GLOBAL TRENDS AND PROSPECTS

Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Global outlook

Prospects for the world economy dimmed towards the end of 2000. After an unprecedented period of expansion, growth in the United States decelerated sharply in the third and fourth quarters of the year in response, inter alia, to a series of interest rate hikes, falling equity prices and rising oil prices. Lower investment spending in the last quarter snuffed out growth altogether at the beginning of 2001, raising concerns that a harder landing than expected might send recessionary shockwaves throughout the world economy. The fact that the slowdown, with its potential consequences, has caught many observers by surprise is a further confirmation that policy makers everywhere are ill-prepared to cope with the changes brought about by the increasing integration of the world economy.[1]

As a result of growing global interdependence both real and financial shocks are transmitted much more rapidly across regions, countries and sectors. At the same time, given the intertwining of the real and financial sides of the economy, such shocks have unexpected consequences. The Asian financial crisis was initially expected to plunge the global economy into recession; instead, it provided a stimulus to the United States economy, prolonging growth there, which in turn supported a rapid recovery in Asia through higher exports (*TDR 1999* and *TDR 2000*). On the other hand, the adverse impact of the Asian crisis on commodity and petroleum prices, which helped keep prices in the United States under control, created balance-of-payments and fiscal difficulties for a number of developing countries. These eventually produced another series of financial shocks, ignited by bond default in the Russian Federation, which triggered a global rush for liquidity that threatened even United States financial markets during the late summer of 1998. The reduction in United States interest rates in response to that threat, followed by substantial injections of liquidity to counter the Y2K computer problem and to support the introduction of the euro, steadied confidence, particularly in the United States, and brought about a global recovery of growth in 1999 and at the beginning of 2000.

However, the global recovery also aggravated domestic and global imbalances in a manner similar to that of previous major cyclical disruptions and periods of financial instability. As was suggested in *TDR 2000*, an end to the expansion in the United States economy was unavoidable and imminent. Monetary tightening by the Federal Reserve, which began in mid-1999 and had pushed interest rates to 6.5 per cent by May 2000, took longer than expected to affect business and household expenditures, but the squeeze was clearly visible in the last quarter of the year. The current slowdown is expected to reduce the burgeoning current-account deficit, which stands at over 4 per cent of GDP, thereby helping to correct a major global imbalance, but without faster growth elsewhere it will lead to a significant decline in global demand.

Unlike the Asian crisis, the United States downturn is not expected to generate significant expansionary impulses elsewhere in the world economy.

A broad body of opinion expects the slowdown to be brief, although more pronounced than had earlier been predicted; once equity prices, excess capacity and inventories return to normal levels, the economy is expected to see robust growth consistent with the spread and further development of new telecommunications and information technologies. On this view, therefore, global growth should be little affected by what, at worst, would amount to a short recession, followed by recovery in the second half of 2001.

However, the current United States slowdown cannot be described simply in terms of previous experience, when booms were ended by a combination of monetary tightening in response to wage and price pressures and fiscal tightening to reign in public debt. Critics of the view that the introduction of new telecommunications and information technology has produced a structural change in the productive potential of the economy and in its cyclical behaviour point to the large increase in debt and the reduction in savings ratios that have been incurred by households and the business sector in the presence of large fiscal surpluses (Godley, 2000). If the private sector were to attempt to repay its excessive debt and restore its savings rates to historical levels, the shortfall in demand could produce a prolonged recession, since it would far exceed any fiscal stimulus that could be expected from planned tax cuts.[2] In this scenario, no region of the world could expect to escape the effects of a United States downturn.

The crucial question is consequently whether a new locomotive of global growth will emerge to compensate for the at least temporary abandonment of this role by the United States. Unlike the Asian crisis, this downturn is not expected to generate significant expansionary impulses elsewhere in the world economy. Japan's nascent expansion, based on rising net exports and higher corporate profits leading to a recovery in investment, is vulnerable to a slowdown in the United States. Moreover, output growth was already negative in the third quarter of 2000, after a strong performance in the first half. In addition, with interest rates close to zero and a large public-sector deficit, there appears to be little room for a policy stimulus without the help of a major adjustment in exchange rates. Most analysts are looking instead to the EU to help sustain global growth and offset declining import demand in the United States.

Growth in EU last year broke through the 3 per cent barrier for the first time in over a decade (table 1.1), and there is confidence that it will outperform the United States in 2001, given that exports to that country amount to less than 3 per cent of regional output. However, despite the fact that the EU countries have successfully reduced their budget deficits, have kept their current accounts in balance and are showing little sign of inflationary pressures, last year's growth recovery continued to rely on net exports, accounting for as much as half of the increase in output, even in larger economies such as Germany. As net exports are expected to make a smaller contribution in 2001, a sustained expansion in private domestic demand will be needed to meet even the modest growth ambitions expressed at the Lisbon summit. Perhaps not surprisingly, and despite the moderate stimulus that has resulted from structural reforms in the fiscal regimes in a number of countries, there has as yet been no policy commitment to the kind of domestic demand-led growth enjoyed by the United States in recent

Table 1.1

WORLD OUTPUT, 1990–2000

(Percentage change over previous year)

Region/country	*1990–1995[a]*	*1995–2000[a]*	*1990–2000[a]*	*1998*	*1999*	*2000[b]*
World	2.0	3.1	2.6	1.9	2.7	4.0
Developed market-economy countries	1.8	2.9	2.3	2.1	2.6	3.5
of which:						
United States	2.4	4.3	3.4	4.4	4.2	5.1
Japan	1.4	1.1	1.3	-2.5	0.2	1.3
European Union	1.5	2.5	2.0	2.7	2.4	3.3
of which:						
Euro area	1.6	2.4	2.0	2.8	2.4	3.4
Germany	2.0	1.8	1.9	2.1	1.6	3.1
France	1.0	2.4	1.7	3.2	2.9	3.1
Italy	1.3	1.7	1.5	1.5	1.4	2.9
United Kingdom	1.6	2.8	2.2	2.6	2.2	3.1
Transition economies	-6.9	1.9	-2.6	-0.6	2.3	5.6
Developing economies	5.0	4.3	4.6	1.5	3.3	5.5
of which:						
Africa	1.5	3.6	2.5	3.2	2.9	3.5
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
Asia	6.2	5.0	5.6	1.1	4.9	6.6
of which:						
China	12.0	8.3	10.1	7.8	7.1	8.0
Other economies	4.9	4.1	4.5	-0.8	4.2	6.2
Memo item:						
Developing economies, excluding China	4.1	3.7	3.9	0.5	2.7	5.1

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.
a Annual average.
b Estimates.

years. Indeed, even as overall macroeconomic conditions suggest that Europe should at last be ready to test the limits of its potential growth rate – as the United States did in the second half of the 1990s – the European Central Bank (ECB) sees no signs that the euro zone's non-inflationary growth potential has risen above its current estimates of 2.0–2.5 per cent,[3] implying that it also sees no immediate scope for relaxing monetary policy.

This reluctance to make a more concerted policy move to bolster recent performance is a matter of concern, since Europe will, in all likelihood, be more affected by the slowdown in the United States than official views, based on the limited trade ties to the United States, suggest. Euro-zone exports to the rest of the world still account for more than 15 per cent of the area's output, which is considerably higher than for either the United States or Japan, and the reliance on exports over the past year of some of the larger European countries suggests that they could still be hit quite hard by a global slowdown. Furthermore, the integration of global production means that corporate profitability and investment plans can be quickly disrupted by changes in a country which plays host to a large number of foreign affiliates. This is particularly true for European high-tech firms that have made very large acquisitions in the United States in recent years. Knock-on difficulties in European equity markets created by reduced corporate earnings in United States affiliates could be further aggravated by a lower dollar, making it even more difficult for these countries to offset the decline in their exports to the United States through higher domestic investment expenditures.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth.

Consequently, without a determined change in economic policy, growth in the EU is unlikely to reach 3 per cent in the current year, and it may be much lower. Moreover, given the current propensity to import, its growth rate would have to be higher than that achieved in the United States in recent years if it is to generate an external deficit similar in size to that of the United States and act as a global buyer of last resort for the recovering economies of Asia and Latin America.

An orderly transition to a world where the leading economies all pull in the same direction is further complicated by the uncertainty surrounding exchange rate adjustments to current imbalances. The recent strength of the dollar has been due to relatively high United States growth and profit levels, the large inflows of capital seeking to join the information and communication technology (ICT) revolution, positive interest rate differentials and the high liquidity premium attached to dollar assets in the aftermath of the global liquidity crisis that followed the Russian default in 1998. If the United States economy were to slow down sufficiently to induce the Federal Reserve to further relax monetary policy, this would eliminate two factors that underpin the dollar's strength. Moreover, the large-scale acquisition of United States companies during the period of boom in high-tech stocks[4] appears to be running out of steam, as European firms move to consolidate existing operations rather than expand into what is an increasingly uncertain market.[5] However, the likely impact on the dollar is not clearcut since not all merger and acquisition (M&A) activity is financed by cash payments requiring the sale of currency for dollars.[6]

In any event, with widespread expectations of slower growth, falling interest rates and lower profitability of high-tech companies in the United States, the liquidity premium on United States assets remains the major support for the dollar. Recent experience teaches that this is not a reliable foundation. The way global imbalances are corrected and, in particular, the behaviour of the United States current-account deficit, may be crucial in determining whether slower inflows into dollar assets leads to a major weakening of the currency and widespread disruption in global financial markets.

While a sharp depreciation of the dollar would increase global financial fragility, a measured decline from its recent highs would be beneficial to global growth. The benefits to European growth of a stronger euro, which would allow interest rates to fall, are likely to outweigh the disadvantages of reduced competitiveness and earnings of European companies with affiliates operating in the United States. In addition, a stronger euro would further reduce the dependence of growth on external demand and encourage a more positive role for Europe in sustaining global growth.

The United States slowdown is likely to have a damaging impact on the developing world, particularly if it is not offset by strong growth in other OECD economies, even assuming a measured decline of the dollar. However, the impact on individual countries and regions will depend on the relative importance of their trade and financial linkages with the United States. In Asia, where rising net exports have financed a post-crisis expansion, a weaker dollar, coupled with a sharp United States downturn, will quickly reduce current-account surpluses and could threaten bank and corporate restructuring.[7] Linkages to United States firms are particularly strong in high-tech sectors, such as semiconductors and personal computers, where declining sales and difficulties in financing production translates directly into lower component imports from Asia. While a substantial depreciation of the dollar would help exports of countries such as China and Malaysia with pegs to that currency, it could create difficulties for the stability of regional exchange rates. It might also trigger currency depreciations across the region, which, together with the fall in semiconductor prices, could result in terms of trade losses and declining demand in countries affected. Japan's recovery would not be helped either by a weaker dollar or by a depreciation of Asian currencies. On the other hand, if the Japanese economy weakens further, the yen/dollar exchange rate might come under pressure. This could lead to similar pressures for depreciation against the dollar across East Asia rather than to a strengthening of regional currencies against the yen.

