Chapter II

INTERNATIONAL TRADE AND FINANCE

A. Recent developments in international trade

After the Asian financial crisis world trade went through a period of slow growth in 1998 and 1999 (table 2.1); this phase ended in 2000. Estimates available at the beginning of 2001 indicate that world trade in 2000 grew at around twice the rate for 1999 and considerably faster than world output (table 2.2).[1] The resilience of the United States economy, a pick-up in economic activity in the EU and Japan, stronger than expected recovery in Latin America and the transition economies, and sustained growth in Asia all helped to stimulate trade. The prolonged period of boom in the United States has left its mark on the global trading system. Already in 1999, the United States economy accounted for an unprecedented 18.5 per cent of global imports in value terms and the proportion in 2000 was even higher (see WTO, 2000, tables III.1 and III.2). In 2001 world trade expansion is expected to moderate, due to the slowdown in world industrial production and more stable oil prices.

All major regions recorded an expansion in trade volumes in 2000, but it was particularly marked in the developing and, according to some estimates, transition economies (table 2.2). For the developing countries as a group, the volume of imports is estimated to have increased by more than 11 per cent in 2000, compared to less than 6 per cent in 1999 and a decline in 1998. In Latin America and in the transition economies, imports had declined in 1999 but are estimated to have grown by more than 10 per cent in 2000. In Asia, imports continued to grow, in some cases even more rapidly than they had in 1999. Growth in the volume of imports accelerated sharply in Hong Kong (China) and Taiwan Province of China, but was slower in Singapore and the Republic of Korea. Among the ASEAN-4, the volume of imports grew faster than in 1999 in Indonesia and the Philippines but slower in Malaysia and Thailand. China again registered strong growth in import volumes in 2000, exceeding even the 26 per cent of the previous year. In Africa, which has been less affected by the recent volatility in global markets, imports grew, but at a slower rate than in other developing regions.

Import growth accelerated also in the developed countries in 2000, albeit at a slower rate than in the developing countries for the first time since 1997. Imports into the United States again grew

Table 2.1

EXPORTS AND IMPORTS BY REGION AND ECONOMIC GROUPING, 1997–1999

(Percentage change over previous year)

	Export value			Export volume		
Region/economic grouping	*1997*	*1998*	*1999*	*1997*	*1998*	*1999*
World	3.5	-1.6	3.5	10.7	5.0	4.8
Developed market-economy countries	2.0	0.8	1.7	10.0	4.6	4.3
of which:						
Japan	2.4	-7.8	8.1	11.8	-1.3	2.1
United States	10.2	-0.9	1.9	11.9	2.3	4.3
European Union	-0.5	4.0	-1.0	9.4	6.3	3.7
Transition economies	4.2	-4.7	-0.6	10.4	5.1	-1.7
Developing countries	7.0	-6.9	8.7	12.5	5.6	7.1
of which:						
Africa	2.0	-15.9	8.7	6.7	-1.8	3.8
Latin America	10.6	-1.3	6.4	11.7	7.6	7.5
Middle East	4.7	-22.5	23.6	12.6	6.9	-3.0
Asia	7.2	-4.5	7.5	13.6	5.3	10.1
of which:						
Newly industrializing economies [a]	3.5	-7.5	5.3	11.6	3.8	7.0
ASEAN-4 [b]	5.1	-4.0	10.7	12.2	10.7	13.1
China	21.1	0.4	6.3	20.6	3.5	15.5
Memo item:						
ASEAN-4 plus Republic of Korea	5.0	-3.5	10.2	18.0	13.7	12.6

	Import value			Import volume		
Region/economic grouping	*1997*	*1998*	*1999*	*1997*	*1998*	*1999*
World	3.5	-0.9	4.0	9.9	4.3	6.0
Developed market-economy countries	2.3	3.1	4.9	9.4	7.7	7.0
of which:						
Japan	-3.0	-17.2	11.0	1.7	-5.3	9.5
United States	9.4	5.0	12.2	12.1	11.7	11.3
European Union	-0.3	5.9	0.8	8.9	8.3	4.2
Transition economies	6.5	-1.8	-11.6	13.7	4.7	-8.8
Developing countries	6.1	-10.2	4.2	10.5	-3.8	5.6
of which:						
Africa	5.7	1.2	0.0	10.0	5.2	-2.0
Latin America	18.2	5.0	-3.0	21.4	8.6	-1.0
Middle East	8.1	-3.2	2.6	10.8	-3.8	1.7
Asia	2.2	-18.5	8.9	7.3	-10.6	12.1
of which:						
Newly industrializing economies [a]	3.4	-19.5	7.3	7.4	-10.0	8.2
ASEAN-4 [b]	-2.4	-27.9	7.3	4.9	-23.1	9.2
China	2.4	-1.3	18.2	5.4	2.5	25.7
Memo item:						
ASEAN-4 plus Republic of Korea	-3.0	-30.9	15.0	3.5	-22.2	16.4

Source: UNCTAD secretariat calculations, based on statistics of WTO.
a Hong Kong (China), Republic of Korea, Singapore and Taiwan Province of China.
b Indonesia, Malaysia, Philippines and Thailand.

Table 2.2

EXPORTS AND IMPORTS BY REGION AND ECONOMIC GROUPING, 2000: ESTIMATES BY VARIOUS INSTITUTIONS

(Percentage change over previous year)

	Export value		Export volume		
Region/economic grouping	*IMF*	*UN*	*IMF*	*OECD*	*UN*
World	9.9	.	10.4[a]	13.3[a]	10.6
Developed market-economy countries	.	.	10.2[b]	12.9	10.2
of which:					
Japan	.	.	9.7[c]	12.5	8.6
United States	.	.	8.8[c]	12.6	10.6[d]
European Union	.	.	9.5[c]	12.6	10.8[e]
Transition economies	.	28.4[f]	.	.	8.3 (15.8[f])
Developing countries	20.4	.	10.3	.	11.9
of which:					
Africa	25.6	.	6.6	.	4.7
Latin America	17.9	20.5[g]	10.8	.	6.4 (4.2[g])
Asia	14.0	.	10.9	.	.
of which:					
East and South Asia	.	.	.	.	13.5
China	.	.	.	.	21.6

	Import value		Import volume		
Region/economic grouping	*IMF*	*UN*	*IMF*	*OECD*	*UN*
World	.	.	10.4[a]	13.3[a]	10.8
Developed market-economy countries	.	.	10.4[b]	12.7	8.8
of which:					
Japan	.	.	6.8[c]	11.5	6.4
United States	.	.	13.0[c]	14.5	13.1[d]
European Union	.	.	8.7[c]	11.0	6.8[e]
Transition economies	.	13.2[f]	.	.	11.8 (17.0[f])
Developing countries	15.1	.	11.2	.	15.7
of which:					
Africa	9.0	.	6.2	.	7.1
Latin America	13.9	17.5[g]	14.4		9.2 (12.3[g])
Asia	17.3	.	13.2	.	.
of which:					
East and South Asia	.	.	.	.	15.1
China	.	.	.	.	45.3

Source: IMF (2000a); OECD (2000a); UN/DESA-UNCTAD (2001).

a Average of annual percentage change for world exports and imports.
b Including NIEs.
c Including services.
d North America.
e Western Europe.
f ECE (January to September).
g ECLAC.

faster than those into other developed economies; on some estimates they expanded by more than 14 per cent in 2000. The continued role of the United States as a buyer of last resort for the rest of the world underpinned the strong performance of world trade in 2000. But import demand also picked up quite significantly in some of the larger EU countries, despite the weakness of the euro; overall import growth for the euro zone is estimated to have exceeded 10 per cent in 2000. Japan, although failing to match growth in either the United States or Europe, also had an accelerated growth in its import volume in 2000, in part due to a rebound in investment spending, especially on equipment related to information and communication technology.

The strong expansion in global import demand in 2000 was accompanied by a correspondingly robust overall global export performance.[2] A particularly rapid turnaround was registered in terms of export volume growth in the Middle East and in the transition economies. For the latter, this is partly attributable to the increasingly closer ties with western Europe (particularly Germany), where output growth picked up in 2000. The strong rise in export volume in the Russian Federation was also due to higher demand for its commodities, notably oil and metals. Higher export growth to other regions continued to power recovery in Asia and in parts of Latin America, aided by currency depreciations. For Asian economies, an additional factor was the revival of intraregional trade, which also contributed to the fast growth of Chinese exports.[3] Similarly, the expansion in export volume in Mexico owes much to its strong links to the United States economy. The exceptions to this trend are those countries, mainly in Africa and Latin America, whose exports are highly concentrated in a small number of non-oil primary commodities. The problems faced by these countries have been compounded by stagnant or declining world prices.

An acceleration in export volume in 2000 is also discernible in developed countries, particularly in the euro zone, which benefited from the competitive edge given by the weakness of the euro. Double-digit export growth in some of the larger European economies, such as France and Germany, is particularly notable. Strong export growth also helped to revive the Japanese economy in 2000.

The trade imbalances among major economic regions that had been building up in recent years, due to significant growth differentials between the United States and other developed economies and to the strong dollar, increased further in 2000. While the United States trade deficit reached a record high, close to 4 per cent of GDP,[4] there was little change in the overall trade surpluses of Japan and the European Union despite considerably higher oil import bills. Oil-exporting developing countries and several transition economies, notably the Russian Federation, registered increasing trade surpluses.

For 2001, growth in overall import demand is expected to be lower than in 2000 owing to the economic slowdown in the United States and in some countries which have recently experienced a rapid recovery. The level of private capital inflows is likely to limit increases in the import capacity of a number of developing countries, particularly in Latin America.

B. Non-oil commodity markets

In 2000, world non-oil commodity prices recovered slightly from sharp declines in 1998 and 1999. Although the overall increase of almost 2 per cent was the first positive growth in five years (table 2.3), prices remained well below 1996–1997 levels. Faster growth in all the major economic regions resulted in increases in demand for a large number of commodities, leading to lower stock levels and higher prices in some cases. These increases were sufficient to offset acute declines in the prices of certain key commodities, notably coffee, cocoa and rice. The combined adverse effects of the persistent weakening of some non-oil commodity prices, on the one hand, and the increase in oil prices, on the other, generated severe balance-of-payments problems and welfare losses for oil-importing developing countries heavily dependent on the production and export of a few commodities.

