world *merchandise trade* has slowed in line with the deceleration of global output growth. The drop in the growth rate of trade flows has been widespread, but even at the slower rate the exports of developing countries continue to grow faster than those of developed countries, thereby increasing their share in the world market. This increase is particularly evident for some of the most dynamic developing countries, such as China and India, whose exports continue to increase at an annual rate of 20 per cent or more.

Subject to important uncertainties, the outlook is for a rebound of business investment in many countries from the weakness of the past few years. This rebound may be assisted by low interest rates and sound corporate profitability, and it would increase global demand for capital goods, thereby raising the exports of major developed countries such as the United States and Germany. Meanwhile, continued robust growth in a few large developing countries should sustain strong international trade flows of energy and raw materials.

The momentum for growth of international trade will depend in part on the progress in multilateral trade negotiations. Some positive developments emerged towards the end of the year. The adoption of the permanent amendment of the Agreement on Trade-Related and Intellectual Property Rights (TRIPS) of the World Trade Organization (WTO) to facilitate access to essential medicines for countries with no or limited production capacities was one of them. Moreover, negotiations at the Sixth WTO Ministerial Conference in Hong Kong Special Administrative Region (SAR) of China in December 2005 were fruitful in the sense that another impasse in these trade negotiations was avoided and a more concrete agenda has been set for further talks. The more difficult task ahead will be to complete all the items on the Doha agenda by the end of 2006. Though marginal, some progress was made in meeting certain developing country needs, specifically for the LDCs, regarding duty-free and quota-free access to developed country markets and the abolition of all forms of cotton export subsidies by developed countries in 2006 (see chapter II). The immediate effects on trade will nevertheless be limited. By avoiding a collapse of multilateral negotiations, however, recent tendencies towards renewed protectionism outside the WTO framework may be stalled.

Oil prices increased sharply in 2005, particularly since May, as a result of tight supply, growing demand (though more slow than in 2004), geopolitical concerns, a series of disruptions to production and refining capacities caused by natural disasters and other incidents. Global oil demand is estimated to have grown about 1.5 per cent in 2005, markedly lower than the 3.7 per cent increase registered in 2004. In 2006, global oil demand is expected to grow by 2 per cent. Global oil supply remains tight. Some spare production capacity exists, but it mainly consists of heavy and sour crude that does not match existing refining capacity. In Iraq, recovery of oil production continues to be impeded by the security situation. Oil prices are expected to remain high in the near term, and the impact on growth and inflation will vary from country to country.

The auspicious international economic environment is expected to become more challenging for developing countries

International trade flows are expected to rebound slightly

Little progress is made at WTO negotiations

Oil prices remain high...

...but prices of non-oil commodities may flatten

The *prices of non-energy primary commodities* displayed divergent movements in 2005, along a generally upward medium-term trend. While the prices of minerals and metals increased substantially, most agricultural commodity prices, except coffee, softened. The outlook is for demand for most commodities to expand at the current pace and in line with the projected GDP growth in major economies, particularly in China and India. Nonetheless, prices are expected to remain flat or even drop in the near term because of an expansion in supply and a build-up in inventories.

Is the improvement in the terms of trade for many developing countries sustainable?

Many commodity-exporting developing countries have witnessed *terms-of-trade* gains in varying degrees over the past few years and/or benefited from increases in export volumes. The question is whether the upward trend is sustainable. Continued strong demand for primary commodities stemming from the robust growth in manufacturing in China, India and some other developing countries might support a continued upward trend in commodity prices in the short run. In view of the past history of high volatility in commodity markets, primary commodity exporters should be aware of the risk of a sharp reversal in prices.

Net transfers continue to flow from poor to rich countries...

Private capital flows to emerging market economies continued to be strong in 2005. The momentum is, however, expected to taper off in 2006, as most of the favourable conditions that bolstered capital flows over the past two years seem to have played themselves out. Despite buoyant private capital markets, the net transfer of financial resources to developing countries is increasingly negative; there is a rising flow of capital—net of interest and other investment income—moving from developing to developed countries (see chapter III), which reflects a variety of causes, positive and negative. Net transfers are still positive for sub-Saharan Africa, but declining. This flow of resources from poor to rich countries has been going on for the past ten years. It is closely associated with the widening external deficit of the United States, which is absorbing the major share of those transfers. For many developing countries, the pattern of resource flows is not a very desirable state of affairs, and, moreover, as discussed further below, is putting the world economy at risk.

...yet private capital flows to emerging market economies are strong

FDI flows continued to recover in 2005, although they remain concentrated in a small number of countries. The level of FDI is expected to remain steady, as many transnational corporations (TNCs) continue to expand their operations in major developing countries that are experiencing high growth. FDI flows concentrate in natural resources, electrical and electronic products, and services sectors. Meanwhile, South-South FDI flows have increased rapidly. So too has the outward investment by developing countries, as companies based in those economies aim to gain access to overseas technology and management expertise, as well as to natural resources.¹

All other types of private capital flows to emerging market economies also increased in 2005, with an especially rapid expansion in bond issues. The improvement of certain macroeconomic fundamentals in many developing countries—including low inflation, current-account surpluses, large capital inflows, and strong build-up of reserves—in conjunction with low yields in developed markets, have generated strong demand for emerging market assets. This demand also applies for lower-rated credits, despite historically high prices. Meanwhile, favourable financing terms have allowed emerging market economies to adjust their debt structures, with some of them accelerating their borrowing programmes planned for 2006. Several Latin American countries managed to issue local-currency-denominated bonds in international markets.

¹ See UNCTAD, *World Investment Report 2005* (United Nations publication, Sales No. E.05.II.D.10).

The external financing costs for emerging market economies have declined: the spreads in the Emerging Markets Bond Index (EMBI) reached an all time low in September 2005, reversing only slightly subsequently. The current level of spreads, however, may not be sustainable, as debt ratios in some countries are reaching critical points of sustainability. As a response to perceived risks of accelerating inflation, the major developed countries may further tighten monetary policies by increasing their policy interest rates.

The exceptionally low spreads for emerging market economies may not be sustainable

Lacklustre employment growth

The employment situation worldwide remains unsatisfactory. During the recent phase of global recovery, employment creation has lagged behind output growth, reflecting a rise in labour productivity. Job creation, however, is falling short of the expansion of the labour supply in the majority of countries, and consequently unemployment rates are still notably higher than their levels prior to the global downturn of 2000-2001 (see tables A.7, A.8 and A.9). At the same time, many developing countries are also facing high levels of structural unemployment and underemployment which are left unresolved by current growth patterns. These employment conditions limit the impact of growth on poverty reduction.

The employment situation worldwide remains unsatisfactory

A gradual but mild recovery in employment continues in most developed countries. In the United States, the average monthly increase in wage employment is still below the pace needed to prevent the unemployment rate from rising. The displacement of labour caused by the hurricanes led to an additional increase in the unemployment rate during 2005. Labour demand in the manufacturing sector continued to stagnate and the total number of jobs in this sector is still far below the level of 2000. In Western Europe, unemployment rates are still about one percentage point above their low levels of 2001, but a gradual improvement is discernible. The cyclical increase in unemployment during the first years of the century did not fully reverse the more structural downward trend in unemployment achieved by labour market reforms enacted throughout Europe over the past decade. In many European countries, more restrictive wage policies have kept domestic demand down, which, along with productivity growth, has led to lower capacity utilization and higher cyclical unemployment. The unemployment rate in Japan has been declining steadily in 2005, but is still above the levels of the lacklustre 1990s. A few other developed economies, such as Australia, Canada and New Zealand, are exceptions to this overall picture. Their unemployment rates have reached historic lows owing to a prolonged period of high output growth, and, even with the more recent deceleration of growth, unemployment has remained low.

A gradual cyclical recovery in employment continues in developed countries...

The unemployment situation in developing countries and economies in transition is more pressing, both in cyclical and structural terms. Official open unemployment data, which often only cover urban areas, in general, underestimate by a large margin the severity of the unemployment and, particularly, the underemployment situation in most developing countries. Nonetheless, even by the open unemployment measure, only a small number of countries in Asia, Latin America and in the group of economies in transition registered a reduction in unemployment rates. Unemployment rates for most Asian economies are still far above their levels prior to the Asian financial crisis of the 1990s, and, despite some improvement, unemployment rates in most Latin American countries and economies in transition are still high—above 10 per cent in many of them. In China and many Asian economies, where rural areas still account for a large share of the population, surplus labour and high rates of underemployment remain a long-term policy concern. In South Asia, for example, the formal sector is unable to absorb a rapidly growing workforce and unemployment is highest among the young—which is also the case for many other developing countries.

...but the unemployment situation in developing countries and economies in transition is more pressing

Structural unemployment and underemployment problems are particularly harsh in Africa despite its recent growth recovery. Official rates of unemployment are 10 per cent or higher in some of those economies. Structural unemployment problems have occasionally been aggravated by special circumstances. For example, the short-term impact of the decline in African textile exports owing to the ending of the ATC in 2005 has included the loss of thousands of jobs in Kenya, Lesotho, Madagascar, Malawi, Mauritius, Swaziland and South Africa.

Impact of higher oil prices on inflation and income

Higher oil prices transfer incomes across countries

An obvious effect of the rise in oil prices has been the transfer of income from consumers to oil producers and from oil-importing countries to oil-exporting countries. Other important effects of higher oil prices include the impact on inflation and the consequences for GDP growth in individual economies and for the world economy as a whole. Some of those effects are less obvious as they are entangled with other factors, and their magnitude varies from country to country, depending on the economic structure as well as policy measures.

