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# **TRADE AND DEVELOPMENT REPORT, 2002**

**Chapter I**  
**THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS**



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# THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

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## A. Introduction

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For the first time since the oil price hike at the end of the 1970s virtually all regions of the world are experiencing a simultaneous economic slowdown, and a new sustained global upswing is not yet in sight. The sharp downturn in the United States economy over the last quarter of 2000 and into 2001, aggravated by the events of 11 September, appears to have bottomed out, but a strong rebound has not yet materialized. In the Euro area growth has stalled and unemployment is rising. Japan, after a year of negative growth, faces the possibility of prolonged recession in 2002, and it may have to rely on a depreciation of the yen to avoid an even more serious economic situation. In the developing world some indicators have recently improved, but most countries are not in a position to fight the global slowdown with domestic measures and must await recovery in the developed world.

The growth rate of industrial production in major developed and emerging-market economies, the best available global indicator of cyclical movements, has been negative since the middle

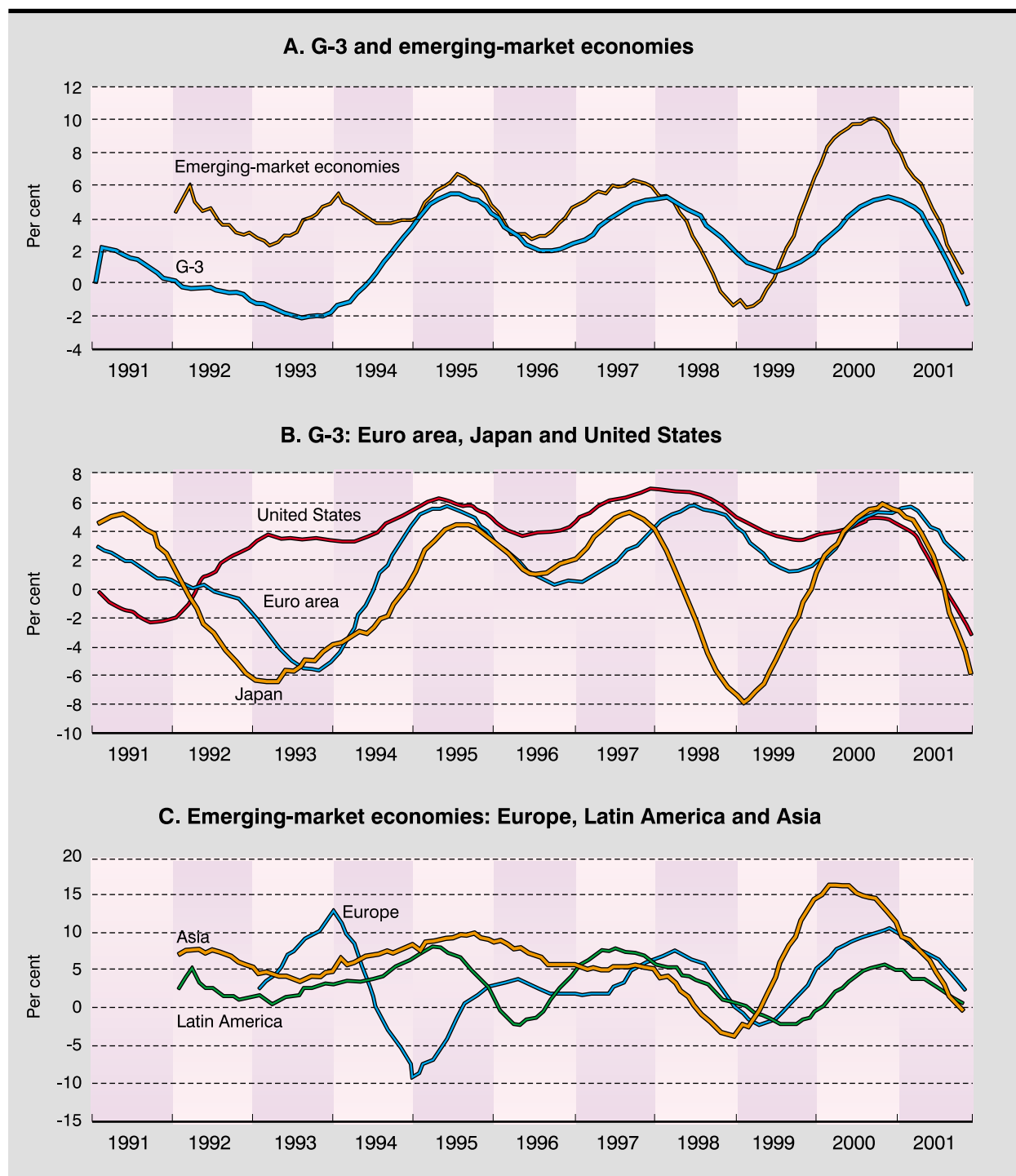
of 2001 (chart 1.1). The negative spillover into emerging markets has been much stronger than in previous downturns in the 1990s. Asia led the downswing and Latin America followed suit. Only China and India, two large and relatively closed economies, have escaped the downward pressure from world markets, their overall growth rates being barely affected despite a much reduced rate of export expansion. In the developed world, economic activity slowed down in Japan and the United States simultaneously, and in the Euro area soon after. World economic growth fell to 1.3 per cent in 2001 from 3.8 per cent in 2000 (table 1.1).