Thus, underlying the overall improvement in prices are sharply divergent trends among various commodity groups. The lingering effects of the decline in demand during 1998–1999 have left producers and exporters of a number of commodities – including coffee, cocoa, rice and tropical logs – with a large stock overhang that needs to be significantly reduced further before prices can begin to recover. For some commodities, particularly nickel and zinc, the fall in stocks which began in late 1999 continued throughout 2000, as a result of strong demand. Changes in the stock levels of agricultural commodities, on the other hand, have been mixed.

Prices of minerals, ores and metals as a group increased by 12 per cent in 2000 from the low of the previous year, on account of nickel, copper, aluminium and tungsten. Nevertheless, prices for all metals, except nickel, remained below their 1996–1997 average. The marked rebound in prices of base metals and some other industrial raw materials is the outcome of strong demand, cutbacks in production and a reduction in inventories. Aluminium prices, which began to recover in 1999 after marked declines in 1998 and early 1999, rose by 14 per cent in 2000 in spite of large stocks and rising production. Copper prices increased by more than 15 per cent because of strong demand, which reduced the large overhang in inventories built up during 1997–1999. Nickel prices rose by 44 per cent, following an increase of 30 per cent in 1999, largely because of strong demand created by a rapid growth in steel production. With demand growth outstripping supply, nickel stocks declined significantly, falling to their lowest levels in many years. Iron ore and zinc prices have increased moderately, while tin and phosphate rock prices remained relatively unchanged. For the fourth consecutive year, lead prices continued to fall, owing to large inventories and weak demand.

Changes in the prices of agricultural commodities in 2000 showed large variations, reflecting significant changes in the balance of supply and demand as well as changes in stock levels. Prices of key agricultural products remained weak owing to continued production increases and large inventories. Continued high output of commodities such as coffee, cocoa and rice resulted in a further build-up of stocks and exerted further downward pressure on prices. Coffee prices continued to fall sharply in 2000, after a cumulative decline of 45 per cent over the two preceding years also due, in part, to weak demand, particularly in Europe and the United States. But a significant increase in coffee pro-

Table 2.3

WORLD PRIMARY COMMODITY PRICES, 1996–2000

(Percentage change over previous year)

Commodity group	*1996*	*1997*	*1998*	*1999*	*2000*
All commodities[a]	**-4.2**	**0.0**	**-13.0**	**-14.2**	**1.9**
Food and tropical beverages	**2.1**	**2.8**	**-14.3**	**-18.3**	**1.0**
Tropical beverages	-15.2	33.3	-17.3	-20.9	-13.2
Coffee	-19.1	54.7	-28.5	-23.2	-16.2
Cocoa	1.2	11.2	3.7	-32.1	-22.2
Tea[b]	...	35.1	4.3	-7.0	6.8
Food	6.8	-3.5	-13.8	-18.1	5.9
Sugar	-9.9	-4.9	-21.2	-30.0	30.5
Beef	-6.4	4.0	-7.0	6.1	5.7
Maize	25.0	-25.3	-13.4	-5.5	-1.0
Wheat	16.2	-22.6	-19.9	-10.9	3.5
Rice	5.0	-10.7	1.3	-18.6	-18.1
Bananas	7.5	4.3	-3.1	-9.9	-2.3
Vegetable oilseeds and oils	**-4.2**	**-0.9**	**7.1**	**-23.3**	**-22.8**
Agricultural raw materials	**-9.9**	**-10.3**	**-10.8**	**-10.3**	**-1.0**
Hides and skins	-23.7	-19.8	-22.7	-27.6	73.8
Cotton	-14.8	-8.9	-8.3	-22.9	3.5
Tobacco	15.6	15.6	-5.5	-7.0	-3.4
Rubber	-11.9	-28.3	-29.8	-12.6	7.9
Tropical logs	-20.1	-5.5	-1.2	-7.2	-4.3
Minerals, ores and metals	**-12.1**	**0.0**	**-16.0**	**-1.8**	**12.0**
Aluminium	-16.6	6.2	-15.1	0.3	13.8
Phosphate rock	8.6	7.9	2.4	4.6	0.2
Iron ore	6.0	1.1	2.8	-9.2	2.6
Tin	-0.8	-8.4	-1.9	-2.5	0.6
Copper	-21.8	-0.8	-27.3	-4.9	15.3
Nickel	-8.8	-7.6	-33.2	29.8	43.7
Tungsten ore	-17.9	-9.3	-6.4	-9.3	12.1
Lead	22.7	-19.4	-15.3	-5.0	-9.7
Zinc	-0.6	28.4	-22.2	5.1	4.8

Source: UNCTAD, *Monthly Commodity Price Bulletin,* various issues.
a Excluding crude petroleum.
b New series, with data starting in 1996.

duction in Viet Nam, which became the world's second largest coffee exporter after Brazil, also contributed to the downward trend in coffee prices. Despite an increase in demand, cocoa prices reached a record low in 2000 because of a large oversupply which led to a further build-up of stocks. The 7 per cent increase in the price of tea offset the decline experienced in 1999, and was due primarily to a reduction in supply volumes, particularly from Kenya and India.

The 6 per cent rise in food prices in 2000 was the first increase since 1996, reflecting a sharp recovery in sugar prices, which rose more than

expected because of a large drawdown in stocks. Wheat prices recovered slightly but remained well below their 1996 levels, while rice prices fell by about 18 per cent. Surplus production capacities in major exporting countries have led to depressed price levels of rice over the past few years. Vegetable oilseeds and oils also remained depressed, dropping by 23 per cent in 2000 following a fall of similar magnitude in 1999.

For 2001, changes in the prices of non-oil commodities will continue to be mixed among individual commodities and commodity groups. On the whole, most commodity markets can be expected to remain weak; short-term prospects are clouded by considerable uncertainties associated with the performance of the United States economy and the impact of a slowdown there on the rest of the world.

C. Recent developments and emerging trends in oil markets

1. *Prices, supply and demand*

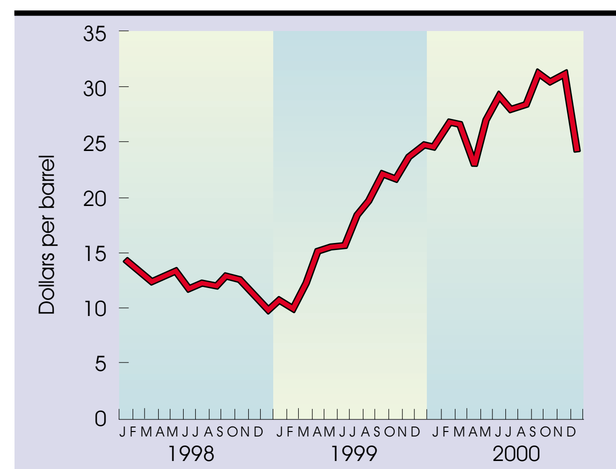
The annual average price of crude oil increased by 58 per cent to $27.6 a barrel in 2000, the highest level since 1985, and monthly average oil prices reached a peak of $31.5 a barrel in September 2000[5] (chart 2.1). Throughout 1998 and early 1999 oil prices had fallen, hitting a low of about $10 a barrel, due largely to the Asian economic crisis, which had greatly reduced global oil demand.[6] In an effort to reverse the price decline, members of the Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC oil exporters (Mexico, Norway, Oman and the Russian Federation) jointly cut oil production by over 2 million barrels per day (bpd) in April 1999. The implementation of these supply cutbacks coincided with a revival of demand associated with economic recovery in East Asia and continued high rates of growth in the United States. The overall outcome was a large drawdown in world oil stocks, while prices tripled from February 1999 to February 2000.

As the price hikes began to be felt in many oil-importing countries, OPEC increased its production quota by 1.7 million bpd in April 2000 and informally adopted a production scheme aimed at keeping the oil price per barrel within the $22–28 range (see *TDR 2000*, chap. III, sect. C). Thus, as prices rose above the $28 limit, OPEC

Chart 2.1

MONTHLY AVERAGE SPOT PRICES OF OPEC CRUDE OILS, 1998–2000

(Dollars per barrel)



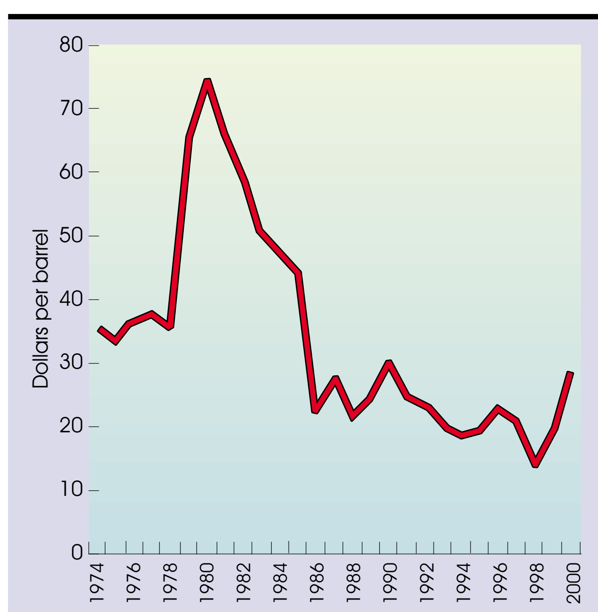
Source: OPEC, *Monthly Oil Market Report,* various issues.

raised its production target in July and October by a total of 3.2 million bpd. Prices reached a peak in September and again in November 2000, as traders continued to worry about the decline in stocks of crude oil, particularly in the United States. However, prices dropped sharply in December 2000, to their lowest level in eight months. Fears of a collapse in prices replaced concerns over high prices. In an effort to prevent a price slide below its target price band amid concerns of slowing oil demand growth, particularly in the United States, OPEC cut production quotas of members, on a pro rata basis, by 1.5 million bpd as of February 2001.