Negative welfare effects have so far been offset by the continued income growth at the global level

Thus far, world economic growth has not been visibly affected by the higher oil prices because the recent upward trend in oil prices has been mainly driven by a strong increase in global oil demand. Negative welfare effects from higher costs for producers and consumers have been offset by the continued growth in income. Should the push no longer come from the demand side, but rather from restrictions on the supply side—as was the case with the oil shocks of the 1970s and early 1980s—world output growth could be hurt substantially.² The risk of such a supply-side shock to oil prices is certainly present, given the current tightness in global oil production capacity, itself a result of underinvestment in the energy sector over the past two decades. New investment plans and policy incentives to redress this situation have been announced in several oil-exporting countries, but these solutions will only raise production capacity in the medium term. In the short run, major supply disruptions could well be caused by various unforeseen factors, including geopolitical tensions and natural disasters. In any case, the significant upward movement in the prices of long-run oil futures reflects the expectation in the market that existing production capacity will remain constrained for some time to come.

Oil-exporting countries continue to enjoy rising income and improving macroeconomic balances

Oil-exporting countries continue to benefit from the higher oil prices, which have boosted income and improved macroeconomic balances. Those countries have been recycling oil revenues into the global economy via their growth in imports, accumulation of foreign assets and, particularly, their reduction in both external and internal public debt. At the same time, the windfall gains from oil revenues have created inflation pressures and resulted in real exchange-rate appreciation. The latter is undermining the competitiveness of other traded-goods activities, which for oil exporters with important manufacturing sectors (such as Mexico and the Bolivarian Republic of Venezuela) will pose future adjustment problems when oil prices drop again.

More oil-importing countries will see growing adverse effects of higher oil prices

Until recently, most oil-importing countries managed to deal reasonably well with the adverse effects of higher oil prices. A growing number of them, however, particularly low-income countries, are now showing signs of deteriorating economic conditions in

² See Pingfan Hong and others, "The impact of higher oil prices on the global economy—A tale of two different cases", Working Paper (2004), Social Science Research Network, available from <http://www.ssrn.com/>.

the form of rising inflation, worsening external and fiscal balances, and declining profits in some sectors.

Oil-importing developing countries are affected by higher oil prices to different degrees. Considering covariant movements between oil and other commodity prices, three discernible patterns exist.³ First, countries with a dominant share of exports of minerals and mining products (for example, Chile, Niger, Peru, Zambia and a few other Latin American and African countries) have witnessed positive terms-of-trade shifts as the prices of their exports have surpassed the increases in oil prices. Second, agricultural exporters show mixed terms-of-trade gains and losses. Cotton exporters, such as Benin and Burkina Faso, have been hit by falling cotton prices and hence by significant terms-of-trade losses. Similarly, Malawi's terms of trade declined dramatically because of weak prices for tobacco and sugar. Cuba, on the other hand, another exporter of tobacco and sugar, has seen an improvement in its terms of trade as it also exports nickel, whose price has risen sharply. A third group of oil-importing developing countries with a high share of manufactured exports has suffered from worsening terms of trade in the past few years, as a result of the higher prices of oil and raw materials and a decline in the prices of their manufactured exports. Also within this group, the impact of the higher oil price has been diverse. Several countries, particularly those in East and South Asia, including China and India, could easily cope with the terms-of-trade shock, given the strong export dynamics of their manufacturing sectors. Others face greater difficulty. Pakistan, for example, suffered very severe terms-of-trade losses as a result of an export structure dominated by labour-intensive clothing products facing heavy international competition and falling world market prices and a higher-than-average share of oil in total imports.

Headline *inflation* rates have edged up markedly in a majority of countries, driven mainly by higher oil prices. Core inflation rates, which exclude such highly volatile components as the prices of energy and food, have been much more stable, indicating that the pass-through of higher oil prices into overall inflation is limited. Economic agents worldwide seem to expect inflation to stay low. With such well-anchored inflation expectations, fears of a return to high inflation seem ill-founded.

Nonetheless, certain inflationary pressures need to be addressed, particularly those associated with higher oil prices. The effects of higher oil prices on overall inflation in an economy will work through various channels in different stages. In the first round, the transmission of higher international oil prices (measured in United States dollars) into domestic oil prices and the prices of oil products such as gasoline is mostly direct in many countries, although the effects may not be so straightforward for some countries. Government controls on domestic energy prices, tax relief on oil products and changes in exchange rates can all shield, to some extent, domestic oil prices from higher international oil prices. For example, domestic oil prices in the euro area did not change much in 2004 because of the offsetting effect of an appreciating euro against the dollar. Prices measured in euros were much higher in 2005, however, when the European currency depreciated. In Asia, a number of economies have managed to contain the rise in domestic oil prices compared with the increase in international oil prices by various measures, including subsidies that in turn have put pressure on fiscal balances. Such measures to smooth spikes in global oil prices can only be temporary, given the magnitude of the oil price increases and difficulties in sustaining large fiscal deficits. As those countries reduce these measures, stronger first-round effects of higher oil prices are expected, as is already the case in Indonesia and a few other economies.

Oil prices drive up headline inflation, but core inflation remains tame

The effects of higher oil prices on overall inflation in an economy will work through various channels in different stages

³ See UNCTAD, *Trade and Development Report 2005* (United Nations publication, Sales No. E.05.II.D.13).

The change in oil prices measured in domestic currency will add to the overall consumer price index, wholesale price index and other measures of inflation, according to the weight of oil consumption in those indices. The effects in the second round will depend on how much firms can pass the increase in their energy costs through to the prices of their products and services and, more importantly, how consumers and firms together will adjust their inflation expectations, as well as their wage and price setting.

Pass-through of higher oil prices is weak

So far, most firms find it difficult to pass the increase in oil prices through to the prices of their products and services, mainly because of a very competitive environment. Meanwhile, the dynamic relocation of energy-intensive manufacturing activity worldwide observed in recent years has allowed the increase in energy prices to be absorbed mostly in the developing countries before the final consumer goods are shipped to the developed countries. Among developing countries, the absorption is made possible partly by the growth in labour productivity (as labour moves from low-productive sectors to high-productive sectors) and partly by squeezing wages. Thus, the transfer of real income to oil producers comes about to the extent that wages are not indexed to inflation and real wage growth does not follow productivity growth.

Real wages are affected by higher oil prices

Labour markets and wage formation play key roles in determining the second-round inflation effects of higher oil prices. With a weak employment situation in most countries, labour has little bargaining power and the once popular wage-indexation mechanism is found today in few economies.

In some cases, higher oil prices can even have a dampening effect on core inflation. If higher oil prices are temporary, households facing lower real income may reduce their savings to maintain their real consumption. If higher oil prices persist, however, consumers may have to cut their spending on other goods and services, leading to lower prices for those goods and services. Precisely how these effects work themselves out varies from country to country, but so far no country has reported strong second-round effects.

Core inflation rates in most developed countries are between 1 to 3 per cent, below the upper bound of inflation targets set by those countries. In contrast, high inflation rates of around 10 per cent can still be found elsewhere. More specifically, inflation is accelerating in economies in transition. In Latin America, inflation decelerated in most countries. In Africa, high inflation rates are mostly related to structural problems rather than to the increase in oil prices. Meanwhile, Hong Kong SAR has just emerged from a period of deflation and Japan also seems close to doing so.

Increased international competition has played a key role in curbing global inflation

Increased international competition has played a key role in curbing global inflation over the past decade. In this regard, rising protectionism may be of more concern than higher oil prices. Rising protectionism could be part of a disorderly adjustment of global imbalances (see below), reducing competition in markets for manufactures and reversing the downward trend in industrial prices.