By contrast, a weaker dollar, accompanied by lower interest rates, could benefit many Latin American countries that have linked their currencies either directly or indirectly to the dollar. With the exception of Mexico and some smaller Caribbean economies, dependence on exports to the United States is lower than in Asia and financial links are more important. Brazil and, in particular, Argentina could stand to gain from a weaker dollar and lower United States interest rates through the effects on the public finances and the services account of the balance of payments. Since the major Latin American economies still have large external financing gaps, they should benefit from lower international interest rates more than they lose from declining exports. However, even in these countries, trade flows would probably decline. Furthermore, if the United States slowdown leads to an overall perception of increased risks and, hence, higher yield spreads for emerging-market borrowers, the final outcome might still involve considerable costs for the region.

B. Developed economies

1. The slowdown in the United States economy

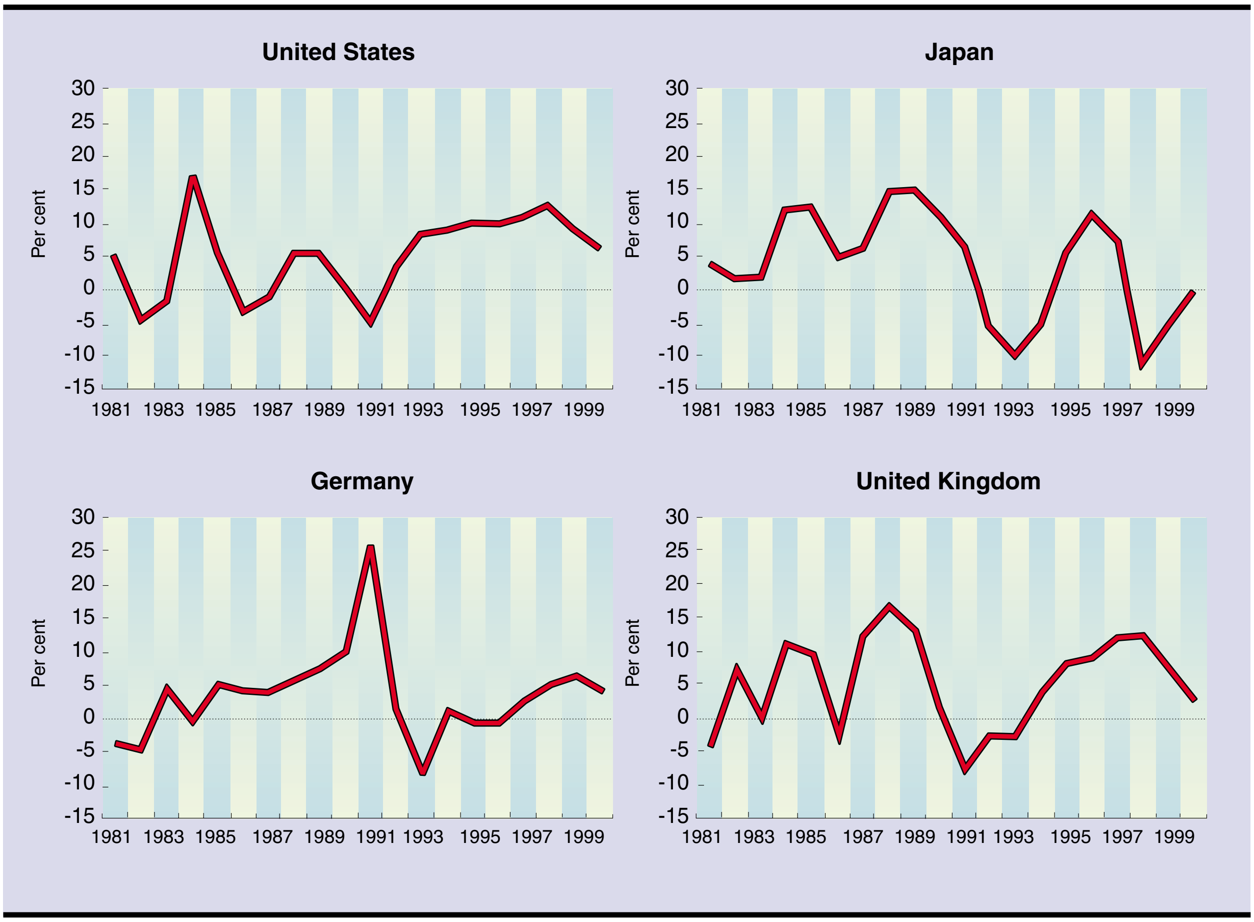
The recent expansion in the United States has been driven by domestic demand and supported by a Schumpeterian process of creative destruction that increased investments in new technologies and raised productivity performance. A series of international events kept the lid on prices, even as the economy grew at around 5 per cent and unemployment dropped below 4 per cent. Although the increase in petroleum prices in 2000 pushed the rate of increase in the consumer price index close to 4 per cent for the first three quarters of 2000, underlying price pressures remain benign.

However, with growth over the past two years exceeding most estimates, the Federal Reserve raised the Federal Funds rate in several steps to 6.5 per cent in mid-2000.[8] While the strong economic activity appeared resistant to tighter monetary conditions until mid-2000, the slowdown in the third and fourth quarters of 2000 was much more pronounced than expected and growth stalled in the first quarter of 2001, suggesting that the risk of recession is by no means negligible. With hindsight, it seems clear that the last increase in the Federal Funds rate of 50 basis points was unnecessary, as was perhaps also the previous increase from 5.75 per cent to 6 per cent, given the lagging effect of changes in monetary policy. In response to falling equity prices and sharply lower

Chart 1.1

INVESTMENT CYCLES IN MAJOR INDUSTRIAL COUNTRIES, 1981–2000

(Real gross fixed capital formation of the business sector, per cent change over previous year)



Source: OECD, *Economic Outlook*, various issues.

indicators of consumer confidence, the Federal Funds rate was reduced by 50 basis points twice during January 2001.

Two mutually reinforcing developments accounted for the faster than expected slowdown: the decline in investment spending on information technologies; and the sharp drop in consumer confidence, resulting in a slowdown in consumer spending.

One of the most striking characteristics of the United States expansion has been the sustained boom in gross domestic fixed investment which lasted much longer than in other major industrial countries and in previous investment cycles in the United States itself (chart 1.1). By the first half of 2000, gross fixed investments in the business sector had risen to over 18 per cent of GDP (chart 1.2) and business investment in equipment and software to over 10 per cent. Spending on investments in ICT has contributed to about a quarter of real GDP growth over the past six years.[9] Much of the investment was in the formation of new start-up companies which needed structures, equipment, and a full range of more traditional services such as legal support and advertising. A good deal of this new investment has been financed by venture capital funds in preparation for raising equity in these companies through initial public offerings

(IPOs). In 1999, new IPOs raised close to $60 billion, a figure matched in 2000 (most of it being raised in the first half of the year) (NVCA, 2001). Such IPOs originated from companies that had benefited from the high-tech bubble in the NASDAQ index, which produced triple-digit price-earnings ratios and extremely easy financing conditions.

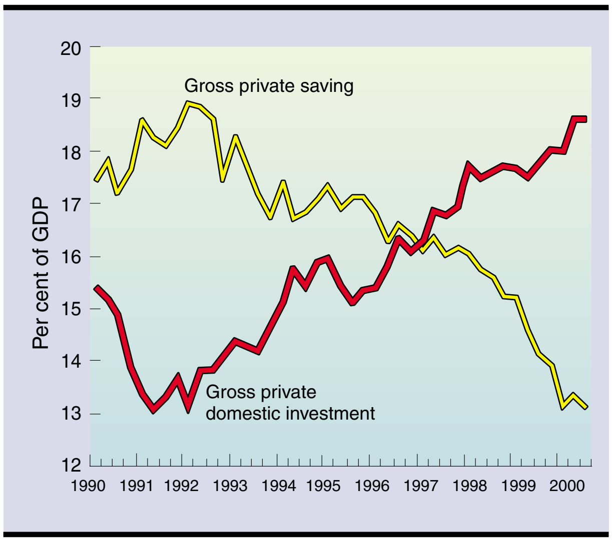
It is now clear that many of the new technology companies could never have developed without the easy financial conditions made possible by the boom in venture capital funding and the stock market bubble. It is also clear that as a result more capacity was created in the sector than if the financing had been made available under normal conditions by bank lending or retained earnings. A sharp reversal of expectations concerning the future earnings capacity of these companies led to a collapse in their share prices in the first quarter of 2000. The NASDAQ index, which contains a high proportion of ICT-based companies, finished the year down nearly 40 per cent. The resulting loss in stocks initially issued in 1999 and 2000 has been estimated at nearly $300 billion, and new issues were halted at the end of 2000 and the beginning of 2001. Thus, in the second half of 2000, the new borrowing that these companies needed to cover their negative cash flows came to an end and many had to close down or default. As a result, investment and related expenditures came to a halt; in the fourth quarter, real non-residential fixed investment in equipment and software decreased by 4.7 per cent on an annualized basis.

All this bears more than a passing resemblance to the Asian experience[10] of easy access to cheap credit and excessively optimistic expectations of higher future earnings, leading to investments that could not possibly be profitable. The Asian boom was followed by a stock market bust and recession, and a similar result appears to be in prospect for the United States. The decline in equity prices has reduced household wealth and dampened consumer spending, which already appears to have been affected by rising domestic prices for energy. In particular, the deregulation and liberalization of electricity and natural gas prices – which in some states have increased fivefold along with the return to more normal cold winter – have resulted in sharply increased heating costs for many households. The decline in consumer confidence and outlays is likely to be further reinforced as the effects of layoffs due to corporate restructuring and inventory adjustment spread throughout the economy.[11] Growth in consumer expenditure fell from an annual rate of 4.5 per cent in the third quarter to 2.9 per cent in the fourth quarter.