Chart 2.2

REAL OIL PRICES, 1974–2000

(Dollars per barrel[a])



Source: UNCTAD secretariat calculations, based on data from BP Amoco, *Statistical Review of World Energy 2000,* and United States Department of Labor (www.stls.frb.org/fred/data/cpi).

a Prices in current dollars have been deflated by the United States consumer price index with the base year 2000.

2. *Impact of the increase in oil prices*

It is commonly believed that higher oil prices depress global economic activity. The negative real income effect of an oil price hike is considered similar to a tax or levy on the real income of private households and companies in oil-importing countries, reducing global demand. However, this view takes into account only the negative effects on consumers in the western world, ignoring the positive effect on oil producers. Any rise in the price of oil which is not fully compensated by a fall in the quantity traded brings about a redistribution of real income from consumers to producers. This redistribution is likely to change the structure of demand for goods on the world market but does not necessarily reduce aggregate global demand and activity.

In any event, even the direct impact of the recent oil price increase on the industrialized oil-importing countries has been much less severe than the increases in 1973 and 1979–1980 for various reasons. Economic activity in the industrialized countries is much less oil-intensive than it was 20 or 30 years ago, and despite the recent sharp increase in nominal terms, oil prices are still relatively low in real terms, with the average real price of a barrel of oil in 2000 being about one third of that in 1980, and 20 per cent lower than in 1974 (chart 2.2). The importance of oil in trade has thus declined considerably in the past two decades, and so has the potential impact of oil prices on inflation in the industrialized countries. Since February 1999, in spite of a nearly threefold increase in crude oil prices, end-use prices in most industrialized countries increased by only about 30 per cent, causing a rise in the overall consumer price index in the order of 0.5 percentage points in both 1999 and 2000 (OECD, 2000a, tables I.8 and I.9).

Nevertheless, the oil price increases in 2000 sparked a wide-ranging debate in major oil-consuming countries on issues relating to oil prices, oil taxation and oil security. The United States Government decided to release some of its strategic reserves, normally earmarked for major emergencies. And some European Governments granted compensation to certain groups, in response to a consumer rebellion against high pump prices. Oil-exporting countries, particularly members of OPEC, have often been held responsible for allegedly high prices of petrol and heating oil.

Table 2.4

G-7 COUNTRIES: AVERAGE PUMP PRICES OF GASOLINE[a] AND REVENUES FROM TAXES ON OIL PRODUCTS[b]

Country	Price	Tax	Taxes	Revenue from taxes on oil products, 1999
	($ per litre)		(Percentage of total price)	($ billion)
United Kingdom	1.15	0.85	73.7	59.6
Japan	1.02	0.55	53.6	79.0
Italy	0.96	0.61	63.4	47.9
France	0.94	0.64	68.0	53.2
Germany	0.90	0.61	67.4	58.2
Canada	0.49	0.42	40.8	14.8
United States	0.41	0.10	24.8	95.7

Source: UNCTAD secretariat calculations, based on International Energy Agency, *Monthly Market Report,* 11 December 2000.
a Average prices in November 2000.
b 1999.

However, consumer prices have risen even during periods of declining prices for crude oil, mainly because of the impact of taxation of fuel consumption in the industrialized countries, particularly in Europe (table 2.4). Gasoline taxes in the EU, for example, on average amount to some 68 per cent of the final price, with the remaining 32 per cent equally distributed between industry margin (i.e. refiners and traders) and oil-exporting countries. In 1999, fuel taxes yielded a revenue of nearly $358 billion in the G-7 countries, an amount almost double that earned by OPEC members from their exports of crude oil.

For the developed countries, rising oil prices in 1999 and 2000 represented an additional import cost of less than 0.5 per cent of GDP, but they also encouraged higher exports to oil-producing countries. Given their different export structure, oil-importing developing countries typically receive much less benefits from any additional demand from oil exporters. As oil use per unit of output is higher in developing than in developed countries, the overall impact of the oil price rise since 1999 has been much more severe in the former.

Indeed, for many developing countries the impact was stronger than that of the oil-price rises in the 1970s and early 1980s as their efforts to industrialize and build their manufacturing industries have increased their dependence on modern fuels; their use of motor vehicles has also increased considerably. As a result, they have become more oil-intensive over time, using almost twice as much oil as developed countries per unit of output. According to one recent estimate, the implied terms-of-trade loss due to the recent price rise in oil has amounted to 1.4–2.0 per cent of GDP for countries in South-East Asia, around 1 per cent for India and South Africa, and 0.5 per cent for Brazil (OECD, 2000a: 15).

Oil import bills of the oil-importing developing countries rose by about $21 billion in 1999 and by another $43 billion in 2000 (table 2.5). As oil generally accounts for a large share of their total imports, their current-account balance deteriorated considerably, by more than 1 per cent of GDP in 2000 alone. Such an effect is likely to have severe consequences for growth and living standards in many instances. For the oil-importing countries of Africa, many of which are LDCs, the

Table 2.5

OIL IMPORT BILLS OF OIL-IMPORTING COUNTRIES, 1998–2000

(Billions of dollars)

Country/region	*1998*	*1999*	*2000*
United States	47.3	67.2	106.3
Japan	23.5	34.0	53.6
Western Europe	45.2	63.3	99.5
Central Europe	5.0	7.2	11.4
Developing countries	52.1	72.8	116.1
Africa	5.0	7.0	11.0
Asia	41.6	58.3	91.6
Latin America	5.5	8.5	13.5

Source: UNCTAD secretariat calculations.

combined increase in the oil import bill over the past two years amounted to about $6 billion, or 2 per cent of their GDP. Given their external financing constraints and inability to achieve offsetting export growth, many of them were forced to reduce their imports of other goods.

On the other hand, the hike in oil prices has alleviated balance-of-payments and budget constraints in many of the oil-exporting developing countries that had suffered severe terms-of-trade losses in 1998. The oil export revenues of OPEC members doubled from 1998 to 2000, reaching their highest level since 1981.

3. Prospects

The outlook for oil prices depends to a large extent on the production policies of OPEC. With the exception of Kuwait, Saudi Arabia, and the United Arab Emirates, whose combined spare production capacity is estimated to be about 3–4 million bpd, all other countries have been producing at full capacity. The major market uncertainty relates to oil exports from Iraq. On the demand side, a key determinant will be GDP growth and energy policies in the major industrial countries. Over the next 12 months, world demand for oil is expected to ease, depending on the extent of the slowdown in the United States and its impact on world economic activity. Oil stocks have increased but remain at relatively low levels, and this will continue to contribute to market fragility and price volatility. However, in the absence of any serious disruptions in supply, average oil prices in 2001 may fall to below $20 a barrel.

Over the medium to long term, oil prices will largely be determined by the development of new production capacities and alternative energies. Apart from providing 40 per cent of global oil supplies, OPEC members account for some 78 per cent of the world's proven crude oil reserves. Most of these known reserves are characterized by low development and operating costs and can be exploited fairly rapidly.

Investment in exploration and production has generally increased in response to the rise in prices, but the bulk of any new production capacity will not come on-stream until after 2001. In particular, international oil companies and other independent producers have been investing in new oil exploration and development ventures which are likely to increase non-OPEC supply capacity substantially. Production increases are expected not only from the Russian Federation and the Central Asian oil exporters, but also from countries in Latin America, Africa and the Middle East. Moreover, technological advances have reduced the cost of exploration and production by nearly one half over the past decade, and have also made it possible for oil companies to explore in new frontier areas, particularly offshore, and to discover oil more easily than ever before. On the other hand, the recent increase in oil prices has, once again, renewed interest in energy conservation, alternative sources of energy and new fuel technologies, such as hybrid engines and hydrogen fuel-cells, so that oil, while remaining a major source of energy, may lose further in importance for economic activity.

D. Currency markets and selected financial indicators in emerging markets

In its discussion of developments in international financial markets during the early part of 2000, *TDR 2000* noted the especially high level of uncertainty attaching to any prognosis. The second half of the year was indeed marked by crises and financial support packages for Argentina (box 2.1) and Turkey (box 2.2), as well as by movements of financial indicators, such as increases in yield spreads on the international bonds of some developing countries, pointing to perceptions of increased risk. But elsewhere in emerging markets, shifts in monetary conditions and pressures on exchange rates were generally more gradual or largely absent (except during brief periods of political unrest in some countries). However, the year was also notable for sharp falls in equity prices.

In Asia there have been few major changes since early 2000 in exchange-rate policy or regimes of exchange control, but in Latin America there has been a trend towards full dollarization. The range of currency regimes in developing and transition economies thus continues to span the spectrum from rigid pegs (in Argentina and Hong Kong (China)) and outright dollarization (in Ecuador and El Salvador) to various types of floating. Several countries have adopted freer floats since 1997, while in some cases retaining the discretion to intervene in the market for their currencies in certain circumstances, such as to maintain orderly conditions or to avoid sudden depreciations or appreciations.[7] Venezuela has maintained its moving band under which the spot rate for the dollar is allowed to fluctuate within a range of 7.5 per cent on either side of an adjustable central rate. Malaysia has maintained a fixed exchange rate of the ringgit with the dollar since September 1998. In Indonesia in January 2001, in order to reduce volatility of the rupiah and given the danger of further destabilization of a still vulnerable financial sector, the Government introduced a package of restrictions on selected capital transactions with non-residents (foreign persons and firms and Indonesian entities abroad), which took the form of ceilings on derivatives transactions, and of prohibition on borrowing, lending and investment, likely to affect the exchange rate.