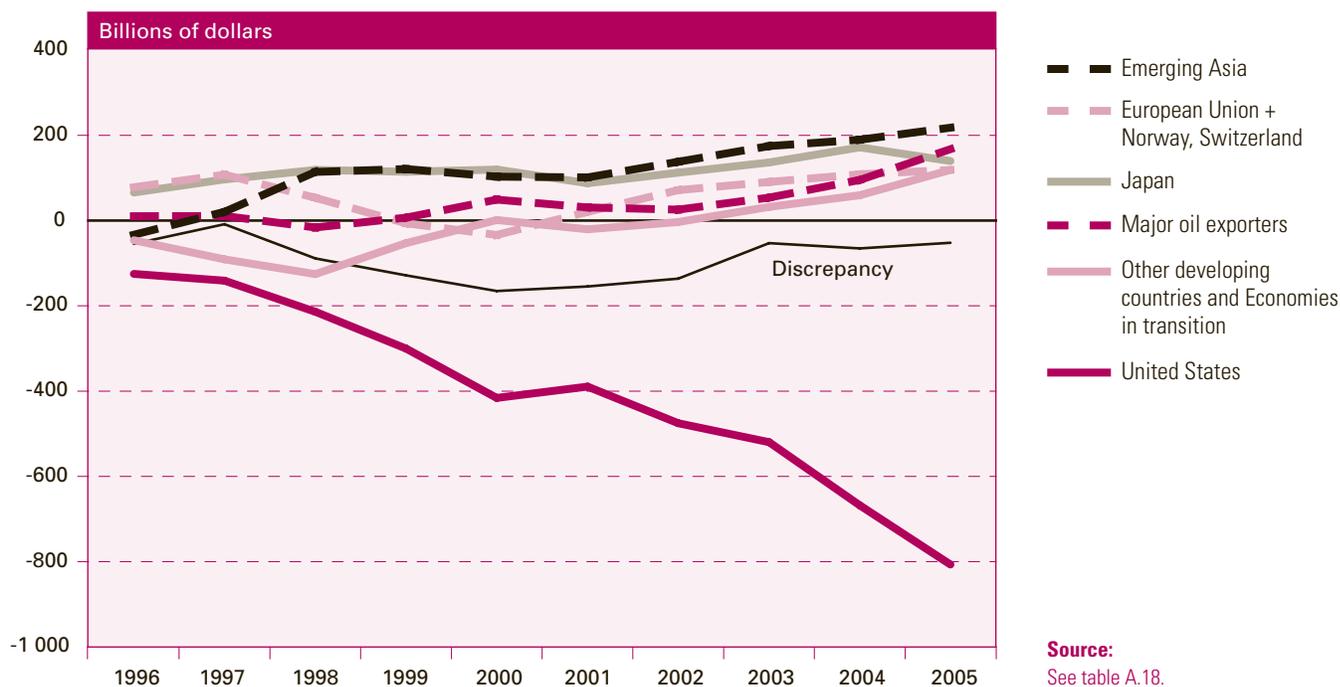
Widening global imbalances

The macroeconomic prospects as delineated above are subject to a number of uncertainties and downside risks. One particular risk is associated with the widening macroeconomic imbalances of the major economies and the possibility of a disorderly global adjustment.

Global imbalances widened further during 2005

Global imbalances widened further during 2005. The current-account deficit of the United States surpassed \$800 billion, matched by increased surpluses elsewhere, particularly in Europe, East Asia and in oil-exporting countries (see figure I.2).

Figure I.2.
Global current-account imbalances, 1996-2005



There are contrasting views on the causes as well as the sustainability of the external and internal deficits of the United States, on the one hand, and the surpluses in the rest of the world, on the other. A large number of developing countries are running current-account surpluses. This is not only the case in East Asia, where savings rates traditionally have been high, but also in a number of Latin American countries. This creates additional uncertainty regarding the implications of a rebalancing of the disequilibrium for world financial markets and global economic growth.

The nominee for the chairmanship of the United States Federal Reserve Board, Ben Bernanke, for instance, holds that United States government policies to reduce its fiscal deficit will not be effective in dealing with the current-account deficit as the latter is mainly caused by what has been going on in the rest of the world. According to this view, global imbalances reflect a worldwide 'savings glut', as is evident from two coinciding trends: a number of countries with high savings rates, mainly in Asia, seem to have enlarged their positive saving-investment gaps over the past few years, and long-term interest rates worldwide have been at exceptionally low levels.⁴ Under those conditions, it seems relatively easy to finance the large external deficit of the United States. Therefore, adjusting the global imbalances through a reduction in the fiscal deficit and a concomitant increase in domestic savings in the United States would not seem to be the first relevant or necessary step to take. While Bernanke does recognize that reducing the fiscal deficit of the United States is "a good idea", in his view effective global adjustment should start elsewhere, specifically with emerging market economies' becoming net borrowers again.

⁴ Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit", Sandridge Lecture (10 March 2005), Virginia Association of Economists, Richmond, Virginia.

Other commentators, in contrast, consider current global imbalances to be almost exclusively rooted in policy decisions in the United States, which allowed the fiscal position to deteriorate and monetary policies to be expansionary. Those policies caused the sharp drop in national savings through increases in the government deficit and in housing wealth, which combined to push down household savings.⁵ Proponents of this view argue that changing macroeconomic policies in the United States is the key to reversing global savings-investment imbalances.

Both positions seem to be overemphasizing what has happened to savings and to miss two crucial points. First, investment rates have fallen to historical lows and have failed to rebound to pre-recession levels despite a sharp restoration of corporate profits and low borrowing costs. Second, the United States has been running rising twin deficits (and, since the private sector has entered into deficit as well, there is now a triplet of deficits) over a prolonged period of time, which has led to a corresponding widening of the net foreign asset positions of the world's largest economies. The situation has reached a point at which exchange-rate adjustment has not only become ineffective in reducing the imbalances, but also at which any major realignment would be likely to disrupt global financial markets.

Global investment anaemia, not a savings glut

There is no global
savings glut...

It seems paradoxical to speak of a savings 'glut' when global savings and investment rates are below 22 per cent of WGP and have been persistently on the decline since the 1970s, reaching an historical low point in 2002. They are still at the lowest level since 1983, despite rebounding modestly from 2003 (see figure I.3). The recent increase in savings in some parts of the world is mainly due to increased *corporate savings* in Japan and fast-growing East Asia (caused in part by corporate restructuring following the financial crisis) and increased *public savings* in Europe (partly explained by tight fiscal policies related in part to concerns over future sustainability of pension schemes and social security systems) and in oil-exporting countries (fueled by higher oil prices). Corporate savings in the United States are also up following the decline in stock market prices. Aggregate savings are down, however, owing to ever-lower household savings and the lack of fiscal adjustment, which keeps public savings low. The overall trend has been towards a declining global savings rate. It is hard to argue that there is too much savings in the world economy, as the recent increase followed a prolonged period of a declining global savings rate.

...but a global
investment anaemia

Further, by basic national income accounting rules, global savings must equal global investment, such that there can be no excess savings ex post, meaning also that the current-account balance for the world must add to zero.⁶ This accounting identity is not fully reflected in the data, as can be observed from figures I.2 and I.3, owing to statistical discrepancies, and thus some caution is required when studying those data. Global income accounting rules, however, imply that savings surpluses of some countries are determined by

⁵ See, for instance, Wynne Godley, "Imbalances looking for a policy", *Policy Note* 2005/4 (2005), Annandale-on-Hudson: The Levy Economics Institute at Bard College; and Nouriel Roubini and Brad Setser, "Will the Bretton Woods 2 regime unravel soon? The risk of a hard landing in 2005-2006" (2005), available from <http://www.stern.nyu.edu/globalmacro>.

⁶ For an elaboration of the global accounting rules and an analysis of the sources of the statistical discrepancies, see, for example, Rob Vos, "Accounting for the World Economy", *Review of Income and Wealth*, vol. 35, No. 4 (1989), pp. 389-408; and Rob Vos and Niek de Jong, "Trade and financial flows in a world accounting framework. A balanced WAM for 1990", *Review of Income and Wealth*, vol. 41 (1995), pp. 139-59.

Figure I.3.
Global savings and investment rates, 1970-2004



Source:
See table A.24.

the external deficits and hence savings gaps of other economies. Hence, to focus solely on the world's major economy is to overlook specific conditions which are driving up savings surpluses elsewhere in the world. The recent increases in oil prices are a cyclical part of the story, driving up savings surpluses in the economies of oil exporters which typically have low absorptive capacity. Fast growth in Asia has pushed up savings rates more than investment. Savings surpluses of oil exporters and emerging Asia may not seem very large as a share of world output (about 0.3 per cent of WGP for each grouping; see table A.21), but are large enough to make an impact on financial markets, pumping dollar liquidity back, mainly to the financial markets of the major deficit country. Notably, much of the excess liquidity is going into dollar-denominated assets, particularly United States government bonds, pushing down interest rates. In China and other emerging market economies many of these assets are managed within official reserves (see below). Most oil exporters have found other uses for their savings surpluses. In particular, West Asian oil exporters have been using an important part of their current financial surpluses to pay off their large internal and external public debts and to fuel fiscal stabilization funds. The remainder is believed to go primarily into dollar assets. Hence, because oil is traded in dollars and the debt of oil exporters is also mainly dollar-denominated, the use of petrodollars and Asian official reserve accumulation alike have been supporting the value of the dollar and sustaining the inflow of capital to the United States.