Chart 1.2

UNITED STATES: PRIVATE INVESTMENT AND SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

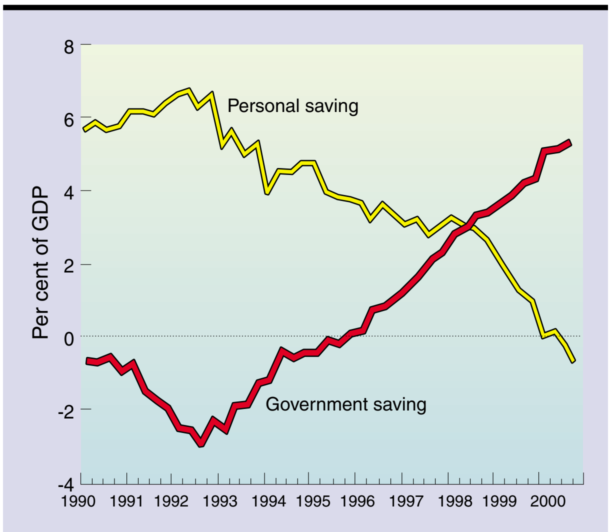
Basically two scenarios are envisaged for the United States economy: a normal cyclical downturn which will quickly bring about adjustments to productive capacity and inventories through a short deceleration in growth during two or three quarters, to be followed by a rapid recovery; or, alternatively, a sustained period of disinvestment, producing recessions similar to those in Japan or Europe in the early 1990s.

At the beginning of 2001 certain developments suggested there might be a quick recovery: petroleum prices were in the range of $20–25 a barrel, inventory accumulation appeared to have come to a halt, equity prices seemed to be stabi-

Chart 1.3

UNITED STATES: PERSONAL SAVINGS AND GOVERNMENT SAVINGS, 1990–2000

(Per cent of GDP)



Source: United States Department of Commerce, Bureau of Economic Analysis.

lizing and the trade balance had started to improve. Furthermore, the dollar had depreciated by over 10 per cent against the euro from its earlier highs, and prospects for increased dollar earnings provided support for equity prices of companies with large international operations. The Federal Reserve moved aggressively to lower rates and announced that it had changed its policy bias from fighting inflation to fighting a rapid slowdown.

Despite these positive developments the risk of a sustained recession cannot be overlooked, since the late stages of the boom were underpinned by historically large increases in private-sector indebtedness, which is the counterpart of the historically large fiscal surplus (chart 1.3). Since 1997, total private expenditure has exceeded disposable income, reversing the normal relation that has held since 1952; by the third quarter of 2000 the private-sector financing gap had reached 8 per cent of GDP, the personal savings ratio had become negative, and household debt had reached 110 per cent of annual disposable income. Thus, while the Government prepares to pay off its outstanding debts, the private sector has been accumulating record amounts of debt relative to its ability to service that debt. Just as start-up companies in the ICT sector needed to borrow to stay in business, households need to borrow in order to sustain their current rate of consumption. A decline in income growth associated with a recession would mean that households would have to increase borrowing just when their ability to meet the payments on their outstanding debt is declining.

The fact that such a long period of expansion is unprecedented should make for a cautious assessment of the current slowdown. However, if, as already noted, the investment boom does share some resemblance to that in Asia in the early 1990s, the conflicting pressures on the economy from expansionary macroeconomic and stagnationary structural impulses point to a more uncertain future than either the V-shaped cyclical downturn and recovery or sustained recession scenarios suggest (box 1.1). Moreover, although the United States economy is in a much stronger position than in the past to make appropriate fiscal and monetary adjustments to avoid a prolonged recession, it seems unlikely that the economy will return smoothly to its growth path of the past decade, and certainly not to the nearly 5 per cent growth it had reached after the Asian crisis.

2. European Union

In 2000, the European Union experienced one of its best growth performances since the 1990–1991 recession (table 1.1). Growth finally exceeded 3 per cent and unemployment dropped to below 9 per cent. The growth disparities between the larger and smaller economies that had created difficulties in formulating a uniform monetary policy also narrowed. France, Germany and Italy grew at about 3 per cent in 2000, while the Spanish economy grew by more than 4 per cent. Among the smaller economies, Ireland continued to surge ahead of the pack, achieving a remarkable 11 per cent growth rate. With investment and consumer spending leading the recovery, the euro area appeared to be emulating the kind of private-sector-led growth enjoyed by the United

States. Indeed, the growth differential of about one and three-quarter percentage points between the United States and the euro area over the last three years was reversed in the second half of 2000.

The failure of Europe to achieve a strong and sustained recovery after 1991 reflects, in part, the responsiveness of European interest rates to those of the United States because of increased integration of financial markets. Furthermore, attempts by the ECB to establish credibility resulted in rising rates in response to United States monetary tightening, regardless of whether that was consistent with European growth and employment trends. The tight fiscal policies to meet the convergence requirements for the single currency and the Stability and Growth Pact meant that the main source of demand expansion had to come from net exports. The stimulus from this source after 1999 reflected increased competitiveness created by the depreciation of the euro, which went unchecked until the third quarter of 2000 when joint intervention by G-7 central banks seemed to halt any further slide. Growth appears to have peaked in mid-2000, around the same time as in the United States. France has continued to grow vigorously on the basis of domestic demand and managed to reduce its unemployment rate, but the German economy registered an unexpectedly sharp downturn in the last quarter of 2000, and most leading indicators of economic activity point to a slowdown in the euro zone in 2001.[12] Net exports are expected to drag down growth and the important question is whether Europe can continue to build on last year's growth performance in the face of the United States slowdown.

The United States slowdown will have an impact not only through trade. Sales of German and United Kingdom affiliates in the United States were roughly five times their exports to the United States in 1998, a figure which is roughly double that for smaller European economies such as the Netherlands. Lower sales will hit profitability, which could make it more difficult to carry out the restructuring necessary to introduce the high-tech production and organizational methods required to compete with United States companies. Economic integration between these two industrial blocs appears to be more significant than a casual discussion of trade ratios might suggest. According to recent estimates, the elasticity of euro-area growth with respect to the United States is as high as 0.4.[13] This suggests that the recent decline in the United States growth rate of more than 3 percentage points from its average over the last five years, could cause a decline of around 1.5 percentage points in European growth, bringing it below 2 per cent, irrespective of any further impact from a loss of export competitiveness due to the strengthening of the exchange rate.

Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.

Nevertheless, Europe seems better placed than ever to decouple from the United States. Since European companies are not as highly leveraged as their United States counterparts, investment should be less influenced by liquidity shortages, increasing spreads in high-yield and corporate capital markets, or difficulties in the ICT sector. The lower share of equity in personal wealth also suggests that consumption expenditures should be less constrained by declining global equity prices. In addition, the macroeconomic picture is broadly favourable. A necessary degree of convergence has been achieved across the region and the launch of the euro has been successful; its initial weakness reflected cyclical rather than structural factors. Moreover, the fall in United States interest rates eases pressure on the ECB, and the fiscal situation is healthy; changes in the fiscal regime of the major economies (Italy, France and Germany) will provide a stimulus of between 35 and 50 billion euros in 2001, adding as much as 1 per cent of GDP. The reversal in the upward trend of petroleum prices should also have a greater positive impact on Europe, since it is a larger net importer of oil than the United States, and this will be reinforced by a stronger euro, creating further increases in purchasing power for households and lower costs for European firms.

Box 1.1

DISSECTING THE UNITED STATES DOWNTURN

Many observers expect that the United States economy will experience a short Keynesian-type downturn, associated with overinvestment and excessive inventories accumulation, followed by a relatively rapid recovery. Such an outcome places considerable faith in discretionary fiscal and monetary adjustments. However, there are a number of factors suggesting that the current downturn is quite different from that which is typical of the Keynesian cycle.

While the sustained high rate of expansion in business investment has played an important part in the unprecedented period of expansion, even more striking has been the increase in investment in new computer and peripheral equipment, with average annual increases close to or above 50 per cent during 1995–2000. Total investment in information-processing equipment and software rose more slowly, at rates of around 25 per cent per annum. Although such spending represented less than 10 per cent of GDP in 2000, it accounted for almost one third of all output growth during 1995–1999.

This exceptionally rapid increase in investment was driven primarily by new business ventures attempting to exploit in full the benefits of a Schumpeterian wave of technological innovation in information processing and telecommunications. The boom in venture capital funding and the bubble in the IPO market allowed the financing of new start-ups with no current earnings and highly uncertain expectations of future earnings.[1] The sharp rise in equity prices after initial public offerings lowered the cost of finance. Venture capital funds were thus able to recover their investments and explore new business plans. As long as the equity market remained bullish, even unsuccessful and never profitable technology firms were able to continue to count on low-cost funding to meet ongoing losses. However, such firms represent excess capacity that will not be absorbed even by an increase in aggregate demand on the cyclical upswing. In a downturn, they are likely to be eliminated by bankruptcy.

This process now seems to be under way. It started with the collapse of the NASDAQ index in the first quarter of 2000, when investors began to distinguish the new start-up companies that were making their way and held out good profit prospects from those that were being kept alive only by continuous cash infusions, with little hope of future earnings to justify their elevated share prices. It is possible to look at the cyclical downturn as the market finally exercising its role selecting from the wide range of information technology innovations those that will be viable in the long run. The kind of excess capacity that is present in the economy may thus be rather different from the excess capacity in steel or automobile plants that had been associated with typical post-war cycles.

But even successful high-tech companies with positive earnings may not be immune from the current process of market selection. Many of them have acquired smaller start-up companies. Others have created their own venture capital funds to invest in start-ups, or financed new start-ups via reduced prices and the provision of credit through vendor financing. Some have accepted stock options in lieu of payment. Thus, sharp declines in stock prices, liquidity difficulties or bankruptcies of the weaker companies will adversely affect the earnings prospects of the more successful ones.

Box 1.1 (concluded)

Although the formal banking system has largely shunned the financing of new technology companies, the share of business lending in bank portfolios rose during the second half of the 1990s. Much of this lending has been to the so-called "old economy" or "blue chip" companies with high credit ratings, either in term lending, in back-up credit lines for commercial paper issues, or in underwriting and supporting bond financing. However, the survival of these companies is threatened by the process of Schumpeterian creative destruction that occurs as successful high-tech companies adopt new, more profitable technological approaches. The performance of these "old economy" companies will suffer from the overall slowdown in activity, which may also entail problems for banks that have substantial exposure to them. Recent weakness in high-yield bond markets, and difficulties in the issuance of commercial paper experienced by many such companies suggest that this is indeed happening (Silverman and Hill, 2001).

A lack of precedent in the current United States economic situation calls for a cautionary assessment. However, there are good reasons to view the current cycle as an interruption in a wave of Schumpeterian innovation rather than as a simple Keynesian problem of insufficient aggregate demand.[2] If that is so, the confidence that has been placed in monetary and fiscal policy in ensuring that the downturn is short may be misplaced. Only a wave of bankruptcies, the extent of which is uncertain, can eliminate the excess capacity in much of the ICT sector and allow more promising investment to resume. The length of the downturn will depend on how rapidly non-viable businesses can be wound up, on the extent to which successful companies elsewhere in the economy will face financial difficulties as a result of this process, and on the impact of possible macroeconomic stimuli on the rest of the economy.