Ecuador adopted a scheme of dollarization in March 2000, and El Salvador in January 2001. In Ecuador, the dollar became legal tender, but the national currency (fully backed by dollars) remained in circulation to facilitate small transactions. A major objective of such a step is to bring interest rates down towards United States levels. However, this process may be slowed by increased credit and political risk stemming from price changes associated with adjustments to the exchange rate at which dollars are substituted for the national currency and by associated disruptions of output and employment. So far, short-term interest rates in Ecuador have fallen substantially, but those with longer maturities remain greatly in excess of dollar rates.

Amongst major financial indicators there was a dramatic change of direction during 2000 in indices of equity prices in emerging markets (chart 2.3). After rises of more than 50 per cent in indices for all major regions in 1999, there were sharp falls in 2000, the decline being largest in Asia. While these declines were partly fuelled by increased economic uncertainty and a less favour-

Box 2.1

EXTERNAL SHOCKS, ADJUSTMENT AND CRISIS IN ARGENTINA

Despite substantial efforts by the new Government to implement an economic programme announced in December 1999 and supported by an IMF stand-by credit, economic performance in 2000 was disappointing, as the economy failed to recover from the recession caused by a fallout from the Russian default.

Since the adoption of the Convertibility Law in 1991, the peso has traded at parity with the United States dollar, supported by a currency board. This, of course, precluded the use of exchange rate or monetary policy to offset dollar appreciation or higher United States interest rates, so that the only possible adjustment was through a deflationary process to improve competitiveness. This adjustment affected the attainment of economic policy goals in different ways. On the one hand, deflation produced a real depreciation of around 10 per cent in 2000 in the effective exchange rate (when measured in terms of relative unit labour costs). Together with higher prices of energy (which represents over 10 per cent of the country's merchandise exports) and the slow growth of imports due to recession, this has resulted in a marked swing in the trade balance, from a deficit in 1999 to a surplus in 2000. On the other hand, however, tax yields were sharply reduced and the fiscal deficit failed to improve. Moreover, the rate of unemployment, which before the downturn in 1998 had fallen to below 13 per cent, resumed its rise, exceeding 14 per cent. Although the net financing requirement of the Government fell in 2000, its net external borrowing increased somewhat.

The improving trade performance and the IMF stand-by credit failed to contain yield spreads, which rose sharply in May and remained at 650–700 basis points until August as markets, became concerned about the deteriorating social climate produced by the renewed economic slowdown and its impact on public finances. There was also concern about the effects of a further tightening of interest rates in the United States. The Government was, nonetheless, able to implement its external financing plan: by early September it had raised over $14.5 billion, more than 80 per cent of the gross financing required for 2000. However, the increase in interest rates charged to prime borrowers, from about 9 per cent to a peak of nearly 20 per cent in November, contributed to a further slowing of economic activity.

In October and November, political instability created turbulence in capital markets, and by the end of the latter month yield spreads rose to nearly 900 basis points and total international reserves fell by about $3 billion.[1] In order to prevent an additional drain on reserves, the Central Bank decided to limit commercial banks' use of short-term Treasury paper (*Letes*) as collateral for their *pases activos*.[2] It also drew on its stand-by arrangement with the Fund.

At the same time, the Government launched a revised economic plan and approached IMF to raise its financing commitment. In the package announced in January 2001, the Fund increased Argentina's existing stand-by credit to $13.7 billion, corresponding to 500 per cent of the country's quota (about $3 billion of which is to be provided under the Supplemental Reserve Facility).[3] The World Bank and the Inter-American Development Bank (IDB) promised new loans of about $4.8 billion over two years, and the Spanish Government contributed $1 billion. Disbursements from these multilateral and bilateral sources are expected to cover about one third of the Government's estimated gross financing requirements of some $30 billion in 2001. The remainder will be financed by agreements with local banks through rollover of maturing bonds and new issues and through

Box 2.1 (concluded)

expected purchases of bonds by local pension funds. The Government is also planning other placements in international capital markets.

Basing itself on the experience of similar agreements with IMF made by Thailand, Indonesia and the Republic of Korea, where targeted reductions in fiscal deficits had to be revised in conditions of recession, the Argentine letter of intent provides for an increase in the deficit to 2.2 per cent of GDP in order to avoid a fiscal contraction in the early stages of recovery. This figure includes the cost of measures to stimulate investment, some additional spending on temporary public employment programmes, and other social spending aimed at mitigating economic hardship for the most vulnerable groups. Federal primary spending is, nonetheless, expected to decline in 2001 by 0.5 per cent of GDP from the previous year's level, and the primary surplus to rise to 1.7 per cent GDP (from 1 per cent in 2000). The overall deficit is to be eliminated by 2005, and fiscal consolidation to be extended to provincial governments. The ratio of public debt to GDP is programmed to decline from 2003 onwards. This implies a freeze on non-interest nominal federal expenditure at the 2000 level and likewise on expenditure by those provincial governments that are in deficit. In addition, IMF conditionality relates to reform of fiscal administration, social security, industrial and competition policy, trade policy, the financial sector, and corporate governance.

Following the implementation of the new package, which coincided with a fall in United States interest rates and depreciation of the dollar, equity prices recovered, and Argentina has been able to raise new funds in the international market.[4] Current global conditions could enable Argentina to emerge from the vicious circle in which the need to increase the external surplus requires lower wages and prices, thus reducing tax yields and undermining the target of a lower fiscal balance. Lower interest rates should enable the interest costs of the debt – and thus the fiscal deficit – to be reduced without cutting expenditures, while a cheaper dollar would help boost exports without the need for lowering wages and prices.

Nevertheless, since there is an outstanding debt of $120 billion, equivalent to 350 per cent of the country's annual export earnings, and since two thirds of foreign exchange receipts are absorbed by debt service, the downside risks should not be underestimated, particularly if there is a loss of investor confidence in emerging markets.

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1 The figure refers to reserve holdings of the Central Bank plus deposits held by the financial system abroad.

2 These are repurchase agreements which the Central Bank uses to provide liquidity to the banking system because under the Convertibility Law, it cannot rediscount commercial bank assets.

3 Argentina received about $3 billion immediately, with three additional drawings of about $1.3 billion each programmed for the remainder of 2001 following the continuous review process. About $4 billion will be available in 2002 and $1 billion in 2003.

4 In February 2001 the Government launched a 500 million euro-bond issue with a maturity of six years and an interest rate of 10 per cent, representing a 550 basis-point spread over German and French government issues. It also completed a debt swap of $3 million short-term debt for a new five-year treasury note and a new 11-year global bond, with another one announced for before the end of the first quarter.

Box 2.2

STABILIZATION AND CRISIS IN TURKEY

The recent Turkish crisis has a number of features common to crises in emerging-market economies that implement exchange-rate-based stabilization programmes. Such programmes typically use the exchange rate as an anchor for inflationary expectations, often relying on capital inflows attracted by arbitrage opportunities to finance growing external deficits, with a resulting appreciation of the currency. The consequent build-up of external financial vulnerability eventually gives rise to a rapid exit of capital, leading to overshooting of the exchange rate in the opposite direction and/or hikes in interest rates. Through such a boom-bust financial cycle, some countries (e.g. Mexico and Brazil) have succeeded in overcoming their chronic price instability and avoiding a return of rapid inflation, despite the collapse of their currencies and the external adjustment necessitated by the crisis. The Turkish programme initially followed a similar path, but ran into difficulties at a much earlier stage of the disinflation process, causing it to abandon the peg and casting doubts on its chances of success. The difficulties arose largely because the programme was launched in a climate of structural problems and fragilities on many different fronts, notably in the public finances and the banking sector.

Following chronic inflation since the mid-1980s averaging an annual 70 per cent, the Government launched a stabilization programme in December 1999 supported by an IMF stand-by credit, with the aim of bringing the rate of inflation down to 25 per cent by the end of 2000 and to the single-digit level by the end of 2002. The programme was adopted after a poor economic performance in 1999, when GNP fell by 6 per cent, partly due to devastating earthquakes and the fallout from the Russian crisis. Furthermore, there were large public sector deficits (an operational deficit of 14 per cent of GNP for the consolidated public accounts), mainly on account of mounting interest payments on government debt and the losses of public enterprises. The banking sector was also highly fragile and largely dependent for its earnings on high-yielding T-bills associated with rapid inflation. Financial markets were consequently highly vulnerable to disinflation, and there emerged an inconsistency in policy since much of the fiscal adjustment was predicated on declines in the very nominal and real interest rates on which many banks depended for their viability. By contrast, the external account was almost in balance. The Central Bank of Turkey (CBOT) was effectively following a policy of an adjustable peg designed to prevent a significant real appreciation of the lira.

The stabilization programme was based on a preannounced crawling peg. The exchange rate targets were set in terms of a basket made up of the dollar and the euro, with greater weight accorded to the former. The value of the basket in lira was set to increase by 20 per cent for the year 2000 as a whole (equal to the target rate for wholesale price inflation), at declining monthly rates. July 2001 was set as the date for exit from the preannounced crawling peg to more flexible rates within a band. The programme also provided for a “quasi-currency board” (whereby money-printing against domestic assets was precluded), as well as for targets for primary budget surpluses. As the CBOT was committed not to engage in sterilization, macroeconomic equilibrium was to be attained mainly through changes in interest rates: if capital inflows fell short of the current-account deficit, liquidity would be withdrawn from the economy and interest rates would rise, thus restoring external equilibrium by attracting more capital inflows, on the one hand, and by restraining domestic demand and imports, on the other.

In the event, during the first 11 months the targets for the nominal exchange rate, net domestic assets, and primary budget deficits were attained, but prices proved to be stickier than expected; annual inflation had come down only to some 40 per cent at the end of 2000, from an average of 65 per cent in 1999. The consequent real appreciation of the currency was aggravated by the rise of the dollar against the euro. Interest rates fell significantly faster than the rate of inflation, even though they were highly volatile: annualized rates on 3-month T-bills averaged less than 40 per cent in January–November 2000, compared to over 100 per cent in 1999. Despite fiscal tightening,

Box 2.2 (continued)

the economy made a sharp recovery, growing over 6 per cent for the year 2000 as a whole. Together with the appreciation of the currency and a rising oil import bill, this led to a doubling of the trade deficit, to an estimated $20 billion, and pushed the current-account deficit to an unprecedented 5 per cent of GNP.