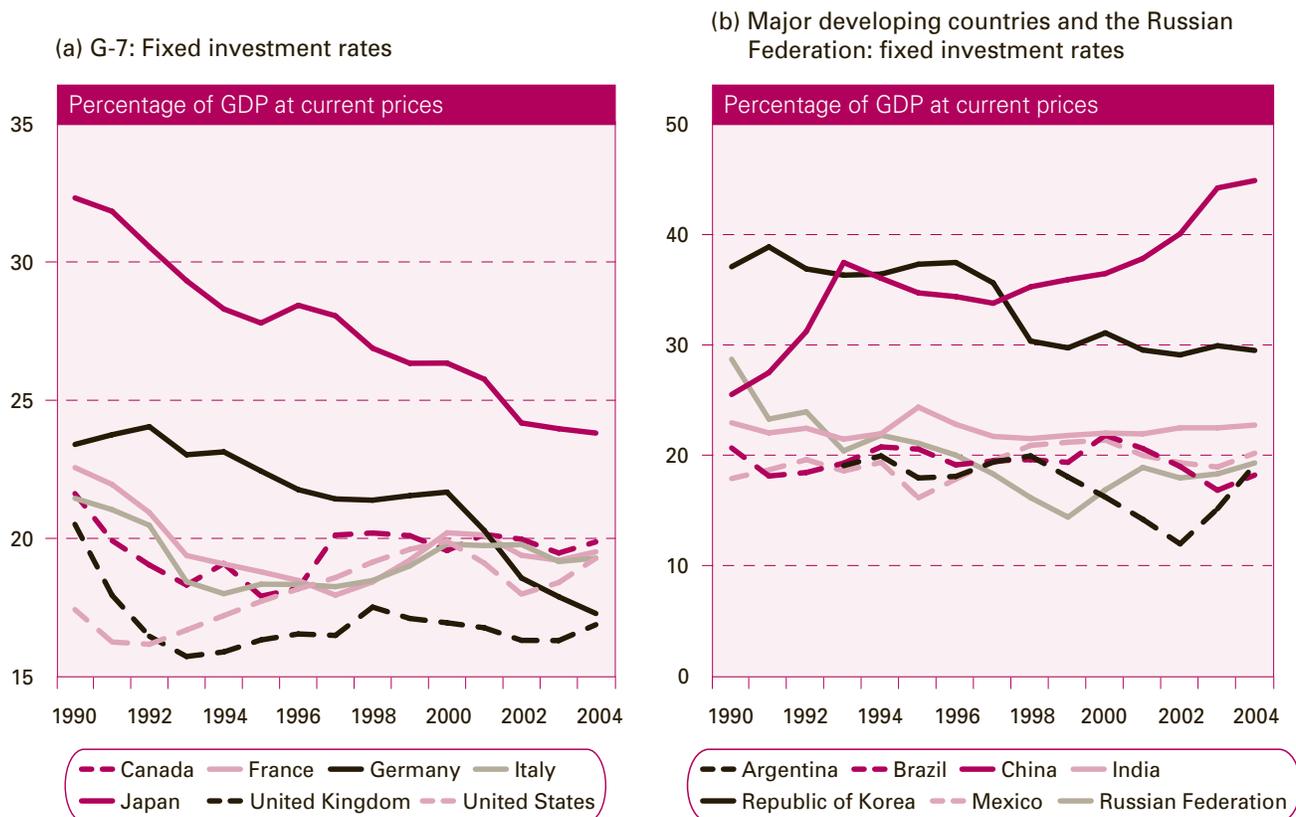
More importantly, a proper look at the data shows that the increased savings surpluses in most major economies in Europe and Asia are primarily due to a weakening of investment growth. Fixed investment rates are down in almost all large developed and developing economies, and this holds for both total and (non-residential) business investment (see figures I.4a and I.4b as well as table A.23).⁷ Declining or stagnant investment rates also

Investment demand
is weak in surplus
countries

⁷ The data in figures I.4 (a) and (b) show investment rates only as shares of GDP at current prices. While not shown here, investment volumes have also been stagnant.

Figure I.4.

Fixed investment rates in major developed and developing economies, 1990-2004



Source: See table A.23.

characterize recent trends in the dynamic Asian economies as well as other large emerging market and developing country economies. China is one of the few large economies that does not fit this pattern. Not only are investment rates down, investment volumes are stagnant in the major developed and developing economies. Thus, instead of defining the current global macroeconomic condition as a 'glut' in savings, it seems more appropriate to speak of a global investment 'anaemia', which has a low global savings rate as its counterpart.

Understanding the current global imbalances thus requires an explanation of the weak investment demand that is particularly present in the private corporate sector of the principal surplus countries. The data clearly show that corporate investment is not picking up in the major economies, such as Germany, Japan and the United States, despite low interest rates and remarkably buoyant corporate profits and savings (see table A.23). Also, in several dynamic Asian countries with robust growth, such as India and the Republic of Korea, business investment is significantly down from levels of the late 1990s.

A number of reasons could explain the weakening trend in business investment around the globe. Investment rates are down in virtually all *developed countries*, but most starkly in Japan and the euro area. The lower rates partly reflect a cheapening of the cost of capital (through low interest rates and productivity growth in capital goods industries) keeping investment down in nominal terms.⁸ Yet, as indicated, non-residential private investment has also come down in volume terms, though more modestly, despite high corporate profits. Several factors

⁸ See IMF, *World Economic Outlook, September 2005: Building Institutions* (Washington, D.C., International Monetary Fund, 2005).

A number of complex factors are behind the weakening global trend in business investment

could explain this behaviour. In Japan and Europe, aggregate demand and consumer confidence have been weak. Major firms across the globe have gone through processes of balance-sheet restructuring and have become more cautious about expanding production capacity in the aftermath of the 2000 recession. Meanwhile, the excess liquidity in the global system has led private investors as well as pension and insurance funds to adjust their portfolios by increasing holdings of financial assets, such as United States government bonds, as well as riskier equities, such as emerging market stocks and bonds, real-estate backed debt and commodity funds. All of this has been to the detriment of production capacity-enhancing business investment. A different, yet compounding factor behind depressed global investment demand is the rise in capital productivity worldwide as a result of the information and communication technology (ICT) revolution.

In many *East Asian economies* (excluding China), lower investment rates are in part the result of the adjustment process following the 1997 financial crisis, characterized by postponing new investment projects and maximizing the use of existing production capacity. In addition, investment growth has been curbed further by the ongoing relocation of some manufacturing bases from those economies to China. Despite high growth, India's investment rate has been virtually stagnant since 1990. The volume of investment has continued to rise, however, though at a slowing pace since 2000. Corporate business investment was driving investment growth in India during most of the 1990s, but since 1998, the dynamics of investment has shifted towards non-residential investment by household-owned businesses, which might suggest output growth is becoming more broadly based. Compared to the 1990s, investment rates have continued to be lower or stagnant in most *other major developing countries* and emerging market economies, including Argentina, Brazil, Malaysia, Mexico, the Republic of Korea, the Russian Federation and Turkey. In some of these cases (Argentina, Mexico and the Russian Federation) there has been a rebound more recently, though rates are still below those achieved in the 1990s.

The upshot for world economic growth and global adjustment of all these factors underlying weak investment demand could be ambiguous. In the short run, they signal meagre demand prospects that could further slow down global growth. On the other hand, they also signal the potential for strengthened long-term growth as current growth is reaching production capacity limits. This could lead to a rebound of investment as long as uncertainties about global macroeconomic stability can be dampened and consumer confidence is strengthened by more accommodating monetary and fiscal policies. Should no portfolio adjustment take place towards productive assets, however, investors will continue to pile into more liquid assets as they are attracted by the low risk premiums. Some analysts see the low yield spreads as indicative of another episode of irrational exuberance in financial markets and growing build-up of liquid financial asset and liability positions. As liability positions mount, investors will demand higher risk premiums, raising the cost to borrowers, which would eventually hurt growth and increase the risk of financial crises.

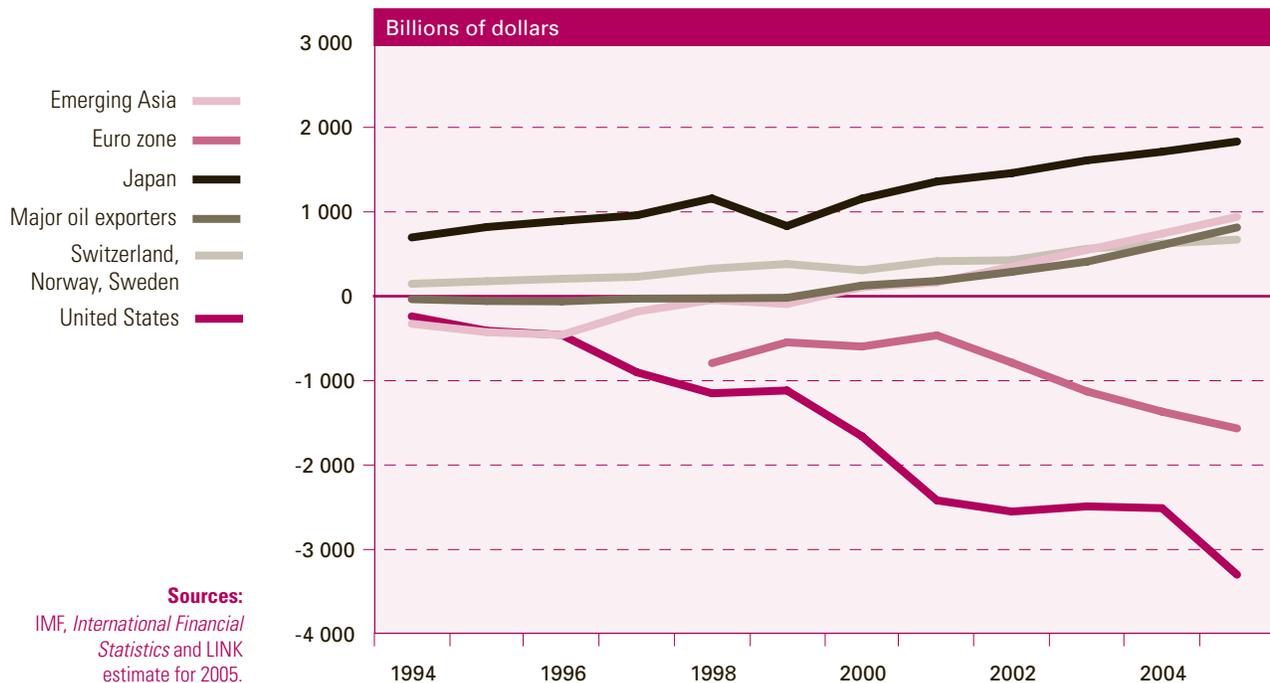
Widening net foreign asset positions and exchange-rate adjustment

The portfolio choices analyzed above imply that the sustainability of the present global imbalances should not only be judged from the savings-investment and current-account positions, but, perhaps more importantly, from the net foreign asset positions of the major economies and the preferences of investors around the globe to continue holding dollar-denominated assets. Net foreign liabilities of the United States have increased to over \$3 trillion (see figure I.5), which is

The implications of weak investment for world economic growth and global adjustment could be rather ambiguous

Sustainability of the global imbalances depends on the net foreign asset position of the major economies

Figure I.5.
Net foreign asset positions of major economies, 1994-2005



mirrored by growing positive net foreign asset positions of Japan, the oil exporters in Western Asia, emerging Asia (particularly China) and several European countries. In recent years, the Asian surplus countries and the oil exporters have become the strongest sustainers of the external liabilities of the United States. The net foreign liability position of the United States now amounts to about 25 per cent of its GDP.