It does not follow from the above that monetary and fiscal stimuli would be inappropriate. However, they would have a much smaller impact than in the past because they can do little to recreate the investment momentum and liquidity conditions that allowed the recent rapid experimentation with new technologies. The improvement that many observers expect from a rapid easing of monetary conditions may be slow to appear unless financial institutions, venture capitalists and households are again willing to return to their exuberant support of new businesses that have no current earnings and highly uncertain expected future earnings. But this is where the problem originated in the first place.

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1 Venture capital funds usually expect a success ratio of 1 to 10 on their investments.

2 Some aspects of the current cycle resemble that described by von Hayek, who argued that an excessively low cost of capital would create investments in techniques that were excessively capital-intensive; the subsequent return to a more normal level of capital costs would show that these investments are unprofitable, and the surplus capacity generated would have to be eliminated by a sharp downturn and widespread bankruptcies. However, while many companies have invested without achieving their expected sales, and the capital-output ratios may have increased, the problem is not one of excess capital intensity, but rather the fact that overgenerous financing conditions allowed unprofitable investments to come on stream.

For all these reasons Europe seems well placed to build on last year's growth performance and bolster global demand in the face of a United States slowdown. A rapid expansion in Europe of domestic demand is also essential to deal with its legacy of high unemployment. To that end a departure is necessary from an undue reliance of the largest economies on exports for growth.[14] The creation of an internal momentum for growth in Europe and its contribution to an expansion of demand are likely to depend in large part on the willingness and ability of governments to use economic policy to anticipate, rather than react to, worsening conditions.

The structural changes that have been made in fiscal policy should boost real incomes and partly offset the adverse impact of higher energy and heating costs. Nonetheless, consumer confidence in Europe does not appear to be improving, and growth in real compensation, which peaked in 1999 at around 3 per cent, had fallen to below 2.5 per cent by the end of 2000. Current wage agreements in some of the larger economies were negotiated under less advantageous conditions and will not be renewed during 2001. For example, the very moderate wage settlements reached in Germany in 2000 still have a year to run. Where wage agreements have been linked to an expected inflation rate that in the event has been exceeded on account of petroleum prices and the weakness of the euro, there should be some recovery of real incomes.

The appreciation of the euro towards the end of 2000 has produced a de facto tightening of monetary policy, with real interest rates reaching cyclical highs – up from around 2 per cent in 1999 to around 3.75 per cent[15] in early 2001. With lower petroleum prices, the strengthening of the euro and monetary growth moving towards ECB targets, there should be ample scope for discretionary monetary easing to accompany any expansive fiscal policy. However, recent pronouncements from the ECB indicate that it will continue to be solely concerned with internal price stability. This sits ill with the spirit of the preparatory discussion of the EMU, when there was a broad consensus that monetary policy could be used to counter symmetric external shocks, such as an oil price hike or a fall in global demand. Failure to counter these influences could result in global imbalances producing disruptive movements in exchange rates similar to those between the yen and the dollar that helped precipitate the Asian crisis.

The United Kingdom economy, which remains outside EMU, has had a consistently better growth performance than that of the euro area since the 1990–1991 recession and was one of the first economies to lead the global recovery. However, during 2000 growth was slightly below the EMU average and appeared to have peaked by mid-year. With industrial production falling sharply in the last quarter of 2000, performance looks set to mirror that in the United States, unless electoral or other considerations result in provision of a more direct stimulus.

3. Japan

Growth in Japan – led by exports – picked up in the first half of 2000 and fed through to increased corporate profits, investment, industrial production and output, suggesting that the foundation for recovery might be in place. The impression of an accelerating recovery was reinforced when the Bank of Japan raised its interest rate to 0.25 per cent in August, since the Bank had maintained that policy would not be tightened until there were clear signs that the threat of a deflationary spiral had subsided. However, growth slipped to an annual rate of -2.4 per cent in the third quarter, and unemployment continued to rise, reaching 4.9 per cent by December despite the rise in employment. Figures for output and private consumption in the second half were also disappointing and, with the decline in exports, inventories began rising. As a result, subsequent Government estimates for growth in the fiscal year ending in March 2001 were lowered to below 0.5 per cent, measured in current prices.[16] Final data for the fourth quarter may well show a new decline in output, returning Japan to recession.

Although weaker markets in the United States and in developing Asia have sharply dampened the export-led recovery, it is still unclear what the effect has been on corporate earnings and investment.[17] Machinery orders from sectors other than export and ICT-related industries started to rise in the second half of 1999 and this should have been reflected in production figures by the beginning of 2000.[18] Whether this will be sufficient to offset the decline in export and ICT-related sectors due to the slowdown in the United States will be a factor determining whether or not the economy falls back into recession.

The Government has traditionally opted for the fiscal tool to spur expansion. However, the fiscal stance became increasingly cautious as government indebtedness rose. In response to the signs of a slowdown in the second half of 2000, a further budget was introduced in November which proposed to increase government spending by 4.8 trillion yen. However, not all of this amount constitutes a new stimulus, since the legislation limits the issuance of new government securities to 2.0 trillion yen and provides for the balance to come from a rollover of the 1999 fiscal year surplus of 1.5 trillion yen (i.e. carry-over of budgeted expenditures that did not in fact take place) and an estimated increase of 1.2 trillion yen in tax revenues. The stimulus resulting from the proposed budget for the fiscal year starting in April 2001 is again modest, and another supplementary budget will, in all likelihood, be required by mid-year.

Local governments are under heavy pressure to shore up their finances by cutting expenditure. Consequently, with little contribution expected from exports, continued recovery will depend primarily on private domestic demand. Investment has shown signs of acceleration, but the implication is that the consumer demand is expected to take the lead. This will mean wage growth will have to pick up to at least match productivity growth.

Considerable uncertainty remains over the future direction of monetary policy. There are increasing concerns that a return to a zero interest rate policy could delay corporate restructuring measures that are urgently needed to restore profitability. However, the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.[19] The fact that the unemployment rate is still increasing in conditions of rising employment indicates that previously discouraged workers are being drawn back into the labour force and that the economy could expand without inflationary risks substantially faster than at the potential rate (estimated at 1 per cent).

> In Japan the return to negative growth in the third quarter raises the possibility that the recovery may be cut off just as it gathers momentum.

Assessment of the impact of the current monetary policy stance is difficult because prices have been falling for most of the 1990s, so that real interest rates are positive even if they are close to zero in nominal terms. Problems with the balance sheets of financial institutions also make it difficult to assess the amount of liquidity that has been injected. Bank profitability and capital have improved over the last several years, without this having led as yet to an increase in bank lending or equity values. The loan books of domestic commercial banks continue to contract at about 4 per cent per annum and the Tankan surveys during the year do not indicate any change in the negative perception of banks' willingness to lend.

The tightening of monetary policy since August 2000 has been reinforced by the appreciation of the yen. At the same time, equity prices peaked in April 2000, but following the trend in the NASDAQ in the United States, fell sharply in April and May. However, rather than stabilizing, as in the United States, equity prices continued to fall, with a particularly sharp drop in mid-December as it became clear that the economy was slowing down. This set off renewed speculation about difficulties in the banking sector and a proposal for a special government investment fund to shore up equity prices. If the recent increase in investment is cyclical – primarily due to the recovery in Asia and the prolonged growth of the United States economy – rather than the result of microstructural factors and the spread of investment to non-export sectors, it may not survive the anticipated slowdown in global demand.

C. Developing countries

1. Latin America

In all Latin American countries economic performance improved in 2000 (table 1.2). In some there was a very strong recovery, pushing the regional rate of expansion to nearly 4 per cent, the highest since the outbreak of the Asian crisis. However, marked differences in performance among countries that prevailed in 1999 persisted in 2000. Mexico and the economies of Central America and the Caribbean, with close trading links to the United States, continued to outperform those economies that are more dependent on commodity exports and intra-regional trade.

Growth accelerated strongly in the two largest economies, Brazil and Mexico. Thanks to higher oil prices, continued expansion in the United States and robust domestic demand, growth in Mexico reached 7 per cent, the best performance in many years, while an aggressive policy of monetary easing allowed Brazil not only to raise output growth (to 4 per cent) but also to reduce its fiscal deficit. The effect on prices of the currency depreciation of early 1999 remained muted despite the recovery, but the current-account balance improved less than had been expected. In Chile, too, there was a sharp rebound in growth (to almost 6 per cent) from a recession in 1999.

Prospects for most countries in Latin America depend on the extent of the downturn in the United States. For the region as a whole growth is expected to slacken, although further depreciation of the dollar would help increase competitiveness in the “dollarized” economies.

In both Argentina and Uruguay the economy contracted (but more slowly) for the second consecutive year. In Argentina deflationary adjustment to the external shocks of 1998–1999 continued, resulting in some improvement in competitiveness and a trade surplus. However, since the services balance deteriorated due to considerably higher financing costs, there was only a modest reduction in the large current-account deficit. International financial markets, which are crucial for financing the deficit, have been closely watching the Government’s efforts to bring its debt under control and to curb wage and price increases sufficiently to restore competitiveness and achieve current account sustainability (see chapter II, box 2.1).

The external environment for the Latin American economies was generally favourable as the recovery of certain commodity prices, which had started during the second half of 1999, continued into 2000. In particular, the hike in petroleum prices benefited several countries, especially Venezuela, where GDP growth rebounded to over 3 per cent in 2000 after a sharp decline of more than 7 per cent in 1999. Several other countries, however, particularly Chile, Paraguay and Uruguay, suffered seriously from higher oil prices.