World financial markets, which had witnessed large price falls in 2001, are still unsettled. The quick and forceful reaction of the world's most important central banks after the events of 11 September achieved its objective of ensuring the continued functioning of major financial markets. However, bad news about the industries and businesses directly affected, declining profits of United States firms, defaults of some large companies, greater realism about the "new economy",

Chart 1.1

### INDUSTRIAL PRODUCTION IN THE MAJOR INDUSTRIALIZED COUNTRIES AND EMERGING-MARKET ECONOMIES, 1991–2001

(12-month moving average of percentage changes  
over the same period in the previous year)



**Source:** UNCTAD secretariat calculations, based on Thomson Financial Datastream.

**Note:** G-3 includes Euro area, Japan and the United States. Emerging-market economies include: Czech Republic, Hungary (from 1994), Poland (from 1995), Russian Federation (from 1995) and Turkey in Europe; Malaysia, Republic of Korea, Singapore, Taiwan Province of China, and Thailand in Asia; and Argentina, Brazil, Chile, Mexico and Peru in Latin America.

Table 1.1

Region/economy	1997	1998	1999	2000	2001	1990– 2000 average	2002 forecast		
							Consensus Economics	Economist Intelligence Unit	IMF <sup>a</sup>
World	3.4	1.8	2.6	3.8	1.3	2.2	1.2	1.4	2.4
Developed economies	3.0	2.1	2.4	3.4	1.0	2.0	.	1.1	0.8
<i>of which:</i>									
United States	4.4	4.4	3.6	4.1	1.1	2.8	1.6	2.2	0.7
Japan	1.6	-2.5	0.2	2.2	-0.3	1.1	-1.1	-1.3	-1.0
European Union	2.5	2.7	2.4	3.4	1.6	1.7	1.5	1.3	1.3
<i>of which:</i>									
Euro area	2.3	2.7	2.4	3.5	1.4	1.7	1.2	1.2	1.2
Germany	1.4	2.2	1.5	3.2	0.6	1.6	0.7	0.8	0.7
France	1.9	3.1	2.9	3.5	1.9	1.4	1.4	1.2	1.3
Italy	1.8	1.5	1.4	2.9	1.8	1.2	1.2	1.5	1.2
United Kingdom	3.5	2.6	2.1	2.9	2.4	1.9	2.0	1.6	1.8
Transition economies	1.9	-0.9	2.7	6.0	4.3	-3.0	3.0 <sup>b</sup>	.	3.6
Developing economies	5.3	1.1	3.4	5.4	2.1	4.3	.	.	4.4
Developing economies, excluding China	4.7	-0.0	2.7	4.9	1.1	3.6	.	.	.

**Source:** World Bank, *World Development Indicators* (various issues); IMF, *World Economic Outlook* (December 2001); EIU, *Country forecasts* (various issues); Consensus Economics, *Consensus Forecast* (11 February 2002).