Even though real interest rates fell sharply during the year, there were considerable arbitrage opportunities for foreign capital, since the nominal depreciation of the currency fell far short of the differentials with foreign interest rates. Consequently, until the crisis broke out in November, private capital inflows and large-scale foreign borrowing by the Treasury were more than sufficient to meet the growing current-account deficit, resulting in increases in reserves and an expansion of domestic liquidity. The latter, together with the shift in government borrowing from domestic to international markets, helped to lower interest rates, thereby supporting aggregate demand.

As in most emerging-market crises, it is difficult to identify a single event behind the collapse of confidence and flight from domestic assets that occurred in November 2000. Probably the most important factors included: disappointing inflation results for October; unexpectedly high monthly trade deficits; political difficulties encountered in privatization; worsening relations with the EU; the economic situation in Argentina; and disclosure of irregularities in the banking system and a criminal investigation into several banks taken over by the Deposit Insurance Fund. There may also have been a rush to liquidity due to competitive manoeuvring among some private banks. However, quite apart from all this, the programme had clearly run into the familiar problems of exchange-rate-based stabilization that relies on short-term arbitrage flows. As confidence eroded, foreign creditors refused to roll over their contracts with local banks. For their part, the banks sold liras in an effort to reduce their end-of-year open foreign exchange positions. The exit from the lira created difficulties for banks relying on foreign funds and resulted in a liquidity crunch and a hike in interest rates by draining international reserves. Banks carrying large T-bill portfolios with funds borrowed in overnight markets suffered significant losses and bid for funds in the interbank market, at the same time unloading large amounts of government paper. Within a few days stock prices plummeted and overnight rates reached three-digit levels. The CBOT faced the classical dilemma posed by loss of confidence under currency-board regimes: either to defend the monetary rule and, ultimately, the currency peg, at the expense of a deeper financial crisis, or to act as a lender of last resort and rescue the financial system by injecting liquidity over and above its net domestic asset targets. After some hesitation it started supplying liquidity to troubled banks. But this only served to accelerate the erosion of international reserves as the sale of liras on the foreign exchange market accelerated.

Within a few days the CBOT reversed its policy and – evidently after consultations with, and securing commitments from, the IMF – reinstated the currency-board rule, with a new ceiling on domestic assets. As liquidity injection was discontinued and reserves were still sufficient to meet short-term external liabilities, capital outflows stopped, but interest rates shot up, overnight rates reaching four-digit levels. At the beginning of December a new agreement was reached with the IMF, including a financial package of some $10.5 billion. The Government undertook fresh commitments, including further spending cuts and tax increases, dismantling of agricultural support policies, liberalization of key goods and services markets, financial sector restructuring and privatization. It also extended guarantees for foreign creditors, as well as for all depositors at local banks, in order to help restore confidence in the banking system.

Although reserves and interest rates were stabilized, it became increasingly clear that the programme was not viable. Inflation remained above the monthly rates of depreciation of the currency vis-à-vis the basket, leading to further appreciation of the currency. Interest rates stayed very high, at some 65 per cent on the newly issued T-bills, as lira assets continued to be viewed as highly risky, and the economy went into contraction. The last straw was a political skirmish in February 2001, at

Box 2.2 (concluded)

the time of writing this report, which triggered a massive outflow of capital, forcing the Government to abandon the currency peg and move to floating, again with the support of the Bretton Woods institutions. Within a few days the currency lost about one third of its value against the dollar and overnight rates reached four-digit figures.

The Government declared its intention of continuing to implement the stabilization programme, targeting directly the inflation rate. This would effectively mean a return to traditional stabilization policies, the success of which would depend in large part on macroeconomic tightening. The combination of fiscal tightening, interest rate hikes and the collapse of the currency could push the economy into a deep recession, in much the same way as in the Republic of Korea. However, the burden placed on the poor may become politically unacceptable, particularly since it would be coming on top of a highly unequal income distribution and falling living standards. If inflation is not rapidly reduced and growth restored with the help of exports and official aid, it may prove very difficult to persist with tight macroeconomic policies. Under such circumstances inflation may come back with greater force.

able macroeconomic outlook, they also reflected a recent strengthening of the links between equity prices in emerging markets and those in major developed countries. This was evident, for example, in increased daily correlations between emerging-market indices and the NASDAQ index (see IIF, 2001; Mathieson, Schinasi et al., 2000, box 3.3). In part, this is a response to the growing importance in emerging stock markets of firms belonging to the technology, media and telecommunications sector: from the end of 1995 to the end of 2000 the share in equity indices of such firms increased from 18 per cent to 32 per cent in Latin America, and from below 15 per cent to more than 23 per cent in Asia.[8] But the correlations are probably also due to a growing tendency amongst international investors to associate emerging-market equities as a class more closely with high-risk segments of developed-country markets.

In Asian emerging-market economies there has generally been little change in monetary conditions (see chart 2.4 for selected countries). The main exceptions were Indonesia, where conditions tightened slightly throughout 2000, and the Philippines, where they tightened in the last quarter, partly in response to political uncertainty. Several countries in the region experienced currency depreciations in 2000: these varied from minor movements (Singapore and Taiwan Province of China) to relatively large declines (15 per cent in Thailand, 24 per cent in the Philippines, and 38 per cent in Indonesia). Movements of real effective exchange rates were smaller, and the indices for the great majority of Asian emerging-market countries remain below their levels of early 1997.[9]

In Latin American emerging markets, monetary conditions were subject to greater variation. The sharp tightening in Argentina in response to its financial crisis is described in box 2.1. A number of other countries (Brazil, Chile, Colombia and Mexico) have adopted inflation targets as a major element in determining their monetary policy (JP Morgan, 2000b: 19–22.), though the definition of the target varies and, thus, the relation between the monetary stance and the current rate of inflation. In Brazil and Chile monetary conditions tended to ease during 2000, while in Colombia gradual tightening was followed by stabilization, and in Mexico short-term rates of interest were subject to substantial fluctuation (chart 2.4). In Venezuela interest rates drifted for much of the year and subsequently decreased, and in Peru the overall direction was also towards greater ease, though this movement was subject to interruptions,

Chart 2.3

EQUITY PRICE INDICES OF SELECTED EMERGING-MARKET ECONOMIES, JANUARY 1999 TO JANUARY 2001

(January 1999 = 100; local currency terms)

Source: Primark Datastream.