Prices of metals, including copper, aluminium, iron ore, nickel, tin and zinc, also recovered, as they did for some soft commodities, such as

Table 1.2

GROWTH IN DEVELOPING COUNTRIES BY REGION, 1990–2000

(Percentage change over previous year)

Region/country	*1990–1995*[a]	*1995–2000*[a]	*1990–2000*[a]	*1998*	*1999*	*2000*[b]
Latin America	3.6	2.9	3.3	1.9	0.1	3.7
of which:						
Argentina	5.8	2.7	4.2	3.9	-3.2	-0.5
Bolivia	4.1	3.2	3.7	4.7	0.6	2.0
Brazil	3.1	2.2	2.7	-0.1	0.8	4.0
Chile	8.7	4.5	6.6	3.4	-1.1	5.7
Colombia	4.7	0.9	2.7	0.5	-4.5	3.0
Ecuador	3.4	0.1	1.8	0.4	-7.3	2.6
Mexico	1.5	5.5	3.5	4.8	3.7	7.0
Peru	5.5	3.4	4.5	0.3	3.8	3.9
Uruguay	3.7	2.1	2.9	4.6	-3.2	-1.0
Venezuela	3.4	0.3	1.9	-0.1	-7.2	3.2
Africa	1.5	3.6	2.5	3.2	2.9	3.5
of which:						
Algeria	0.1	3.5	1.8	5.1	3.3	4.3
Cameroon	-1.9	4.8	1.4	5.1	4.4	4.2
Côte d'Ivoire	1.9	4.6	3.2	4.5	2.8	2.2
Egypt	3.4	5.2	4.3	5.6	6.0	3.9
Ghana	4.3	4.4	4.3	4.7	4.4	4.0
Kenya	1.6	2.3	1.9	2.1	1.5	1.6
Mozambique	3.3	8.7	5.9	12.0	8.8	4.5
Nigeria	2.4	3.2	2.8	1.9	1.1	3.5
South Africa	0.8	2.2	1.5	0.6	1.2	2.7
Uganda	7.0	6.2	6.6	5.5	7.8	5.0
Asia	6.1	5.0	5.6	1.1	4.9	6.6
Newly industrializing economies	6.9	5.0	6.0	-2.6	7.6	8.6
Hong Kong, China	5.3	3.5	4.4	-5.1	3.1	10.4
Republic of Korea	7.4	4.8	6.1	-6.7	10.7	9.3
Singapore	8.6	6.3	7.4	0.4	5.4	10.1
Taiwan Province of China	6.4	5.8	6.1	4.7	5.7	6.0
ASEAN-4	7.0	1.6	4.3	-9.4	2.8	5.3
Indonesia	7.1	0.7	3.9	-13.0	0.3	5.2
Malaysia	8.7	4.6	6.6	-7.4	5.4	8.7
Philippines	2.2	3.4	2.8	-0.6	3.2	3.5
Thailand	8.6	0.3	4.3	-10.2	4.2	4.2
ASEAN-4 plus Republic of Korea	7.2	3.2	5.2	-8.2	6.5	7.3
South Asia	4.5	5.5	5.0	5.6	5.7	5.5
Bangladesh	4.4	5.1	4.7	5.1	4.4	5.5
India	4.5	6.1	5.3	6.3	6.4	5.7
Nepal	5.2	4.1	4.6	2.3	2.3	5.5
Pakistan	4.8	3.2	4.0	2.6	2.7	4.7
Sri Lanka	5.4	4.8	5.1	4.7	4.2	5.0
West Asia	1.3	3.4	2.4	3.3	-0.5	4.3
China	12.0	8.3	10.1	7.8	7.1	8.0

Source: UNCTAD secretariat calculations, based on data in 1995 dollars.
a Annual average.
b Estimates.

cotton, fish meal, pulp, soybeans and wool. On the other hand, there was a continued decline in prices for food and beverages, particularly cocoa, coffee and sugar. Nevertheless, the terms of trade for the region as a whole improved. Since, in addition, relatively weak domestic demand kept increases in imports well below those of exports, there was a (modest) improvement in the regional current-account deficit. FDI inflows declined in 2000 and total net capital inflows remained far below the levels of 1996–1998.

For 2001, prospects for most of the Latin American countries depend on the extent of the downturn and the speed of the recovery in the United States economy. For the region as a whole, growth is expected to slacken as a result of a weaker export performance, although further depreciation of the dollar would help increase competitiveness in the "dollarized" economies. The impact of reduced import demand in the United States will be the greatest in Mexico, and probably small in Brazil, Chile and Peru. The two latter countries, in particular, will continue to benefit from higher prices for base metals and from relatively robust growth in the Asian economies, which are important export markets. The outlook is particularly uncertain for Ecuador, where hyperinflation continues to pose a major challenge to policy makers, as well as in Venezuela and Colombia. Fiscal imbalances remain a serious problem in some countries, including Argentina and Brazil, while others, having experienced financial crises during the 1980s and 1990s, are still contending with weak and fragile banking systems.

Latin America continues to face large financing constraints. While the region remains dependent on capital inflows, it continued in 2000 to experience a negative net resource transfer. Lower United States interest rates mean reduced costs of new borrowing and, eventually, of carrying of old debt, provided that sovereign risk spreads do not increase by more than the reduction in the benchmark rates. On the other hand, the financing constraints may be aggravated if the slowdown in the United States leads to reduced global trade growth. With more countries choosing a regime of full dollarization, the region will become increasingly dependent on conditions and policy decisions in the United States.

2. Asia

Growth in the developing countries of Asia as a whole (excluding China) accelerated further in 2000, reaching 6.2 per cent, after having already recovered in 1999 from the contraction of almost 1 per cent in the previous year (table 1.1). There were, however, considerable differences in performance among the subregions and their constituent countries (table 1.2).

A sharp turnaround was registered in West Asia, from slightly negative growth in 1999 to more than 4 per cent in 2000. Wary of the volatility of oil prices, oil producers in the subregion were initially cautious about spending their windfall of additional earnings, preferring to replenish their foreign exchange reserves and increase their holdings in foreign assets. However, as oil prices remained high because of strong world demand and low world stocks (see chapter II, section C), governments started to increase their spending on infrastructure, education and health care. Higher revenues reduced borrowing requirements and domestic arrears. At the same time, stronger fiscal and external balances, improved confidence and strong domestic demand greatly boosted economic activity, contributing to overall economic growth in the oil-exporting economies of the region. Many oil-importing countries in the subregion, however, suffered from substantial terms-of-trade losses.

The Turkish economy recovered well from the severe damage caused by the earthquake in 1999 and the spillover effects of the Russian crisis. However, its exchange-rate-based stabilization programme started running into difficulties in late 2000, casting doubts on its ability to sustain growth (see chapter II, box 2.2).

The outlook for West Asia in 2001 is broadly favourable. Driven by increases in oil revenues, growth is expected to accelerate in Kuwait, Oman, Saudi Arabia, United Arab Emirates, Yemen and, to a lesser extent, in the Islamic Republic of Iran, where external debt repayments and higher food imports because of drought are offsetting features. Qatar will additionally benefit from the rise in its gas production and exports. Drought will also, to some extent, offset the gains from higher oil prices in several countries. From a longer-term perspective, for most countries in the subregion growth will continue to be constrained by low investment rates. Moreover, without substantial diversification of production, they will remain exposed to terms-of-trade shocks. Many countries are pressing ahead with reforms to improve the efficiency of the public sector and have also introduced measures to privatize and deregulate economic activity with a view to encouraging the private sector and promoting domestic and foreign investment.

In South Asia, overall economic activity continued to be dominated by the performance of the Indian economy. Despite the lingering effects on exports of the Asian financial crisis and the more recent sharp increase in oil prices, growth for the region as a whole remained at the level of the two preceding years. Growth in India, which has expanded strongly in recent years, slowed down slightly. The drought in northern India affected agricultural production less than anticipated and, despite flooding in the state of Andhra Pradesh during late August and early September, which affected the rice crop, the country has a large grain surplus. Strong overall growth was underpinned by a robust industrial performance and rapidly growing foreign demand for ICT-related services; in order to promote exports of services, legislation was introduced to support the ICT sector and develop e-business infrastructure.

Continued strong growth in Sri Lanka in 2000 was led by exports, especially garments. Higher tea and rubber prices also contributed to the sharp rise in export earnings. The more than 5 per cent growth in Bangladesh was also export-led. In Pakistan growth accelerated, but still lagged behind the other countries in the region; the external sector remained fragile, reserves continued to decline from already low levels and the currency came under pressure following the depreciation of other currencies in the subregion.

The short-term prospects for the subregion are mixed. Growth in India will remain relatively strong, despite some negative repercussions from world trade, underpinned by the country's huge agricultural sector, which stands to benefit from moves to reform price-control policies and stimulate domestic trade in agricultural products. Export-oriented manufacturing sectors are also expected to benefit from a relaxation of the FDI regime in special economic zones, and robust expansion of the ICT sector will support service activities. In Sri Lanka, growth will continue to be driven by strong demand for its two major exports, garments and tea, whereas in Pakistan, financial difficulties are likely to be a restraining factor. All countries in South Asia, but especially the smaller ones, are heavily dependent on energy imports and agricultural exports. Adjustments to terms-of-trade losses from the recent adverse movements in primary commodity prices may dampen growth to some extent, and further structural reforms in agriculture and industry may be needed to strengthen competitiveness.

In East Asia, almost all major economies further consolidated their recovery. The five countries that had been most affected by the financial crisis – the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) and the Republic of Korea – registered an overall growth in 2000 of more than 7 per cent, compared to 6.5 per cent in 1999. Despite substantial currency devaluations and the rapid pace of recovery, inflation rates have remained low. In Malaysia and Thailand there is a possibility of price deflation (which is already a reality in China and Hong Kong (China)).

In addition to strong export performance, growth has been supported by low interest rates and expansionary monetary policies. Although capital outflows have continued as banks have reduced their foreign exposure, they have not outgrown current-account surpluses. This suggests that the generalized currency depreciation has been the result of deliberate policy. There has been a significant recovery in intra-Asian trade, which is now growing more rapidly than trade with either the United States or EU. For several East Asian economies the internal driving forces behind recovery have started to shift from inventory adjustment and government spending to the more self-sustaining elements of business investment and private consumption. On the other hand, the gains from export volume growth and higher export prices were partly offset by higher oil prices during 2000.

Among the ASEAN-4, Malaysia continued to be the best performer, with growth accelerating to 8.7 per cent. However, by the end of the year, domestic demand had slowed markedly and manufacturing sales were growing considerably faster than output, which would indicate a decline in inventories. Producer prices have been declining, and the rise in December 2000 of consumer prices was at an annual rate of just over 1 per cent. In Thailand exports rose by 20 per cent in 2000, contributing more to growth than in previous years, when domestic consumption had been the driving force. Despite higher energy prices, inflation has virtually disappeared; capacity utilization is still below 60 per cent and there is still excess labour. As in Thailand, recovery in the Philippines has been relatively slow. At the beginning of 2001, the country faced an extremely large fiscal imbalance and the peso came under pressure, despite a very strong current-account position. Indonesia experienced its first year of strong growth since the financial crisis, but domestic demand, which has become increasingly important in sustaining growth in the other ASEAN countries, remains weak.

In the Republic of Korea, which has already regained its pre-crisis level of per capita income, growth slowed somewhat in 2000, but still exceeded 9 per cent. Economic activity continued to be driven by exports, particularly of computers, and there was a strong increase in manufacturing output, notably of semiconductors. A second year of fast growth has led to a resurgence of capital inflows, and although the currency depreciated by an average of around 10 per cent, there was a recovery in the exchange rate at the end of the year. Inflation started to rise, reflecting, in part, the impact of higher oil prices in a country that relies on imported oil for about half its energy needs. This prompted the Bank of Korea to raise its overnight call rate in October for the second time in 2000. Consumer prices declined in October and November, resulting in an annual increase in the price index of just over 2 per cent.