The Asian surplus countries and the oil exporters have become the strongest sustainers of the growth in external liabilities of the United States

Normally, to sustain external liabilities as a percentage of GDP, a debtor country must run a surplus on its external current account, excluding net investment income, assuming the interest rate it has to pay on its liabilities exceeds its long-term growth rate. Further increases in the net debt ratio could trigger expectations of exchange-rate depreciation, and foreign investors will be less interested in holding assets of the debtor country, unless compensated through a higher interest rate. The case of the United States is not normal, however. First, the status of the United States dollar as the international reserve currency gives investors an incentive to hold dollar-denominated assets. Second, specific circumstances have led to the peculiar situation that, despite being the world's largest net debtor country, income earned on foreign assets held by United States agents is higher than what the country pays on its foreign liabilities. Rates of return on United States direct investment abroad appear to be substantially higher than on United States based assets. This has slowed the growth of the debt-to-GDP ratio, despite strongly widening trade deficits. In addition, the depreciation of the dollar against other major currencies has increased the value of United States foreign holdings and contained the rise in the value of its liabilities.

Looking ahead, however, the net investment income balance is expected to revert to a deficit in 2006 as a result of the rising interest rate and further debt increases. A further depreciation of the dollar could help dampen the increase in the net foreign liability position. Over time, however, the weakening of the dollar will erode confidence in the major reserve currency

and the willingness of foreign investors to hold assets in the United States unless compensated by higher interest rates. Such higher rates, however, will complicate adjustment of the current account, as net investment income will become more negative. This negative wealth effect will have a contractionary impact on those economies where agents hold large amounts of dollar-denominated assets, which in turn may spill over to the United States economy.

Given the widening of net foreign assets positions, the wealth effects of a dollar depreciation may well outweigh the relative price effect on trade balances. A strong devaluation of the dollar would form the prelude to a disorderly adjustment of global imbalances, as it would undermine confidence in the dollar and likely trigger a swift retreat from dollar assets. Looked at from the trade side, a very large depreciation would be needed to reduce the deficit in a major way, given the large size of the trade deficit in relation to traded goods production in the United States. The other side of the coin will be correspondingly large exchange-rate appreciations in Europe and Japan. As mentioned above, an exchange-rate realignment of that magnitude will likely shock asset markets and trigger a rather disorderly global adjustment process, with strong negative consequences for world economic growth.

A substantial devaluation of the United States dollar would also lead to significant negative wealth effects for many other developed and developing countries holding dollar-denominated assets, and depress aggregate demand in those countries and in the world economy as a whole.⁹ Therefore, restoring the global imbalances solely through major exchange-rate realignment seems neither an adequate nor an efficient path.

In practice, the movement of exchange rates in 2005 has been characterized by two diverging trends. On the one hand, the United States dollar has managed to rebound measurably vis-à-vis the euro and Japanese yen after it had depreciated substantially in the previous few years. On the other hand, currencies in many developing countries have appreciated steadily against the dollar, along with a move towards more flexible exchange-rate regimes in some developing countries, most notably China. Such a dichotomy implies, among other factors, a shift in the potential burden of adjusting the global imbalances away from Europe and Japan to developing countries.

International reserves in a large number of emerging market economies in Asia, Latin America and a group of oil-exporting countries elsewhere have increased significantly in the past few years. By various measures for reserve adequacy, such as the ratios of reserves to imports, to short-term debt and to money supply, reserves in most of those economies are all at historical highs, leading many analysts to believe that reserves in many of those countries are above the levels required by economic fundamentals.

Some of those economies registered surpluses in both their current and capital accounts to build up ample foreign reserves, while others have done so on either the current or capital account. For example, in China, of the surge of about \$200 billion adding to its reserves in 2004, the current-account surplus and FDI accounted for about \$60 billion and \$55 billion respectively. The rest of the surge—some \$70-\$80 billion—came from other types of capital inflows, including “hot money” for speculating on a revaluation of the Chinese renminbi. A slightly lower accumulation of reserves is estimated for 2005, with more originating from the current-account surplus and much less from short-term inflows. In Mexico, net capital inflows offset a deficit in the current account. In general, most Asian economies

The wealth effects of dollar depreciation may well outweigh the relative price effect on trade balances

Diverging exchange-rate movements

International reserves increased strongly in many developing countries

⁹ This point has been emphasized also in *World Economic and Social Survey 2004: Trends and Policies in the World Economy* (United Nations publication, Sales No. E.04.II.C.1) and *World Economic Situation and Prospects 2005* (United Nations publication, Sales No. E.05.II.C.2). See also Hans Genberg and others, *Official Reserves and Currency Management in Asia: Myth, Reality, and the Future*, Geneva Reports on the World Economy 7 (London, Centre for Economic Policy Research, 2005).

Managing reserves along with other policy objectives is a challenge

have a relatively larger current-account surplus than Latin American economies, although a number of the latter have also experienced tangible surpluses in their current accounts for the first time in many years as a result of the higher prices of and strong external demand for their primary commodities exports.

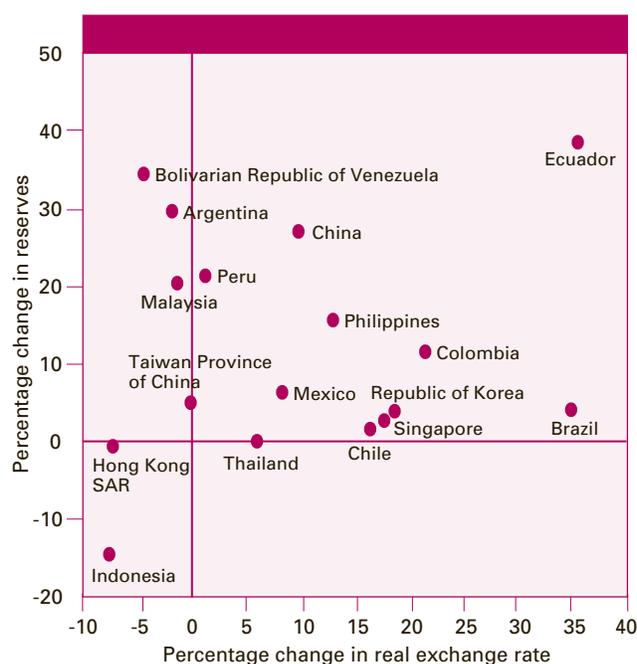
The efficient management of foreign-exchange reserves, and dealing with the associated excess liquidity in a manner compatible with a stable exchange rate, low inflation and stronger economic growth, are major policy challenges for many developing countries. Pressures for real exchange-rate appreciation tend to emerge as a consequence of rising foreign reserves. In response, many countries have been intervening in foreign-exchange markets with several objectives in mind, not all of them easily reconcilable. Some have focused on keeping the exchange rate stable and competitive, most notably the Asian exporters, and China in particular. In addition, those countries wish to avoid an erosion of the value of their dollar-denominated assets. Latin American countries, in contrast, seem to have given greater priority to keeping inflation down and to preserving financial stability. For example, Brazil intervened when its currency depreciated, but allowed pressures for an appreciation to take effect, thereby making it easier to reach its inflation target. Some of the countries in the region, like Chile and, more recently, Colombia, have been or are becoming more concerned with preserving a competitive exchange rate, or at least avoiding further appreciation. Because of different degrees of foreign-exchange market intervention, the observed relationship between foreign reserve accumulation and real exchange-rate appreciation is not very strong (see figure I.6a).

Sterilization of excess liquidity is more intense in Asia than in Latin America

To prevent the emergence of inflationary pressures, there will be a need for sterilization of the excess liquidity created by persistent one-way foreign-exchange market interventions in the form of buying up foreign exchange and thereby increasing base money. In addition, countries little inclined to intervene may need to sterilize in order to mop up the excess liquidity generated by external account surpluses. Countries have sterilized to different degrees as there will be both costs and benefits associated with the implied monetary adjustment and with further accumulation of foreign reserves. While sterilization is reportedly more intense in most Asian economies than in Latin America, there are some exceptions. Measured by the difference between the contribution to reserve money growth through the change in net foreign assets held by monetary authorities and the change in reserve money, the accumulative sterilization in the past few years has reached more than 10 per cent of the money supply (M2) in economies such as Malaysia, Singapore, Taiwan Province of China and Thailand, while the measure for China, the Philippines and the Republic of Korea ranged from 5 per cent to 10 per cent.¹⁰ Little evidence of sterilization is, however, found in Hong Kong SAR, particularly in the years before 2005, as the economy was suffering from deflation, with the expansionary effects of foreign exchange intervention being perfectly auspicious for reflating the economy (the same was true in Japan, where foreign-exchange intervention was used to inject additional liquidity into the economy to attack deflation). On the other hand, Argentina, in contrast to its Latin American neighbours, sterilized intensively, and actively intervened in the foreign exchange market. Yet, despite these attempts at sterilization, in most countries money supply growth has expanded in tandem with reserve accumulation (see figure I.6b).