Chart 2.4

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, JULY 1999 TO JANUARY 2001

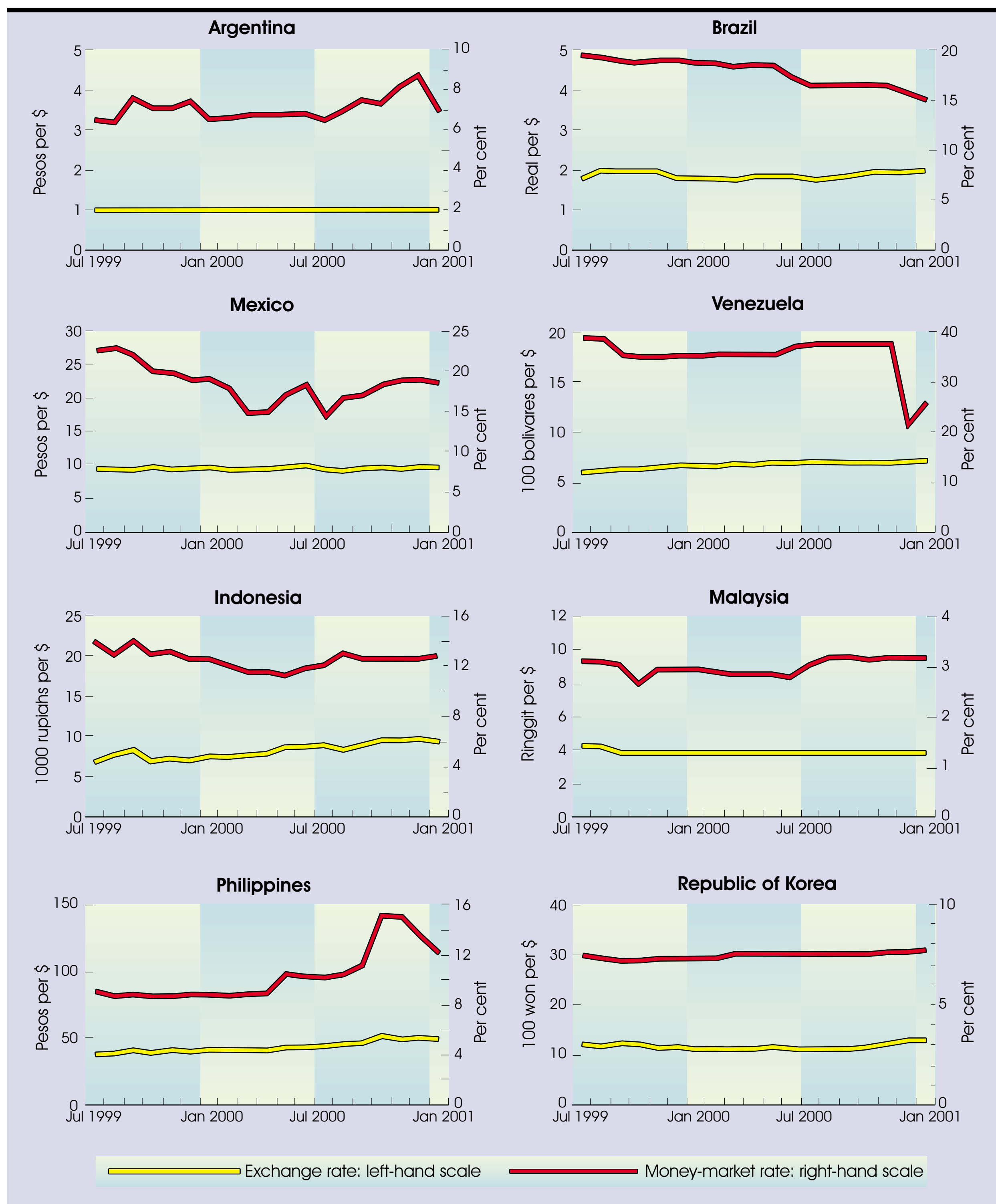

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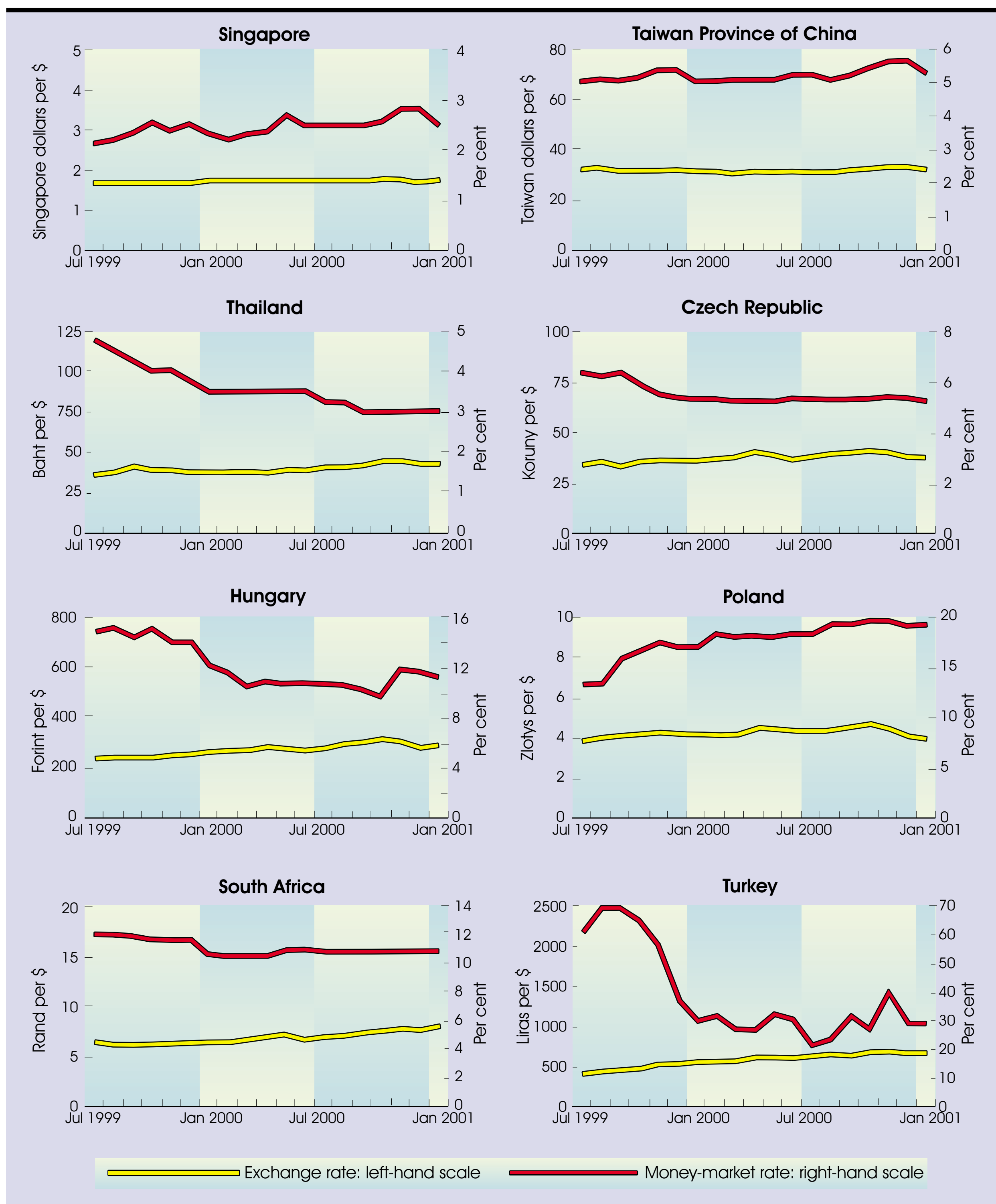
Chart 2.4 (concluded)

EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, JULY 1999 TO JANUARY 2001



Source: Primark Datastream; JP Morgan, *Global Data Watch*, various issues.

Note: Argentina, Brazil, Mexico, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China, Thailand, Czech Republic, Hungary and Poland: three-month domestic money-market rates or nearest equivalent; Venezuela: average lending middle rate; South Africa: discount three-month middle rate; Turkey: three-month Treasury bill rate.

for example, owing to political unrest in the third quarter. The spot exchange rates of Latin American emerging-market countries generally remained fairly stable, Brazil and Chile experiencing small depreciations and Colombia a larger one. Movements of real effective exchange rates were more marked, generally in the direction of appreciation. Since 1997, relative competitiveness as measured by this indicator has improved somewhat in Brazil and Peru, but declined in Argentina, Chile and Mexico.

Turkey was struck by a financial crisis in the final quarter of 2000, as creditors' confidence broke down in an exchange-rate-based stabilization programme that relied heavily on capital inflows (box 2.2). In other emerging-market economies, exchange rates and interest rates were mostly subject to only small movements (chart 2.4). The principal exception was South Africa, where the exchange rate came under attack in late 2000, a year during which the rand depreciated more than 20 per cent. In Hungary, monetary conditions tightened late in 2000, and in Poland monetary policy loosened at the end of the year after earlier tightening, while conditions changed little in the Czech Republic. The currencies of the three latter countries depreciated slightly during part of the year but strengthened subsequently. Their real effective exchange rates appreciated, with the rise for Poland being more than 10 per cent. The longer-term movements have also tended towards appreciation since 1997, though for Hungary the change has been minimal.

E. Private capital flows to emerging-market economies

The uncertainty surrounding the forecasts in early 2000 of private capital flows to emerging markets proved to be justified: during the second part of the year there were substantial downward revisions of both provisional estimates of such financing and of new forecasts. Provisional figures for 2000 still point either to little change or to a fall from 1999 levels. The outlook for 2001 is again highly uncertain, owing partly to the difficulty in forecasting the impact on financial flows of slowing economic growth in major industrial countries, particularly the United States (see chapter I, section A), and partly to the awareness that links and fault lines in the new global network of financial markets are not fully understood and thus hard to identify in advance.

1. Developments in 2000

Of the two sets of estimates in table 2.6, one shows a small rise in net private external financing for developing and transition economies and the other a sharp decline.[10] Since both series are provisional, they may yet be substantially revised. Nonetheless, they are indicative of the continuing shortfall of such financing in comparison with the levels achieved in 1996–1997. The totals reflect considerable regional divergences. The IMF estimates show substantial declines for Asia, the Middle East and Europe, a slight recovery for Latin America, and little change for Africa. If allowance is made for the effect of outflows due to

Table 2.6

NET CAPITAL FLOWS TO DEVELOPING AND TRANSITION ECONOMIES, 1997–2000: ESTIMATES OF THE INSTITUTE FOR INTERNATIONAL FINANCE AND THE IMF

(Billions of dollars)

Type of flow/region	*1997*	*1998*	*1999*	*2000*
	Estimates of the Institute for International Finance			
Net private capital inflows				
Total	269	139	148	154
by category:				
Private creditors				
Commercial banks	44	-54	-43	-16
Non-bank private creditors	84	59	28	20
Equity investment				
Direct equity	116	119	146	128
Portfolio equity	25	15	18	22
by region:				
Africa/Middle East	15	6	10	7
Asia/Pacific	73	-1	31	49
Europe	74	56	36	30
Latin America	107	99	71	68
Memo item:				
Resident lending/other, net[a]				
Total	-197	-147	-125	-127
Africa/Middle East	-4	1	-5	-6
Asia/Pacific	-105	-73	-60	-73
Europe	-56	-26	-25	-27
Latin America	-33	-49	-36	-20
	Estimates of the International Monetary Fund			
Net private capital inflows				
Total	115	66	67	36
Net direct investment	141	152	155	142
Net portfolio investment	39	0	5	17
Other net flows[b]	-66	-86	-92	-123
Africa	12	7	10	9
Net direct investment	8	7	9	8
Net portfolio investment	7	7	9	5
Other net flows[b]	-3	-6	-7	-4
Asia	7	-41	2	-18
Net direct investment	55	60	54	48
Net portfolio investment	8	-15	4	5
Other net flows[b]	-57	-85	-56	-71
Middle East and Europe	23	10	1	-18
Net direct investment	7	8	5	8
Net portfolio investment	-6	-17	-10	-7
Other net flows[b]	21	19	6	-20
Western hemisphere	68	62	40	48
Net direct investment	53	57	65	57
Net portfolio investment	19	20	9	6
Other net flows[b]	-5	-15	-34	-15
Transition economies	6	28	13	16
New direct investment	17	20	21	22
Net portfolio investment	11	6	-7	8
Other net flows[b]	-22	2	0	-14

Source: IIF (2001); IMF (2000a).

a For explanation of this term, see note 10.

b Other net flows comprises other long-term net investment flows, including official and private borrowing.