Output growth picked up sharply in Hong Kong (China) as tourism recovered, and Singapore experienced another sharp acceleration of growth in 2000. However, in all the NIEs exports began to fall in the course of the year. For example, in Singapore, electronic exports in December were over 11 per cent lower than in December 1999 and exports of semiconductors some 17 per cent lower. Exports to all major markets except Japan and China declined. In Hong Kong (China) consumption has remained weak despite a fall in real interest rates and in the unemployment rate and a stabilization of the property market, and in Taiwan Province of China the revival of domestic demand in the first quarter of 2000 could not be sustained.

In China, economic activity continued to gather momentum in 2000, resulting in a one percentage point increase in output growth over the previous year and reversing the deflationary trend that had been caused by weak domestic demand in recent years. Expansionary policies, strong exports and progress in structural reforms resulted in rapid growth in construction and industry, which more than compensated for a sluggish performance in agriculture. Exports and imports also benefited from a real depreciation of the renminbi and higher export tax rebates. There was also a sharp increase in new FDI commitments, which had been declining for nearly four years. However, given its growing dependence on the United States market, the slowdown in that country is likely to reduce export growth in 2001. Exports and imports may also be affected by the prospect of China's accession to WTO and the implications thereof for the exchange rate. Although export growth is expected to be slower in 2001, the economy should receive a stimulus from current stimulative fiscal and monetary policies. Infrastructure investment, in particular, can be expected to increase, especially in the western provinces.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States.

Prospects for many developing countries in East Asia in 2001 are closely linked to the high-tech cycle in the United States and the movement of their currencies against the dollar and the yen. Growth in the subregion depends to a large extent on external demand for electronics, and would therefore be hit by any deceleration of global demand. The rate of increase in new orders received from the United States for electronic goods had already declined by half in October 2000. The outlook is for further declines as inventories in the United States continue to increase, and there were clear signs of declining semiconductor prices in early 2001. Additionally, there is still a drag on growth from ongoing financial and corporate sector restructuring. The NIEs are likely to grow at a slower pace in 2001, and Singapore and Taiwan Province of China, in particular, will be affected by weak demand for electronic products. Slower growth in the Republic of Korea will be a reflection, in part, of the continuing problems of the major *chaebols* and the associated risks of further problems arising in the banking sector.

In Malaysia, lower electronics exports may cut the growth rate considerably in 2001. This may require reconsideration of the policy of maintaining a fixed exchange rate, but a lower dollar may alleviate the need to move the peg. Reversing the expectations of deflation and lower growth will require aggressive monetary easing and fiscal stimulus. Growth prospects for Thailand are also dampened by the likelihood of slower export growth in 2001; and the slow pace of debt restructuring and the weakness of the banking sector are also matters of concern in that country. However, with ample room for interest rate reductions and the expectation of a vigorous fiscal stimulus, Thailand is better placed to resist the downturn in the United States than other countries in the subregion. The impact of external shocks remains a threat for Indonesia and the Philippines. Moreover, fiscal positions are a cause for concern in these countries, and much remains still to be done in the area of financial and corporate restructuring. In those two countries prospects are thus fraught with considerable downside risks.

3. Africa

Even more than in other regions, external factors continue to dominate growth and development prospects in Africa. Economic activity in the oil-exporting countries was boosted by the rise in oil prices, which led to significant improvements in fiscal and external balances. The economies of oil-importing countries, however, were severely affected by high oil prices and external financing constraints. In particular, sub-Saharan countries continued to be affected in varying degrees by the fallout from the 1997–1999 emerging-market crises as prices of some of their major non-fuel export commodities remained depressed.

GDP growth in Africa picked up from 2.9 per cent in 1999 to 3.5 per cent in 2000 (table 1.2). In contrast to some recent years, it was the lowest among developing regions and barely kept pace with population growth. Even before the confirmation of the slowdown in the United States, growth forecasts for Africa were being lowered, owing to weaker performance by some of the larger economies, worsening weather conditions and disruptions caused by civil and political unrest.

Growth performance in 2000 varied much among the different subregions.[20] Growth was close to the continental average in Central, East and West Africa, whereas it was higher in North Africa but lower in Southern Africa. Output growth in Botswana, Mozambique, Uganda and the economies of the CFA franc zone was above the African average, but in Angola, the Democratic Republic of the Congo, Ethiopia, Sierra Leone and Zimbabwe it was well below this average.

Among the countries of North Africa, Algeria and the Libyan Arab Jamahiriya benefited from higher oil revenue, which provided a strong boost to growth. In Algeria, however, these benefits were offset, to some extent, by adverse weather conditions, especially poor rainfall, which also seriously affected Morocco and Tunisia. After a decline in 1999, output growth in Morocco is estimated at 0.7 per cent in 2000, despite a decline of 17 per cent in agricultural production, which accounts for some 40 per cent of aggregate output. Agricultural output also fell in Tunisia (by 15 per cent), leading to a reduction of the growth rate from 6.2 per cent in 1999 to 4.2 per cent in 2000. With more favourable weather conditions, both countries may experience faster growth in 2001. In Egypt, growth slowed to less than 4 per cent in 2000, due to a tightening of monetary policy to keep inflation in check. The rapid expansion of domestic credit in recent years and the rise in the real effective exchange rate as a result of a de facto peg to the dollar led to mounting pressures on the external accounts and a substantial loss of foreign reserves.

Growth in Southern Africa in 2000 was restrained by the continued weakness of the economy of South Africa. While in most countries in the subregion growth continued to be healthy, recovery in the continent's largest economy continued to remain fragile. GDP growth rose to 2.6 per cent in 2000, supported by improved competitiveness and the expansion in global output and trade, but a depreciation of the rand, a surge in food prices after flooding in some areas, together with higher oil prices, led to a build-up of inflationary pressure. In Zimbabwe, the economic crisis continued to deepen and is estimated to have resulted in an output contraction of some 6 per cent in 2000. In Mozambique, where the implementation of the Government's comprehensive reconstruction plan received generous and timely international support, output is estimated to have grown by more than 4 per cent (after 8.8 per cent in 1999), although flooding caused substantial damage early in the year.

> Most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure.

The potential for higher growth in East Africa failed to be realized partly on account of policy formulation and implementation and partly because of various adverse shocks. Economic activity in the Democratic Republic of the Congo was adversely affected by war, and in Eritrea and Ethiopia by both drought and war. On the other hand, the United Republic of Tanzania managed to withstand the adverse impact of weak prices for its main exports (coffee and cotton) even though it was hit by food shortages due to the failure of seasonal rains. Kenya, which has been among the slowest-growing economies in Africa in recent years, was also plagued by drought and weak export prices, but the resumption of IMF lending may boost confidence and the inflow of aid. Uganda, a major coffee producer, continued to achieve growth of about 5 per cent, despite a further drop in international coffee prices.

Among the countries in West Africa, Nigeria benefited greatly from rising oil prices, raising its GDP growth by more than 2 percentage points, to 3.5 per cent. The Government has initiated steps to restore macroeconomic stability and improve relations with creditors. Ghana, maintained an output growth above 4 per cent, as it has done consistently since 1995. Countries in Central and West Africa which are members of the CFA franc zone (see also chapter V, box 5.2) have been among the best performers on the continent in recent years. Because their currencies are linked to the euro, some of them have benefited from increased competitiveness due to the euro's weakness vis-à-vis the dollar. However, growth in Côte d'Ivoire is estimated to have continued its downward trend since 1998 as the economy had to contend with weak cocoa prices and a significant slowdown in disbursements of external assistance. Overall, output growth in the CFA franc zone has remained fairly robust and is expected to accelerate in 2001.

For Africa as a whole, the rate of output growth in 2001 is expected to pick up moderately, supported by faster recovery in South Africa. It should remain strong particularly in Cameroon, Ghana, Mozambique, Uganda and the United Republic of Tanzania, which have begun to reap some of the benefits of macroeconomic and structural reforms. Underlying this improvement is the expectation that the terms of trade of commodity exporters will stabilize or improve moderately due to lower oil prices. Recent European and United States initiatives to open up their markets to the poorest economies in Africa as well as bilateral debt reduction accorded by some industrialized countries should bring benefits. In addition, around 80 per cent of debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative concerns economies in sub-Saharan Africa. Presently, nine African countries (Benin, Burkina Faso, Cameroon, Mali, Mauritania, Mozambique, Senegal, Uganda and the United Republic of Tanzania) have already qualified, and several more are expected to reach the completion point in the near future.[21] However, the impact of these international measures will not be felt immediately, and many countries in sub-Saharan

Africa continue to suffer from a debt overhang. Moreover, most African economies remain highly vulnerable to changes in prices of primary commodities, and growth continues to be severely constrained by inadequate infrastructure in transport and communications. Levels of official assistance remain insufficient to fill the resource gap.

D. Transition economies

There was a strong recovery in the transition economies in 2000 (table 1.1) and, on average, the growth rate was the highest since 1989. While domestic demand continued to expand in most countries, the main stimulus was from exports. However, it is too early to judge whether this growth will be sustainable in all cases and whether the process of catching up has really begun. The recovery in 2000 was from a very low base and export prospects are less promising in the light of global conditions. The immediate policy challenges vary for the different economies: some will have to accelerate progress towards a market economy, while others will need to correct macroeconomic imbalances or to cope with adverse shocks.

After the devastating financial crisis in 1998, the Russian Federation had one of the highest rates of growth in 2000, at 7.6 per cent (table 1.3). Due to their strong links with the Russian economy, most of the other CIS countries also posted high growth rates in 2000, with double-digit figures in Kazakhstan and Turkmenistan. Depreciation of the rouble and of the CIS currencies stimulated exports and led to import substitution, all of which boosted industrial output. It thus seems that the business sector in these economies may be much more flexible and able to respond to market signals than commonly believed, even though the process of corporate restructuring has yet to be completed.

Among the central European countries, growth in the Czech Republic, Hungary and Slovenia in the first nine months of 2000 exceeded expectations. Hungary was the fastest growing economy (6 per cent). Industrial output accelerated sharply in the Czech Republic and Slovakia. While initially growing much faster than in 1999, the Polish economy showed some signs of slowing down in the course of the year. Romania also reported positive growth but without clear signs of a breakthrough to sustained expansion, while in Bulgaria output continued to grow for the third successive year. The Baltic States recovered early from the recession of 1999, but growth flagged in the second half of 2000.

For the European transition economies as a whole, exports to the rest of the world increased by one third. Whereas the CIS countries benefited from the boom in commodities, those of Central and Eastern Europe increased their exports of manufactured goods, as did also the Baltic States. Imports also increased everywhere, but in most cases less than exports, resulting in a significant improvement in current-account balances. Substantial terms-of-trade gains in the relatively small group of commodity-exporting CIS countries contrasted with sizeable losses for the net commodity importers, comprising all the Central and Eastern European and Baltic States, as well as a number of CIS countries.