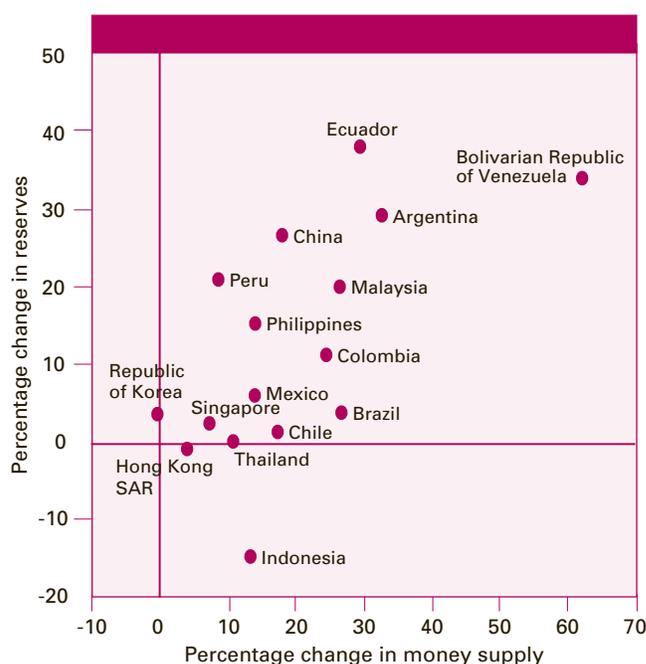
¹⁰ See Phil Garton, "Foreign reserve accumulation in Asia: Can it be sustained?", Australian Government, The Treasury, 2004, available from http://www.treasury.gov.au/documents/930/PDF/01_Foreign_Reserve.pdf.

Figure I.6a.
Reserve accumulation and real exchange rates in Asia and Latin America, 2004-2005



Sources: Percentage change in reserves is for 2004-2005 (annual data in dollars) based on data from ADB; IMF *International Financial Statistics*; and JPMorgan. Percentage changes of real effective exchange rates refer to November 2005 compared to January 2004 and are calculated from data of JPMorgan.

Figure I.6b.
Reserve accumulation and money supply growth in Asia and Latin America, 2004-2005



Sources: Percentage change in reserves is for 2004-2005 (annual data in dollars) based on data from ADB; IMF *International Financial Statistics*; and JPMorgan. Percentage changes in money supply (M1 plus quasi-money) refer to most recent available month in 2005 compared to January 2004. Data are from IMF, *International Financial Statistics*.

In all, under current global conditions, exchange-rate policies in emerging market economies require subtle management of reserves. On the one hand, exchange-rate competitiveness is a crucial objective of macroeconomic policy in open economies and can have important effects on economic growth and employment generation. On the other hand, the accumulation of reserves in those economies represents in effect a transfer of resources to the country in whose currency reserves are held (mainly the United States) at a price equivalent to the difference between the cost of their external borrowing and the (lower) returns to their holdings of foreign reserve assets. Countries may consider that the benefits of accumulating certain amounts of foreign reserves to slow down the pressure for exchange-rate appreciation outweigh such costs. The challenge is to find the 'optimal' level of the reserve holdings in line with the desired degree of exchange-rate competitiveness.

The costs of sterilized intervention must also be evaluated. There are two main concerns. The first is associated with the interest-rate differential between domestic financial assets and foreign assets (the higher the differential, the higher the costs). The second concern stems from uncertainties about the effectiveness of the intervention: sterilization by issuing more domestic bonds may push up domestic interest rates, which in turn will attract additional foreign capital inflows, creating further pressures for appreciation and requiring additional intervention and sterilization. To avoid surges in capital inflows undermining exchange-rate management and monetary policy, capital account regulation could

The costs of sterilized intervention must also be evaluated

be called for.¹¹ In this regard, the costs of sterilization are in general lower in many Asian economies than in Latin American economies, as domestic interest rates in the former are usually lower than in the latter. The costs of sterilization for Asian economies in the past few years have been estimated to range from zero to 0.5 per cent of GDP.¹² Moreover, the relatively lower costs of sterilization combined with the benefits of maintaining competitive exchange rates explain why Asian economies have in general been more active in foreign exchange intervention than Latin American economies.

Developing countries thus stand to gain from a narrowing of global imbalances and the reduction of pressures arising from the huge accumulation of foreign reserves. A large swing in the exchange rate of the reserve currency would lead to large asset revaluation and hence a major monetary shock. An orderly adjustment of the global imbalances will require weighing the risks to developing countries, since, given the amount of outstanding reserves, large shocks to these economies will feed back into global financial markets.

Downside risks of the global outlook

Disorderly adjustment of imbalances

A disorderly adjustment of the global imbalances will lead to recession and destabilization of global financial markets

All of these factors suggest that there is a looming risk of a disorderly adjustment of *global imbalances* leading to a worldwide recession and destabilization of global financial markets. The worst-case scenario would be an abrupt retrenchment in the spending of households and businesses in the major deficit country, the United States, triggered by a sharp erosion of the willingness of the surplus countries to hold dollar-denominated assets and thereby continue financing the deficits of the United States. In such a scenario, the rebalancing would generate a substantial contraction, not only in the United States, but also in the world economy as a whole, accompanied by a precipitous change in exchange rates and a detrimental shock to financial markets. For instance, as quantified in an earlier simulation using the LINK global model system¹³ and in other studies, cutting the external deficit of the United States in half through a contraction in private domestic demand would come at a price of a drop in GDP of the United States of 4.6 percentage points and of about 2 percentage points in world GDP. By contrast, a benign rebalancing process engendered by both a gradual adjustment in the United States and necessary policies in the surplus countries to boost their domestic demand would produce much smaller adverse effects. Such a benign rebalancing would require, however, international macroeconomic policy coordination and cooperation, for which there is currently no adequate framework in place. This situation heightens the risk of the worst-case scenario, as the global imbalances continue to widen.

¹¹ See, for instance, *World Economic and Social Survey 2005: Financing for Development* (United Nations publication, Sales No. E.05.II.C.1); as well as José Antonio Ocampo, "Capital account and counter-cyclical prudential regulations in developing countries" and John Williamson, "Proposals for curbing the boom-bust cycle in the supply of capital to emerging economies", both in Ricardo Ffrench-Davis and Stephany Griffith-Jones, eds., *From Capital surges to Drought: Seeking Stability for Emerging Economies* (Basingstoke: Palgrave, 2003).

¹² See Genberg and others, *op. cit.*

¹³ See Pingfan Hong, "Global implications of the United States trade deficit adjustment", DESA Discussion Paper No. 17 (ST/ESA/2001/DP.17), 2001, available from <http://papers.ssrn.com/>.

Additional oil price shocks

The uncertainties related to *oil prices* emanate from the tight global oil production capacity. It has now become evident that the rise in oil prices over the past few years is quite different from the price hikes associated with the two major oil crises in the 1970s and 1980s. The difference is both in terms of the causes of the increases in oil prices as well as the impact on the world economy. The current situation has mainly been driven by an upward shift in the demand curve (as well as some supply-side factors, such as geopolitical uncertainty and natural disasters), while the crises in the past were essentially a downward shift in the supply schedule caused by large-scale disruptions in oil supply.

Nevertheless, concerns about supply-side constraints have recently increased. In this regard, there are two kinds of uncertainties. First, barring any disruptive shocks to global oil production, there is the question of to what level oil prices must rise in order to balance oil demand and supply and what the implications of this equilibrium price level would be for global economic growth. Second, given the tight capacity, there is uncertainty regarding the effect of a large-scale disruption in global oil production on oil prices and world economic growth. While both of these questions are crucial for the outlook of the world economy, the second one seems to encompass greater downside risks.

The rise in oil prices is mainly caused by demand, but...

... concerns about supply have recently moved to the forefront

End of the housing market bubble

The vulnerability of the global economy is also derived from the possible burst of the *house price* bubble in some countries. A number of economies have experienced substantial appreciation in house prices over the past decades, with the appreciation particularly strong in recent years. Various housing indicators in those countries, such as the affordability ratio, price-to-rent ratio, mortgage loans-to-GDP ratio, and ownership ratio are at historical highs, suggesting a peak in the value of houses relative to the underlying economic fundamentals. Moreover, indications of possible bubbles in house prices, at least in some countries, are also visible from the increase in speculative activities. For example, in the United States, turnover in housing markets has increased, the share of investment-oriented house purchases has risen and novel mortgage products such as interest-only loans, innovative forms of adjustable rate mortgages and the allowance for a limited amount of negative amortization have been proliferating, thus enabling many marginally qualified and highly leveraged borrowers to purchase homes at inflated prices.

Meanwhile, the booming housing sector has been a major driver for GDP growth in many developed countries. For example, in the United States, home equity extraction, namely cash taken out during refinancing, has financed 30 to 40 per cent of the increase in consumer spending in recent years, accounting for one percentage point or more of total real GDP growth, with the residential building sector contributing another 0.6 of a percentage point. Part of the housing boom in recent years can be attributed to various country-specific features, but low interest rates and easier access to mortgage loans seem to be the common factors for most of these countries. Therefore, an increase in interest rates can lead to a flattening or reversal in the growth of house prices, turning the positive growth contributions of the housing sector into negative ones. As an example, the recent notable growth moderation in Australia and the United Kingdom of Great Britain and Northern Ireland was unambiguously attributable to a cooling down of the housing sector. At the same time, house prices have a substantial impact on the banking sector, as mortgage loans account for a sizable pro-

Possible burst of the house price bubble foreseen in some countries

portion of total bank loans. Declining house prices will heighten the risk of default and can trigger bank crises, as has happened in a number of countries in the past.