Table 2.7

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING[a] AREA VIS-À-VIS DEVELOPING AND TRANSITION ECONOMIES, 1997–2000

	1997	1998	1999	2000[b]	Stock (end-June 2000)
	Percentage rates of increase[c]				$ billion
Total[d]	**8.6**	**-7.7**	**-8.5**	**0.4**	**884**
of which in:					
Latin America	11.3	-2.8	-5.6	2.7	288
Africa	19.6	0.3	0.8	-0.9	43
West Asia	16.5	18.0	1.4	-0.2	78
East and South Asia	1.1	-21.7	-17.1	-1.5	305
Central Asia	35.5	17.6	26.9	-2.1	3
Eastern Europe	19.4	-0.4	-1.5	-4.4	95
Other Europe[e]	27.1	9.4	15.6	11.1	54
All borrowers[f]	15.4	3.0	2.5	5.8	10252

Source: BIS, *International Banking and Financial Market Developments*, various issues.
a Including certain offshore branches of United States banks.
b First two quarters.
c Based on data for the end of the period after adjustment for movements of exchange rates.
d Excluding offshore banking centres, i.e. in Latin America: Bahamas, Barbados, Bermuda, Cayman Islands, Netherlands Antilles, and Panama; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in South-East Asia: Hong Kong (China), Singapore and Vanuatu, but including residual amounts which could not be attributed to countries.
e Malta, Bosnia and Herzegovina, Croatia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia.
f Including multilateral institutions.

net lending by residents and selected other adjustments to the estimated net private flows, the regional pattern for 2000 displayed by the IIF figures is not dissimilar, with some recovery in Latin America, little change in Africa, a decline in Europe and continuing net outflows for Asia.

A major factor in the decline in net private financial flows to developing and transition economies since 1997 has been the contraction of bank lending. Since 1998, repayments to banks have tended to exceed new loans, and the total exposure of BIS-reporting banks to these economies has decreased by more than $150 billion since 1997 (table 2.7). The contraction in lending of BIS-reporting banks slowed in the first two quarters of 2000. It reflected primarily developments in East and South Asia, net repayments by which were responsible for a larger part of the decline in net total lending to developing and transition economies in 1999.

Elsewhere, experience in the first half of 2000 was varied. The decrease in banks' exposure to Eastern Europe was strongly influenced by the figure for the Russian Federation. In Latin America, much of the rise was due to lending to Mexico, much of which was associated with the financing of Spanish banks' purchases of Mexican financial firms (BIS, 2000a: 19). The growth in BIS-reporting banks' claims on Africa was relatively little affected by the financial crises of the 1990s. Although exposure to certain countries such as Egypt, Morocco and Tunisia has increased significantly in recent years, the total borrowing of the region nonetheless remains relatively small.

Table 2.8

INTERNATIONAL ISSUANCE OF DEBT SECURITIES[a] BY DEVELOPING AND TRANSITION ECONOMIES,[b] 1997–2000

(Billions of dollars)

	Gross issues[c]				*Net issues*			
	1997	*1998*	*1999*	*2000[d]*	*1997*	*1998*	*1999*	*2000[d]*
Total	**123.6**	**78.3**	**79.2**	**69.8**	**82.1**	**37.4**	**34.1**	**30.8**
of which in:								
Latin America	64.0	43.0	48.0	39.9	41.1	22.5	26.4	21.8
East and South Asia	39.8	10.8	16.7	15.2	25.4	-0.7	-1.1	1.9
Europe	11.4	20.4	10.3	11.1	11.1	15.1	6.5	4.7
Memo item:								
World	1508.6	1657.2	2305.0	993.0	560.4	681.1	1215.4	797.7

Source: UNCTAD secretariat calculations, based on BIS, *International Banking and Financial Market Developments*, various issues.

a International money market instruments and international bonds and notes, classified by residence of issuer.

b Other than offshore financial centres.

c Gross issues include gross issuance of money market instruments and announced issues of international bonds and notes.

d First three quarters.

Recent financial crises have been followed by a lengthening of the maturity profile of outstanding bank loans to the countries affected. Thus, in Indonesia, Malaysia, Philippines, the Republic of Korea and Thailand, the proportion of bank claims with a residual maturity of one year or less fell from over 65 per cent in late 1993 to about 50 per cent by the end of 1998.[11] Since then, movements have been less marked, though there has been a continuing decline in the proportion of loans with short maturities for the Philippines and a rise for the Republic of Korea (where much of the upturn was due to maturing longer-term debt rather than new short-term borrowing). In the Russian Federation, loans with a residual maturity of up to one year declined (partly as a result of restructuring exercises), from 46 per cent in mid-1998 to 26 per cent in mid-2000, and in Brazil they fell from 63 per cent to 54 per cent during the same period. Elsewhere the degree of concentration of bank debt at short-term maturities has varied among countries and regions, the share of such maturities for African and West Asian countries, for example, being about 55 per cent and that for Eastern European countries only 40 per cent.

Latin American borrowers were once again the most important issuers of international bonds and other debt securities, accounting for more than 50 per cent of total net issues in the first three quarters of 2000 (table 2.8). During the year a number of such borrowers also exchanged Brady bonds for Eurobonds at lower interest rates and longer maturities.[12] Preliminary figures indicate a decrease in issuance in the fourth quarter of 2000 (which reflects, inter alia, the absence from the market of Argentina and Turkey, substantial issuers earlier in the year), and a recovery early in 2001 (as in 2000, driven mainly by Latin American borrowers). Outstanding issues of debt securities by developing countries remain heavily concentrated among a restricted group of borrowers and amount to less than half of BIS-reporting banks' exposure to them (a figure similar in magnitude

to that of outstanding bank loans with a residual maturity of up to one year).

The spreads on the international bonds of emerging-market economies (chart 2.5) were subject to considerable country-by-country variation until October, when there were widespread increases with the advent of more unsettled conditions in financial markets, the rises being most marked for Argentina, Brazil, the Philippines and Turkey. Spreads then stabilized or fell slightly towards the end of the year, probably partly in response to the packages of international financial support put together for Argentina and Turkey.

After a period of relative buoyancy in the aftermath of the financial crises of the late 1990s, net flows of foreign direct investment (FDI) to developing and transition economies decreased in 2000. But much of the contraction was accounted for by a limited number of recipients; for some Asian countries the rise in FDI which followed the region's financial crisis may have largely run its course, and the figures for the Republic of Korea were reduced by an increase in outward FDI; as regards Argentina, the figure fell back from a level boosted in the previous year by the proceeds of a single privatization project (the petroleum conglomerate, YPF; *TDR 2000*, chap. III, sect. E.1). Flows of FDI to Brazil continued to remain high, preliminary estimates being of a magnitude similar to the country's deficit on current account.

Capital flows to developing and transition economies in the form of private equity can take two forms: international equity issues and foreign investment in local equity markets. Sums raised in the first form amounted to more than $32 billion in the first three quarters of 2000, a little more than 50 per cent of the figure being due to issuers in East and South Asia (BIS, 2000a, table 18). Separate figures for foreign investment in local equity markets in 2000 are not yet available, but provisional estimates of the IIF for all forms of foreign portfolio equity investment fall well short of that given above for international issues for the first three quarters only, pointing to the probability of substantial net foreign disinvestment in local equity markets. Much of the disinvestment is likely to have taken place in the second half of the year in response to the widespread price falls described in the preceding section. Indeed, a two-way connection between such falls and foreign disinvestment was probably at work here, each giving additional impetus to the other.

2. Outlook

The outlook for private financial flows to developing and transition economies remains uncertain. One view emphasizes that emerging-market economies as a group are now less susceptible to financial shocks owing to such features as lower dependence on short-term bank debt and more flexible exchange rate regimes. But as the experience of Argentina and Turkey during the past year has shown, reduced vulnerability for the group does not necessarily imply that individual countries are innoculated against the outbreak of serious balance-of-payments problems. Moreover, the access of emerging-market economies to private external financing remains linked, through various channels, to global conditions. Some of these channels involve traditional connections between their access to financing and prospects for global economic growth, trade, as well as for the terms of trade.[13] Others involve a prominent role for impulses between different financial markets which are generally very difficult to forecast: these include contagion effects between emerging markets themselves as well as destabilizing influences transmitted from markets in the North to those in the South.

Relations between markets in developed and transition economies, on the one hand, and in industrial countries, on the other, are subject to change as a result of various processes associated with greater financial integration. In the preceding section reference was made to recent strengthening of the links between equity markets in emerging-market economies and developed countries. Other changes have been in the direction of greater decoupling. For example, during the first half of 2000 the trend in spreads on the debt of developing countries was downwards at a time when spreads of high-yield debt of developed-country borrowers denominated in dollars and euros were moving upwards (BIS, 2000b: 5–6; IIF, 2001: 9). Moreover, the heightened volatility of

Chart 2.5

YIELD SPREAD[a] OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKET BONDS, JULY 1999 TO JANUARY 2001

(Basis points[b])

Source: Primark Datastream.

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

b One basis point equals 0.01 per cent.

the NASDAQ index during 2000 was accompanied by a weakening of its link with the yield on the debt of emerging market economies.[14] Nevertheless, major turbulence in the financial markets of developed countries may continue to have important spillover effects in emerging markets. And recent experience indicates that owing to new methods of risk management, such as techniques of cross-border hedging, some of the fault lines associated with these effects are difficult to identify in advance.[15] Thus, financial flows to developing and transition economies are now subject not only to traditional supply-driven influences originating in industrial countries, such as those due to shifts in monetary policy and in the risk aversion of investors and lenders, but also to the impact of portfolio management decisions of international financial firms which may have little connection to the fundamentals of the countries whose markets are affected.

F. External financing and debt of the least developed countries

The LDCs are the major "pocket of poverty" in the world economy. As domestic savings in these countries are insufficient to attain a faster pace of growth, they continue to depend on external finance, and especially on official capital flows, for the financing of their development. But aggregate net capital inflows fell in the 1990s, in real as well as in nominal terms and in relation to the recipient countries GDP (table 2.9).

Given their weak economic fundamentals and high-risk profiles, most LDCs have practically no direct access to international capital markets. While for developing countries as a group, private flows other than FDI represented almost half of the net aggregate capital inflow in the 1990s, and about 2.3 per cent of their GDP, such private inflows into LDCs were negligible over much of the past decade and were even negative in 1998 and 1999. Flows of FDI to LDCs are also relatively small, but in relation to GDP they have been almost as important for LDCs as a group as for other developing countries. However, FDI in LDCs has been mainly in mineral extraction rather than in manufacturing, and has essentially been concentrated on a few countries that are rich in oil, gas and other natural resources.