Table 1.3

TRANSITION ECONOMIES: SELECTED ECONOMIC INDICATORS, 1998–2000

	GDP			Consumer prices			Current-account balance		
	Change over previous year[a]								
	(Percentage)						(Percentage of GDP)		
Region/country	*1998*	*1999*	*2000[b]*	*1998*	*1999*	*2000[c]*	*1998*	*1999*	*2000[d]*
Central and Eastern Europe									
of which:									
Bulgaria	3.5	2.4	4.5	0.9	6.2	11.0	-0.5	-5.5	-8.1
Croatia	2.5	-0.4	2.8	5.6	4.6	7.3	-7.0	-7.5	-7.7
Czech Republic	-2.2	-0.8	2.7	6.7	2.5	4.2	-2.4	-1.9	-3.0
Hungary	4.9	4.5	6.0	10.4	11.3	9.2	-4.9	-4.3	-3.6
Poland	4.8	4.1	4.2[e]	8.5	9.9	10.6	-4.3	-7.4	-7.4
Romania	-5.4	-3.2	1.5	40.7	54.9	41.0	-7.2	-3.8	-2.9
Slovakia	4.1	1.9	1.6	5.5	14.2	15.4	-9.7	-5.5	-1.6
Slovenia	3.8	4.9	4.8	6.6	8.1	9.9	-0.8	-3.9	-2.7
Baltic States									
of which:									
Estonia	4.7	-1.1	5.5	6.8	3.9	3.0	-9.2	-5.7	-5.5
Latvia	3.9	0.1	4.5[f]	2.8	3.3	2.6	-10.7	-10.3	-5.6
Lithuania	5.1	-4.2	2.1	2.4	0.3	1.3	-12.1	-11.2	-4.2
CIS									
of which:									
Belarus	8.4	3.4	2.5[g]	181.6	251.3	190.7	-7.6	-2.4	-3.3
Russian Federation	-4.9	3.2	7.6[e]	84.5	36.6	20.2	0.4	13.7	22.2
Ukraine	-1.9	-0.4	6.0[e]	20.0	19.2	30.3	-3.2	2.8	1.5

Source: ECE (2000, tables 1.2.1 and 1.2.2) and subsequent updates.
a For consumer prices change from December to December unless otherwise indicated.
b October official forecast unless otherwise indicated.
c June 1999 to June 2000.
d January–June.
e Preliminary estimates.
f 4–5 per cent.
g 2–3 per cent.

The strong performance of most of the transition economies was accompanied by increased inflationary pressures. Despite sharply rising productivity and a predominantly export-driven recovery, consumer prices generally rose faster than expected, mostly on account of soaring prices for fuel. In some cases, the resurgence of inflation spurred a tightening of monetary policy. The rise in fuel prices threatened export competitiveness, since there is still a relatively high energy intensity of output in the transition economies. So far this adverse effect has been more than offset by productivity gains, but if productivity growth slows down and nominal wages are increased to offset past inflation, exports could be adversely affected.

The fiscal position has been better than expected in most transition economies, not only due to the strength of the recovery but also because of windfall gains related to price-sensitive revenue items such as duties and excise taxes. In most countries, the recovery has not led to a significant increase in employment, which suggests that there was slack to be taken up and also that there has been a further deepening of the process of economic restructuring. Indeed, unemployment rates in several countries have increased or remained high.

The factors that were favourable to growth in the transition economies in the last two years are not in place in 2001.

The factors that were favourable to growth in the last two years are not in place in 2001. World trade expansion is slowing, the stimulating effect of currency depreciations in the aftermath of the Russian crisis is fading away and commodity prices have peaked. The stimulus to continued growth will thus have to come from domestic demand. The task will be all the more difficult as inflation was on the rise in 2000. Several transition economies are determined to achieve the conditions necessary for association with, or even accession to, the European Union, to which end they may be obliged to take strong measures, in particular a restrictive monetary policy to combat the inflationary tendencies. However, such measures would aggravate the employment situation, which is particularly serious in south-east Europe, where unemployment already exceeds 20 per cent of the labour force in a number of countries. ■

Notes

1 At the end of September 2000, the International Monetary Fund (IMF) revised its growth estimates upwards because: "The global economic expansion has continued to gain strength, with global output growth now projected at 4.7 per cent in 2000, 0.5 percentage points higher than expected in the May *World Economic Outlook* … Growth is projected to increase in all major regions of the world, led by the continued strength of the United States economy; the robust upswing in Europe; the consolidation of the recovery in Asia; and a rebound from last year's slowdowns in emerging markets in Latin America and the Middle East and Europe" (IMF, 2000a: 1).

2 The proposed tax cuts reflect the policies of the new Administration and their primary purpose is not the short-term stabilization of domestic demand. Hence they may not be reversed in response to a macroeconomic need. If the optimists are proved right, the impact will be felt just when the economy is again growing at its potential, forcing a sharp tightening of monetary policy. This potential inconsistency between fiscal and monetary stances raises familiar concerns for the rest of the world, particularly developing countries. Furthermore, to the extent that the increase in disposable income resulting from tax cuts is spent on consumer goods rather than saved, aggregate domestic savings would be reduced with the effect of aggravating external imbalances.

3 Speech by ECB Governing Council member and Deutsche Bundesbank President, Ernst Welteke, at the University of Hohenheim, 23 January 2001, reported in *Market News International.* The reluctance to revise its estimate of potential growth is based on the view that: "on all the available evidence we cannot as yet conclude that a decisive shift in the

trend rate of productivity growth is discernible" (W. Duisenberg, ECB Press Conference, 14 December 2000).

4 In 1999, non-resident companies spent $283 billion to acquire or establish businesses in the United States, up sharply from $215 billion in 1998 and $70 billion in 1997 (Zeile, 2000: 141). Of Europe's $425.5 billion worth of FDI outflows in 1999, $235 billion were directed to the United States (UNCTAD, 2000a, annex tables B1 and B2; Zeile, 2000, table 16).

5 Indeed, since non-repatriated profits of foreign-owned affiliates are counted as FDI inflows into the United States, a decline in sales there would reduce recorded FDI inflows and may lead to decisions to repatriate more profits, thereby increasing downward pressure on the dollar.

6 Since 1997 the share of cross-border M&As financed by stock swaps rather than cash has increased dramatically. For developed countries as a whole, less than 10 per cent were financed by stock swaps in 1997, but the share rose to 31 per cent in 1998 and reached 40 per cent in 1999. For the United States, it is estimated that roughly half of all inward M&As have not involved direct acquisition of dollar assets with foreign currency, but have been financed by means of stock swaps, and that much of the remaining M&As have been financed by borrowing in the United States. Thus the European M&A boom in the United States after 1997 may have had a smaller direct impact on the foreign exchange market than is commonly supposed. Nonetheless, there may be indirect portfolio effects, since stock swaps increase the foreign currency denomination of assets in United States investors' portfolios. If United States investors were to sell their foreign equity, repatriate the proceeds and invest in dollar-denominated securities, the demand for dollars would increase in much the same way as a direct purchase.

7 The extent of the region's dependence on United States growth is reflected in the share of its exports to the United States. They account for more than 20 per cent of GDP in Malaysia, Singapore and Hong Kong (China), more than 10 per cent in the Philippines and Taiwan Province of China, and 7 per cent in the Republic of Korea.

8 As a result of the new productivity performance and the absence of any wage or price reactions to tight labour markets, the Federal Reserve now appears to accept that the natural growth rate is above the 2.0–2.5 per cent commonly cited in the first half of the decade, although it has not explicitly endorsed a specific target. The latest *Economic Report of the President* estimates a potential growth rate of 3.8 per cent.

9 ICT investment includes business outlays for computers and peripherals, software, communications gear, instruments, photocopying equipment and office equipment. The first three categories account for 88 per cent of the total, while software alone accounts for 43 per cent. Expenditures on communications equipment are only half as important as those on software.

10 Since the United States investment boom was driven primarily by companies attempting to exploit new technological advances to create new markets, it differs from the late 1980s investment boom in Japan and the early 1990s boom in the Republic of Korea, both of which were driven primarily by expanding capacity in existing lines of business or by the entry of new competitors into existing lines.

11 The Conference Board index at year-end was about 11 per cent lower than its peak in May 2000, and the University of Michigan index was about 12 per cent below its peak of January 2000. The declines in these two indices have been especially noticeable since both had previously been at historically high levels for extended periods. The University of Michigan index dropped sharply from December 2000 to January 2001.

12 Confidence indicators in the major EU economies have been in decline since early in the third quarter. The German IFO index of future expectations has declined since October 2000, and that of the overall business climate in industry had already been in decline since May 2000; the French INSEE indicator, which had peaked in July at 40, fell to 17 in January 2001. The Italian ISAE index fell from 40 in January 2000 to 18 in November 2000 and even further in December 2000.

13 See Credit Suisse/First Boston, *Euro Area Weekly*, 12 January 2001.

14 Domestic demand seems to have played a more important role in the strong growth performance of some smaller European economies in the second half of the 1990s than in the larger economies.

15 Nominal interest rates adjusted for core inflation.

16 However, since Japan is still suffering from deflation, the estimated real growth is slightly higher.

17 Over 40 per cent of Japanese exports are to Asia and over 25 per cent to the United States. Exports to EU are less than 20 per cent and are probably more sensitive to exchange rate changes. Consequently, they should improve with a recovery of the euro relative to the yen.

18 Although the December Tankan survey revised second half profits downwards and excess capacity figures rose.

19 The Central Bank appears to take the view that, to the extent that higher interest rates create pressure for restructuring, they will through increased efficiency lead to lower prices and deflation. However, a Bank of Japan study (6 October 1999: 56, box E) finds that: "data do not show evidence that techno-

logical innovation increases the number of industries that make profits while decreasing their prices even more in Japan".

20 The subregions distinguished in this subsection are as defined by the United Nations Economic Commission for Africa: (1) *Central Africa* (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon; Sao Tome and Principe); (2) *East Africa* (Burundi, Comoros, Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Seychelles, Somalia, Rwanda, Uganda and United Republic of Tanzania); (3) *North Africa* (Algeria, Egypt, Libyan Arab Jamahiriya, Mauritania, Morocco, Sudan and Tunisia); (4) *Southern Africa* (Angola, Botswana, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Zambia and Zimbabwe); and (5) *West Africa* (Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone and Togo). North Africa and Southern Africa account respectively for about 40 per cent and 35 per cent of African output, while the shares of West Africa, East Africa and Central Africa were 14 per cent, 7 per cent and 4 per cent, respectively.

21 Potential qualifiers include Chad, Ethiopia, Gambia, Guinea, Guinea-Bissau, Madagascar, Malawi, Niger, Rwanda, Sao Tome and Principe, and Zambia.