For the global economy, the risks associated with the housing sector are serious, not only because of the large size of the economies concerned, but also because of an inextricable linkage between the increase in house prices and global imbalances. A number of economies that have seen a substantial appreciation in house prices are also running large external deficits (relative to their GDP) and experiencing a decline in household savings to very low levels. In that regard, the housing boom in those countries has been to some extent financed by borrowing from the high-saving countries running external surpluses. Therefore, a burst in house prices is likely to lead to an abrupt and contractionary adjustment of the global imbalances.

Other risks

Other risks include the threat of international terrorism and an avian influenza pandemic

Other downside risks, such as international terrorism and an avian influenza pandemic, can also not be precluded. The recent outbreak of avian influenza, or bird flu, has already caused prodigious economic losses and may have claimed more than one hundred lives worldwide. There is no evidence yet that the virus or some variant could actually be transmitted from one human being to another, making it more uncertain whether it will turn out to be a pandemic. So far the damage has been concentrated mainly in several Asian countries (see box IV.3), but the virus has also spread to some European countries. As the world is not yet adequately prepared, there is a risk that it could become a global pandemic.¹⁴ The macroeconomic costs of a possible pandemic are difficult to estimate. Based on similar outbreaks in the past, however, including the post-First World War pandemic or Spanish influenza, but with a particular reference to the outbreak of severe acute respiratory syndrome (SARS) a few years ago, the World Bank has estimated that the overall costs could be as high as \$800 billion, equivalent to 2 per cent of the world gross product.¹⁵ Such a colossal loss would entail the death of millions of people and illness for many more, along with disruptions of trade, tourism and other economic activities, shocks to housing and financial markets, and erosion of consumer and business confidence. Many countries, individually and collectively, have begun to intensify preventive measures. But even if those measures were to mitigate the risks for a global pandemic significantly, their costs would be substantial (though lower than those of a pandemic) and would still entail growth costs for the world economy, as resources may be deflected from productive economic activity.

¹⁴ See World Health Organization (WHO), "Avian influenza: frequently asked questions" (2005), available from http://www.who.int/csr/disease/avian_influenza/avian_faqs/en/index.html#pandemic2.

¹⁵ See World Bank, "Spread of avian flu could affect next year's economic outlook" (2005), and other related articles, available from <http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/EAP-Brief-avian-flu.pdf>.

Policy challenges and the case for international macroeconomic policy coordination

Current macroeconomic policy stance

Facing various challenges, macroeconomic policies and, in particular, monetary policies have become less synchronized worldwide in 2005, in contrast to 2004 when many economies were unwinding the policy stimuli injected in earlier years. While central banks in some countries have continued to raise policy interest rates, those in other countries have reduced interest rates or maintained their policy stance for several months.

Among the developed countries, the United States Federal Reserve Board has so far raised interest rates by a total of 325 basis points from mid-2004, pushing up the Federal Funds rate to 4.25 per cent. Its recent policy statements imply that it will likely continue to increase interest rates until the Federal Funds rate reaches 4.5 per cent in 2006, with the real interest rate reaching about 2 per cent, a neutral position on the long-run average. No further monetary tightening is expected in the euro area, even though it is not clear whether the ECB's interest rate increase in late 2005 will be the beginning of a more prolonged restrictive monetary stance. Signals from the Bank of Japan are more clearly in the direction of maintaining the policy framework of quantitative easing, creating an environment where short-term interest rates stay very close to zero. The central banks in other developed countries will likely keep their policy stance at the current levels.

In the developing countries and economies in transition, further monetary tightening is expected, although in measured steps. This strategy holds in particular for most Asian economies, along with continued intervention in foreign-exchange markets and sterilization. In contrast, in Latin America, room for easing remains in several countries with high interest rates and relatively low growth, such as Brazil and Mexico, as inflation is contained within the target range. Governments of other economies in that region, including those facing appreciation pressures, are expected to adopt a policy mix of tightening, foreign exchange intervention and sterilization. While most African countries will maintain a cautious monetary policy stance, many economies in West Asia are likely to raise interest rates. Meanwhile, monetary policy in most economies in transition will remain accommodative.

Fiscal policies are even more country-specific. Broadly speaking, fiscal policy in the United States should become slightly more expansionary because of the expected increase in government spending on post-hurricane reconstruction. The countries of the euro area need to reach the targets established by the Stability and Growth Pact (SGP) and will have to undertake contractionary fiscal policies. Other European countries can maintain a neutral-to-mild expansionary stance, while Japan should be expected to continue its fiscal consolidation. Among the developing countries and economies in transition, most countries in Latin America, Africa and East Asia are likely to adopt more restrictive or cautious fiscal policies.

The current policy stances are not well focused on redressing the global imbalances. This lack of concerted policy action is reflected in the baseline assumptions used for the global outlook, according to which the projected world economic growth of 3.3 per cent would be accompanied by a further widening of global imbalances. The budget and current-account deficits of the United States are expected to increase further. Increasing differentials in the policy interest rates among the major developed economies will provide continued

Macroeconomic policies are becoming less synchronized worldwide

These current policy stances are not well focused on redressing the global imbalances

incentives for an increase in financial flows from Europe and Asia to the United States. In the baseline scenario, developing countries will continue to seek their own paths to adjust to the uncertain global environment, but none of these paths add up to an internationally consistent policy framework, further increasing the already large uncertainty.

Dealing with higher oil prices and inflated house prices

Oil prices and house prices pose particular challenges for monetary policy

Meanwhile, the risks associated with oil prices and house prices, as discussed in the previous section, pose particular challenges for *monetary policy*.

Although the two episodes of oil crises in the 1970s and 1980s have been extensively studied, views are still split over the implications for monetary policy in dealing with the inflationary risks associated with higher oil prices. It is generally agreed that monetary policy should ignore the effects of short-term fluctuations in oil prices, particularly if they are caused by temporary supply-side shocks. There is also some consensus that, even if there is a permanent rise in oil prices, it will either be unnecessary or impossible for monetary policy to offset the first-round effects on overall inflation, and that monetary policy should focus on the second-round effects in the medium run, namely, a notable pass-through of higher oil prices to wages and overall inflation. Some analysts would argue, however, that by the time the second-round effects are actually ascertained, it would be too late to activate a monetary tightening, as it would take months or longer for monetary policy to show any effects on the economy. Others would suggest that policy makers should differentiate between demand-driven higher oil prices and supply-driven ones: a monetary tightening would exacerbate the already contractionary effects of supply-driven higher oil prices. Meanwhile, even in the case of higher oil prices driven by strong global demand, as in the current situation, monetary tightening in individual countries would have only limited effects, unless the major economies initiate a coordinated tightening in monetary policy.

So far, monetary authorities in most countries have refrained from aggressive tightening, partly because of an expectation that oil prices will fall back in the medium term and mainly because of the fact that overall inflation remains stable and low. Some nascent signs appear to indicate an upward movement in the core inflation rate, however, so that, if higher oil prices persist, central banks will be faced with more difficult policy choices. It is important to note that, according to some studies, most of the contractionary impact on the real economy of past oil price shocks was attributable to monetary policy tightening in a context where pre-shock inflation was already on the rise.

Monetary authorities in countries with substantially appreciated house prices are also facing a significant quandary. The link between house prices and aggregate demand suggests that monetary policy should take into account the fluctuation in house prices. In practice, however, house prices are not included in overall inflation indices. Meanwhile, the combination of strong inflation in house prices and low inflation in goods and services, as witnessed in recent years in many economies, generates a conflict: monetary tightening consistent with stability in the housing market may trigger deflation in the goods market, while low interest rates will continue to fuel the surge in house prices and the increase in household indebtedness. This situation heightens the risks for a housing bubble, making future adjustment more difficult when the bubble bursts.

Redressing imbalances through coordinated policies

While dealing with higher oil prices and possible housing bubbles poses certain challenges for macroeconomic policies in individual countries, redressing the global imbalances requires a broader perspective.

Rebalancing the global pattern of growth and that of savings and investment will require recognition by policy makers worldwide that an orderly global adjustment will be a lengthy process and that coordinated action is required. The adjustment will take time primarily because savings and investment patterns are not easily shifted owing to structural and institutional factors. In addition, a substantial reduction of the widely diverging net foreign asset and liability positions across nations requires a prolonged shift in savings-investment balances. Furthermore, an exclusive focus on regions or countries that have a trade deficit is likely to end in excessive contractionary adjustment, as experience has shown. Surplus and deficit countries alike will have to share the burden of adjustment.

Viewed from this perspective, coordinated global adjustment will require measures that will stimulate savings in the deficit countries and investment in the surplus countries. The major deficit country, the United States, will need to stimulate private (household) savings and reduce public dissaving. The current direction of gradual increases in the interest rate might help to encourage private savings to some extent in the short run, although additional measures (for example, through fiscal incentives) may be needed to increase the private savings rate in the long run. Fiscal policies need to take a less expansionary stance. The policy adjustments may come at the cost of lower growth in the short run as the fiscal and monetary stimulus is reduced. Expansionary macroeconomic policies in the surplus countries may compensate for the growth loss and stimulate United States exports and investment in export sectors. If there is no such expansion, business savings may decline, and it is not certain that national savings will increase. The direction of adjustment would then be a decline of investment and growth.