Official capital continues to be the predominant source of external financing of the LDCs; for more than a decade, the share of official flows in their long-term inflows has remained at around 88 per cent, whereas in other developing countries this share had steadily declined to around 20 per cent by the end of the 1990s (*TDR 1999*, table 5.1, and UNCTAD, 2000b: 56).

During the 1990s, official capital flows to all developing countries declined considerably in both nominal and real terms,[16] and despite the rhetoric about poverty alleviation, ODA grants and bilateral credits to LDCs, where the incidence of poverty is the highest, have also fallen. Indeed, unlike other aid recipients, the LDCs did not benefit from the partial recovery in nominal official flows during 1998–1999. As a share of donor GNP, aggregate official flows from the members of the OECD's Development Assistance Committee (DAC) to the LDCs amounted to only 0.05 per cent from 1997 through 1999 – far short of the target ratio of 0.15 per cent set at the Second United Nations Conference on the Least Developed Countries in 1990. It is also only half of what it was at the beginning of the 1990s, in spite of the commitments by donors to increase aid to the

LDCs. Among the members of DAC, only five countries met the 0.15 per cent target in 1999: Denmark (0.32 per cent), Luxembourg (0.16 per cent), the Netherlands (0.16 per cent), Norway (0.30 per cent) and Sweden (0.17 per cent) (OECD, 2000b, table 31).

Apart from insufficient inflows of capital, especially in the form of long-term credit and grants, the majority of LDCs continue to be burdened with a serious debt overhang. In 1999, outstanding external debt of the LDCs as a share of their aggregate GDP amounted to 89 per cent, and the average ratio of debt service paid (as opposed to scheduled payments) to exports was 15 per cent. A number of countries continued to be unable to meet their obligations in full, accumulating further arrears on scheduled payments.

Given their debt overhang, there is an urgent need to reduce the debt burden of LDCs. Among the 41 countries identified as heavily indebted poor countries (HIPCs), 31 are LDCs. By the end of 2000, a total of 22 countries, 17 of which are African LDCs, had reached the "decision point" under the HIPC Initiative, and are due to start receiving interim debt relief from multilateral creditors as well as enhanced relief from Paris Club creditors. So far, Uganda is the only LDC to have reached the "completion point" under the Initiative, whereby it is entitled to enjoy the full benefits provided by the Initiative. Meanwhile, an additional 11 LDCs, most of which are affected by conflicts, have a debt burden that is regarded as unsustainable according to HIPC criteria, even after the application of traditional relief mechanisms. However, under current procedures it may take several years before these countries are able to fulfil the conditions required to reach the decision point. Moreover, there are several debt-stressed LDCs which are not defined as HIPCs (UNCTAD, 1999, box 3).

Current expectations regarding the economic impact of the HIPC Initiative on countries which have reached decision point are unrealistic. First, the additional fiscal space which is opened up by the Initiative is not particularly large. While the magnitude of debt relief appears significant in terms of a reduction in the present value of future debt service obligations, the annual savings on debt service provided through HIPC assistance per se up to 2005 are modest for most countries that have reached decision point. Secondly, the medium-term forecasts of a durable exit from the debt problem assume high rates of economic and export growth, sustained over a long period, often over and above the rates achieved in the 1990s, as well as declining import intensity of growth. Thirdly, there is a risk that the financial resources freed by the debt relief will not be fully additional. For 14 of the 17 African LDCs which have reached decision point, official flows fell considerably between 1996 and 1999. This suggests that, with the provision of HIPC assistance, there may be a general reduction in such flows unless there is a change in official attitudes; throughout the 1990s official capital flows to LDCs were closely related

Table 2.9

CAPITAL INFLOW OF LDCs BY TYPE OF FLOW, AND NET TRANSFER, 1990–1999

(Percentage of GNP)

Type of flow	*1990–1997*	*1998*	*1999*
Total net inflow	10.5	7.7	7.5
Official inflows	9.2	6.4	6.0
ODA grants [a]	6.5	4.8	4.7
Official credit	2.7	1.6	1.4
Bilateral	0.3	-0.1	-0.4
Multilateral	2.4	1.7	1.7
Private inflows	1.3	1.3	1.5
Foreign direct investment	1.1	1.5	1.6
Other	0.2	-0.2	-0.1
Interest payments	0.9	0.8	0.8
Profit remittances	0.6	0.5	0.6
Net transfer [b]	9.0	6.4	6.1

Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance, 2001,* preliminary version (CD-ROM).

a This item corresponds to "Grants" as defined by the World Bank in the source and excludes funds allocated through technical cooperation.

b Net capital inflow less interest payments on external debt and profit remittances.

to their indebtedness and levels of debt service payments (UNCTAD, 2000b: 123–6).

Furthermore, the HIPC process has become even more complicated with the explicit linking of debt relief to poverty alleviation, through Poverty Reduction Strategy Papers. As has recently been suggested by the Dutch Minister for Development Cooperation, if the successful implementation of these wide-ranging poverty reduction strategies requires broader and faster debt relief, then development partners will have to be prepared to provide additional financing.[17]

An important and welcome development in 2000 was the commitment by an increasing number of creditor countries, in the context of the HIPC Initiative, to grant full cancellation of bilateral debt. However, the commitment does not involve a rapid or across-the-board cancellation for all LDCs, and implementation will depend on their progress in economic policy reforms and poverty reduction. Country coverage, timing of relief, and the coverage of debts (including post-cut-off-date debt) can also be expected to vary among creditors.

The underlying economic problems of LDCs are manifold, so that debt write-off alone will be insufficient to set them on a path of sustainable development. A solution to their debt problem is nonetheless a necessary condition, and the special situation of LDCs requires an assessment of their needs for debt relief quite independently of HIPC considerations. Given that debt forgiveness cannot be expected to be forthcoming swiftly, interim arrangements should be considered to allow for immediate alleviation of their acute debt burden. To that end, and pending the full implementation of the HIPC Initiative, an immediate suspension of the debt-service payments of all LDCs, without any additional interest obligations, should be considered. In this way, rather than having to divert scarce resources to service debt, governments would be able to use them to finance badly needed social expenditure programmes and productive investments. For the same reason, it is also necessary to reverse the declining trend of official financing. In the absence of adequate private capital inflows, a greater injection of official external finance is indispensable for kick-starting the capital accumulation process in LDCs.[18] ■

Notes

1 It is not easy to fully account for serious discrepancies, in magnitude and even in direction in some cases, in time series for trade published by WTO, IMF and UN/DESA.

2 For some of the reasons underlying the discrepancy between world exports and imports, see *TDR 2000* (chap. III, note 1).

3 For a detailed discussion on the role of intra-Asian trade in the recovery of the East Asian economies, see *TDR 2000* (chap. III).

4 The United States deficit on trade in goods and services in 2000 is estimated by IMF to be in the order of $360 billion, and the current-account balance in the order of $420 billion (4.2 per cent of GDP). JP Morgan estimates it to be as high as $439 billion (4.4 per cent of GDP). See IMF (2000a, table I.2 and appendix tables 27 to 29) and JP Morgan (2000a).

5 Average spot price of the basket of seven crude oils produced by members of OPEC.

6 The marginal cost of production in the highest-cost areas of non-OPEC countries ranges from $10 to $15 per barrel. Consequently, an oil price of not much higher than $15 per barrel should, in principle, provide oil companies with sufficient incentives to operate in these high-cost areas. However, unlike other commodities, oil is a strategic resource

and its price is also influenced by speculative factors. For a more detailed discussion of the factors shaping the world oil market in recent years, see *TDR 1999* (Part One, chap. III, sect. E).

7 For a discussion of recent debate on different regimes for the exchange rate, see Part Two, chap. V.

8 See IIF (2001: 11). The technology, media and telecommunications sector has accounted for an even higher share of recent international equity issuance by emerging-market economies: 57 per cent in 1999 and 77 per cent in the first half of 2000. See Mathieson, Schinasi et al. (2000, box 3.5).

9 The real effective changes cited here are the estimates of JP Morgan available at www.jpmorgan.com.

10 Differences among institutions in estimates of private financial flows to developing and transition economies reflect mainly differences in coverage and in methods of estimation. The estimates of IMF cover the great majority of its member countries. They are on a balance-of-payments basis and, thus, net of outflows by residents. The IIF covers a sample of 29 "emerging-market economies", and its estimates of net private flows are before adjustments for net lending by residents, changes in monetary gold, and errors and omissions in the balance of payments, which typically represent a substantial proportion of its figures for net private flows. The IIF estimates of January 2001 reflect a substantial downward adjustment in comparison with those of September 2000, which projected a figure of $188 billion for net private flows for the year as a whole, with an offsetting item of $127 billion for "resident lending/other".

11 The data on the residual maturity of BIS-reporting banks' exposure to countries have been taken from various BIS press releases on BIS-consolidated international banking statistics.

12 Exchanges of Brady for new bonds are partly the reason for the substantial divergence between gross and net issues of international bonds reported in table 2.8. The incentives for such exchanges typically include: gaining access to collateral in the form of United States Treasury instruments backing the Brady bonds; reduction of the country's debt stock in cases where the Brady bonds are exchanged at a discount; and extension of the yield curve for the country's internationally issued debt instruments to the extent that the new bonds carry long maturities.

13 For a discussion of the various channels of transmission between developments in the global economy and capital flows, see JP Morgan (2000c: 7–8).

14 For a discussion of correlations between the yield on emerging-market debt and the NASDAQ index, see Mathieson, Schinasi et al. (2000, chap. III, box 3.3).

15 For further discussion of evidence concerning the effects of these methods, see Cornford (2000a: 3).

16 For a more detailed analysis of the long-term patterns of external financing in the developing countries, see *TDR 1999* (Part Two); and for a discussion of external financing in Africa, where most LDCs are located, see UNCTAD (2000c).

17 E. Herfkens, "Bringing Solidarity to Brussels", speech given at UNCTAD Trade and Development Board, Geneva, 27 February 2001.

18 For a more detailed discussion, see *TDR 1998* (Part Two), and UNCTAD (2000c).