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*

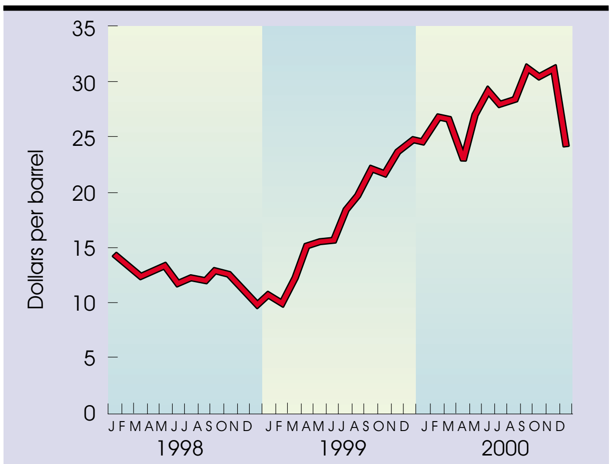
The annual average price of crude oil increased by 58 per cent to $27.6 a barrel in 2000, the highest level since 1985, and monthly average oil prices reached a peak of $31.5 a barrel in September 2000[5] (chart 2.1). Throughout 1998 and early 1999 oil prices had fallen, hitting a low of about $10 a 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.

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.

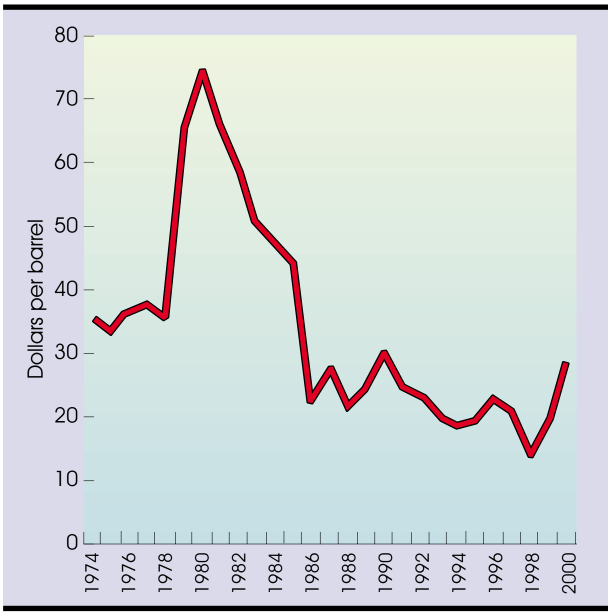
In any event, even the direct impact of the recent oil price increase on the industrialized oil-importing countries has been much less severe than the increases in 1973 and 1979–1980 for various reasons. Economic activity in the industrialized countries is much less oil-intensive than it was 20 or 30 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 three-fold 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.

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.

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

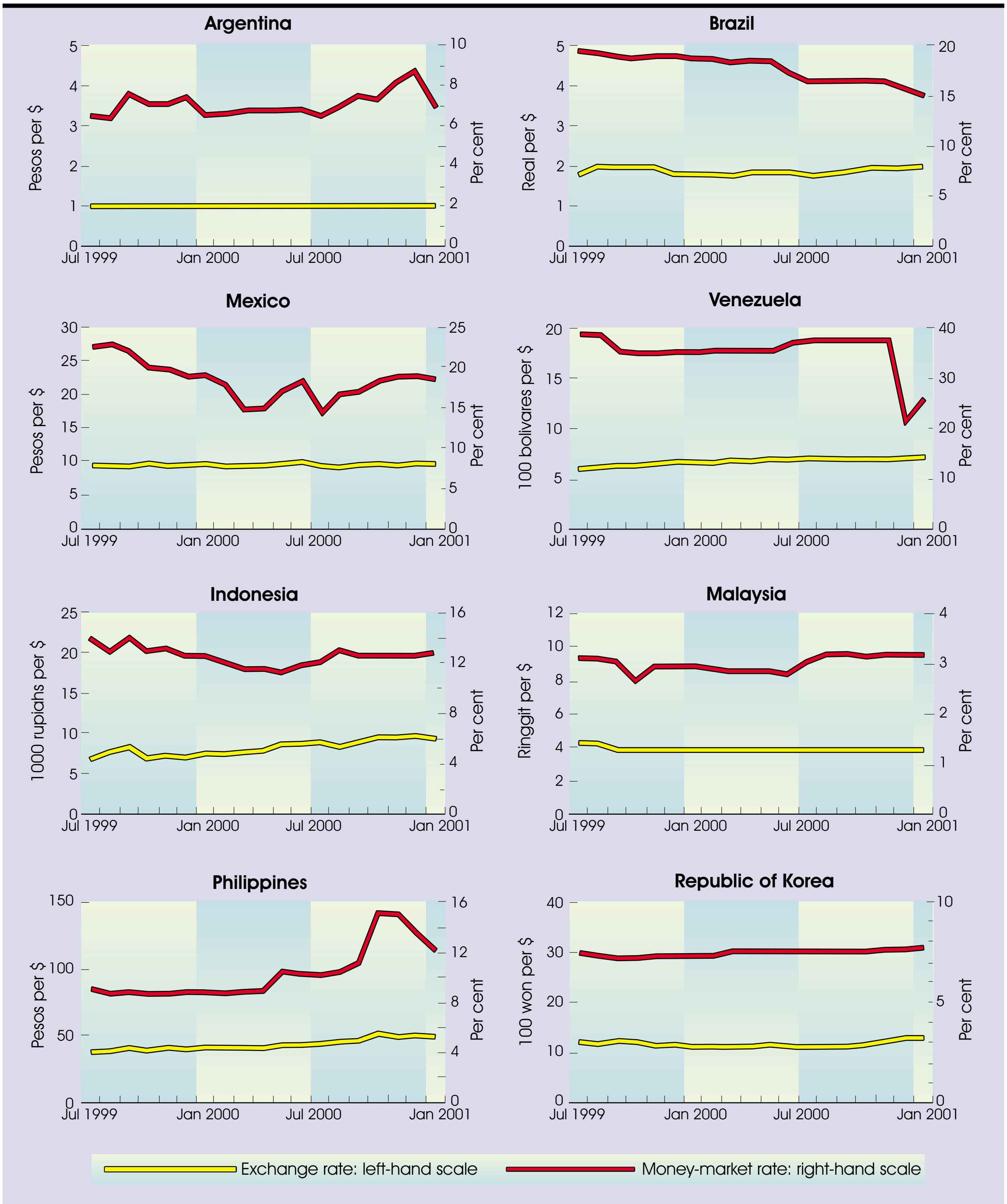
EQUITY PRICE INDICES OF SELECTED EMERGING-MARKET ECONOMIES, JANUARY 1999 TO JANUARY 2001

(January 1999 = 100; local currency terms)

Source: Primark Datastream.

Chart 2.4

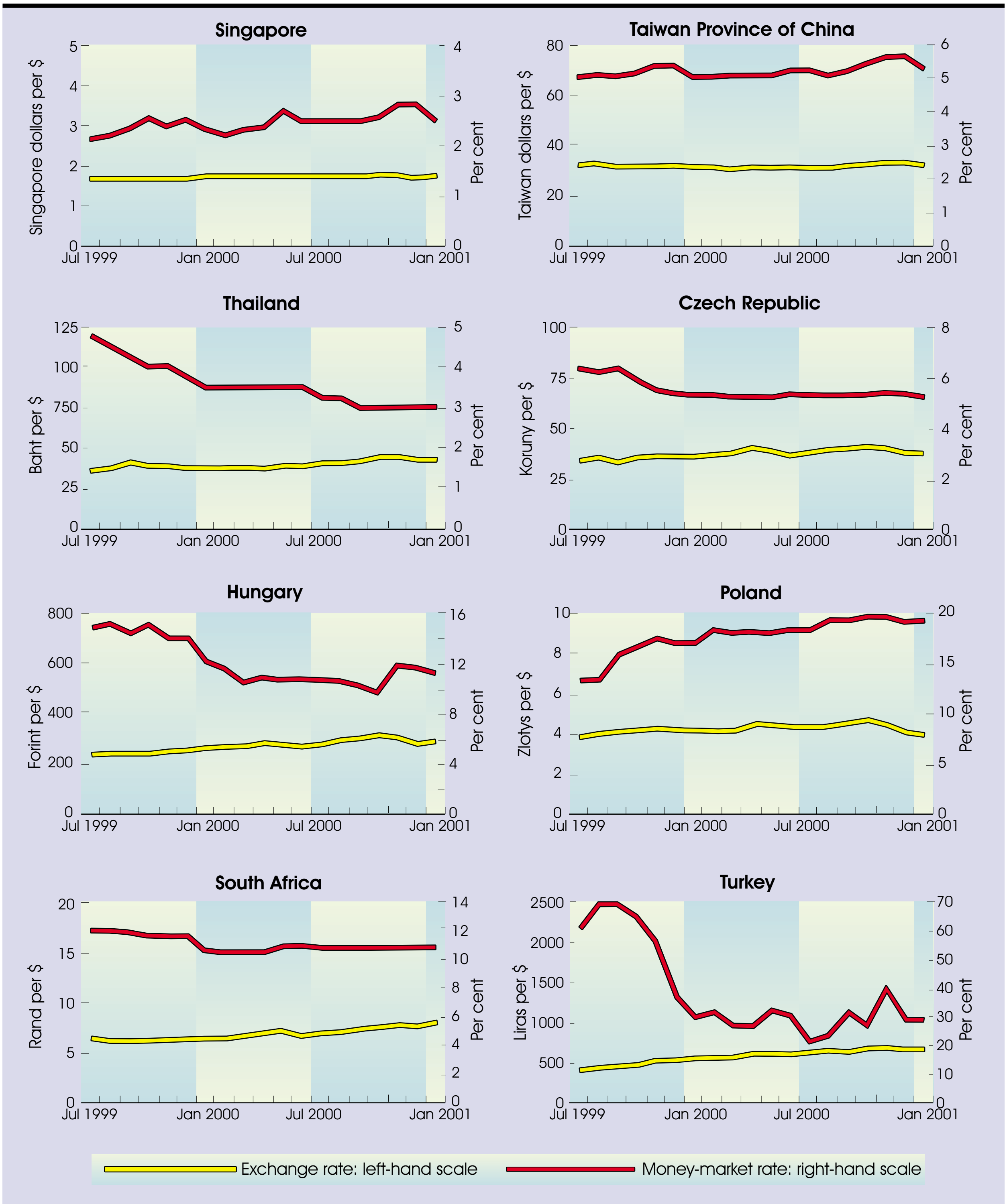
EXCHANGE RATES AND MONEY-MARKET RATES IN SELECTED EMERGING-MARKET ECONOMIES, JULY 1999 TO JANUARY 2001



/...

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).