In Europe, economic stimulus should come primarily from keeping interest rates down in an effort to stimulate private demand. Room for fiscal expansion is more limited in most countries. Yet more should be done to revitalize consumption and investment demand. Structural reform policies of recent years have thus far not been able to create such a stimulus. The focus on trying to promote international competitiveness has stimulated export growth but has contained real wage increases and increased job insecurity, having a negative impact on domestic demand. Remaining excess private savings should be redirected towards domestic investment.

In Japan, continued financial sector reform and fiscal incentives to stimulate private investment demand should combine to reduce domestic savings and trade surpluses. Asian surplus countries should try to boost public and private investment rates, or, if these are considered sufficiently high such as in China, boost broad-based consumption demand, particularly by redressing growing income inequality.

All major economies should contribute to the mobilization of the additional financial resources to assist the poorest countries in achieving the Millennium Development Goals in compliance with international agreements. To support an orderly and equitable global adjustment process, the major surplus countries in developed and emerging Asia and Europe, along with the major oil-exporting countries, could further strengthen their contribution to

Coordinated action is required for restoring global imbalances

Global adjustment will require measures stimulating savings in deficit countries and investment in surplus countries

All major economies should contribute to the additional financial resources for the MDGs

global development by channelling some more of their excess savings to those developing countries with insufficient investment finance for economic and social infrastructure.

**A broad platform
for international
macroeconomic
policy coordination
is required**

When implemented in a timely and coordinated fashion, a cooperative policy approach could avoid a contractionary and/or disorderly adjustment of the global imbalances. Such an approach would require a substantial degree of international macroeconomic policy coordination involving a much broader forum of countries than the major economies of the G-8. Unfortunately, the interest in international macroeconomic policy cooperation and coordination has diminished since the 1980s, partly because of the dubious success of that decade when the adjustment of large global imbalances ended with a considerable shock to the world economy. The unsatisfactory policy coordination of the 1980s was, however, precisely due to the unwillingness of the major economies to sacrifice their national interests for the sake of international coordination. Since then, the key players on the international stage have been shunning the subject, arguing that the best policy for the world economy, in terms of cost-benefit trade-offs, is for individual countries to adopt policies that fit best their own needs. Given the systemic risks associated with the global imbalances and the existence of externalities in national approaches to resolving the imbalances, there should be a net gain from a cooperative policy approach. Such an approach will also be needed to address the global investment anaemia with a coordinated fine-tuning of macroeconomic policies involving tightening fiscal and monetary policies in the major deficit countries and more accommodating policies in the surplus countries to avoid a collapse in global demand and a deterioration of future investment prospects.

**IMF should play a key
role in surveillance of
international policy
coordination**

Given its nature, the surveillance of international policy coordination would be a natural task for the International Monetary Fund (IMF). The role of the IMF in such matters, however, has eroded over the past two decades or so. The Fund should remain the central institution charged with fostering global financial stability and growth, even though there may be no consensus yet on how exactly it would achieve those targets. The member states of the IMF have recognized the need for a more balanced voice and participation of all members, particularly those from developing countries.

In its enhanced role, a politically rebalanced IMF should assess the responsibility of major countries and country groupings for adjusting the large global imbalances, with special attention to exchange-rate developments and their impact on global financial stability. In doing so, the Fund should go far beyond analysis of the problem and play a pro-active role to bring about collaborative efforts among countries for an orderly adjustment, as discussed above. Increasing the coordination of the economic policies of the major industrialized countries is not an easy task for the IMF, since those countries do not have IMF support programmes and can easily disregard its advice. As a result, some observers have suggested that the IMF surveillance function become fully independent of its lending and other activities. It has also been suggested that there should be increased transparency, candour and more specificity in its surveillance activities, as well as a change in the focus of multilateral surveillance from a bottom-up to a top-down approach. This surveillance would involve starting with an evaluation of the needs and objectives of the international monetary system and then proceeding to an assessment of how the policies of systemically important countries can be made compatible with this evaluation. Improving the efficiency of multilateral surveillance, however, can only be achieved if the larger economies accept the Fund's advice.

Galvanizing aid, trade and finance for achieving the MDGs

Despite a notable strengthening of economic conditions, as well as of the external economic environment for the developing countries over the past two years, the growth rates in many poor countries are still not strong enough for them to fulfil the Millennium Development Goal of halving poverty by 2015, or to meet the other internationally agreed development goals. They therefore require more official flows and development assistance. As detailed in chapter III, ODA has recently increased in nominal terms, but the amount of aid received by the LDCs in recent years, excluding resource flows for emergency assistance, debt relief and reconstruction, was only marginally higher than that of a decade ago. Some progress has been made in official development cooperation between donor and recipient countries. The international community has reiterated that improving the quality of aid is as important as mobilizing more aid. Meanwhile, developing countries, particularly in Africa, have continued their efforts to forge a multi-actor and multi-dimensional partnership with the developed countries, focusing on efforts at capacity-building, establishing and maintaining peace and security and building an enabling climate for business investment.

There are also new commitments to strengthen and widen cooperation among developing countries, as reflected in the Second South Summit in Doha in 2005 and several other meetings, with the United Nations at the forefront of efforts to foster South-South development cooperation. The major form continues to be technical cooperation, with more initiatives being taken by countries such as China, India and a number of others. Other forms of South-South cooperation have also been flourishing in such areas as monetary and financial cooperation, debt relief and grant assistance. One area that requires more attention is the transmission of remittances among developing countries.

A few more countries have reached the completion point in 2005 under the Heavily Indebted Poor Country (HIPC) Initiative, with its implementation continuing to progress slowly. As a result of debt relief under the HIPC Initiative, most debt indicators of developing countries have improved, with their debt-service ratios declining. Poverty-reducing expenditures of the Governments for the 28 decision point countries have recently increased relative to their debt-service payment, with the former at four times the latter. HIPC countries continue, however, to face difficulties in reconciling the objectives of achieving and maintaining debt sustainability, promoting long-term growth and reducing poverty, as some of them have to engage in borrowing to meet the increased needs for financing poverty reduction strategies. In the absence of additional grant financing, many of those countries would have to rely on new borrowing to fund their MDG expenditures, creating the danger of a new cycle of excessive borrowing and unsustainable debt.

As reaffirmed at the 2005 United Nations World Summit, a universal, rule-based, open, non-discriminatory and equitable multilateral trading system, as well as meaningful trade liberalization, can substantially stimulate development worldwide, benefiting countries at all stages of development. In practice, however, the prevailing global trading system is far from such an ideal state, with many developing countries, particularly LDCs, in a disadvantageous and unequal position compared with most developed countries. While the agenda for the multilateral trade negotiations under the Doha Round finally gave priority to the development dimension in order to enable more developing countries to benefit from trade, progress has been extremely slow.

Growth rates in many poor countries are still not strong enough to enable them to reach the MDGs

New commitments exist to strengthen South-South cooperation

Implementation of the HIPC Initiative progresses only slowly

Slow progress is seen in improving the multilateral trading system

Completing the Doha Round remains a major challenge

After a few years of impasse, the Sixth WTO Ministerial Conference in Hong Kong SAR concluded with some, although only marginal, progress. Among the substantive decisions, an agreement was made to eliminate all forms of agricultural export subsidies by the end of 2013, in a progressive and parallel manner. Although the agreement is conditional upon many future unknown factors and has no immediate economic effects, it represents a substantial systemic advance by bringing further agricultural trade liberalization under the umbrella of general multilateral trade rules. Another achievement is a limited “development package” for LDCs consisting of several decisions. The most substantive one among them is the decision to provide duty-free and quota-free market access by developed countries and developing countries declaring themselves in a position to do so on “a lasting basis” for all products originating from all LDCs by 2008, or no later than the start of the implementation period, in a manner that ensures stability, security and predictability. Meanwhile, a decision was made to eliminate all forms of export subsidies for cotton by developed countries in 2006 and to grant duty- and quota-free access for cotton exports from LDCs by developed countries from the commencement of the implementation period (see chapter II for more details). On the other hand, more formidable work remains to complete all the items on the Doha agenda by the end of 2006, in such areas as more market access in agriculture, a reduction of tariffs and non-tariff barriers in manufacturing, and new rules for trade in services, as well as investment and intellectual property issues.

Aid for Trade

While further trade liberalization under the WTO negotiations is expected to bring considerable long-term benefits, developing countries are facing short-term adjustment costs, including tariff revenue losses, reduction in preferential access to major markets, and the forgoing of tariffs. A key question is how the developing countries can develop production and export supply capabilities to take advantage of further market opening. The latest WTO agreement in Hong Kong SAR recognized the importance of Aid for Trade to help developing countries, particularly the LDCs, to improve supply-side capacity and trade-related infrastructure in order for them to implement and benefit from WTO agreements and to cope with short-term adjustment costs associated with trade liberalization.

All countries should live up to the commitments towards the international development agenda

The prospects for ODA in the medium term are encouraging, boosted by the commitments made during the meeting of the Heads of State of the G-8 developed economies in 2005, along with proposals for more debt relief for some HIPC countries. More importantly, at the 2005 World Summit, world leaders reinforced the political commitments expressed at previous high-level international meetings on development issues, particularly the commitments contained in the Millennium Declaration and the Monterrey Consensus. The challenge for all countries is to live up to those commitments at the agreed level and within the agreed time frame.