<sup>a</sup> Based on country weights in terms of PPP.

<sup>b</sup> Including Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Poland, Romania, Russian Federation, Slovakia, Slovenia, Turkey, Ukraine and Uzbekistan.

and the restructuring of banks' balance sheets have blocked a quick return to more bullish conditions.

Recent events have revealed the limitations of monetary policy as an instrument for stabilizing the real economy in spite of its useful role in alleviating the burden of private debt in industrial countries. The bursting of the stock market bubble highlighted the vulnerability of the financial position of households and companies in the United States. Private savings have been extremely low and excess capacity is a damper on profitability. Moreover, debt levels are likely to hold down both consumption and investment.

The global slowdown has pointed to the difficulty of achieving a coordinated macroeconomic policy response in such circumstances. In the Euro area the response has been constrained by the fiscal guidelines of the Stability and Growth Pact and by the reluctance of the European Central Bank (ECB) to stimulate demand. Only in the United States have the monetary authorities acted quickly and forcefully to limit the impact of the slowdown on employment and real income. Moreover, the Government has boosted public expenditure in the aftermath of 11 September and accepted a huge swing from surplus to deficit in the fiscal position. However, these measures seem unlikely to provide a sufficient demand stimulus

for faster world growth, even though they have helped the United States economy to bounce back sharply.

An imminent vigorous and sustained recovery thus does not seem on the drawing board. Much of the bottoming-out so far is due to the ending of inventory adjustment in the United States. Moreover, certain features of the recent unbalanced pattern of growth may prove troublesome for the future. While the United States experienced a long period of expansion, there was slower growth in Europe and stagnation in Japan. This pattern led to difficulties in absorption and generated external imbalances. The dollar has

been excessively strong, adding to global imbalances resulting from disparities in demand creation among the major industrial countries. If an increasing number of countries were to depreciate their currencies against the dollar as part of their attempts to emerge from recession, the eventual correction needed in the dollar could become very large, creating a risk of sharp swings in the exchange rates of major currencies, with attendant consequences for financial stability and economic growth in developing countries. Avoiding such an outcome requires a better balance in the contribution of major industrial countries to global demand, with much of the responsibility resting with Europe.

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## B. Developed economies

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### 1. *Recession and recovery in the United States*

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The United States economy, which entered into recession in the spring of 2001, has been sending out mixed signals. On the one hand, consumer confidence has recovered faster, unemployment is lower and wage rates are higher than expected. Private consumption, after a sharp decline in September, bounced back strongly in the fourth quarter of 2001, with spending fuelled by extraordinary zero-interest-rate financing for car purchases and prepaid tax rebates, leading to unexpectedly rapid decline in inventories. On the other hand, investment is still subdued and, despite many efforts to reduce costs, the corporate earnings seem too low to justify current price earnings ratios. Government expenditure has been increasing at home and abroad since 11 September, and the Government is prepared to accept a fiscal deficit of 1 per cent

of gross domestic product (GDP) in 2002 following four years of surpluses. United States exports are set to fall in volume for the second consecutive year in 2002, depressed by sluggish world demand and the strength of the dollar.

As is usual in a cyclical downturn, the bulk of the adjustment burden has been born by profits and the inventory cycle. Company earnings, which rose to unprecedented levels during the prolonged boom in the late 1990s, dropped sharply after the cyclical peak was passed in the autumn of 2000. Debt of the non-financial corporate sector has been high by historical standards, in relation to turnover and cash flow. Industrial production declined by more than 4 per cent, and capacity utilization in manufacturing reached a low point of 73 per cent in the second half of 2001. As a result, investment in plant and machinery has been cut sharply and total employment has shrunk since the first quarter of 2001. The unemployment rate, histori-

cally low at the end of the boom, moved in line with industrial production as gains in the service sector and a general reduction of hours worked failed to compensate for the shedding of labour in industry.

By the beginning of 2002 many of the purely cyclical adjustments had been completed. The running down of inventories, which had been stronger than in any recession since the 1960s, has come to an end. Company earnings seem to have bottomed out. Claims for unemployment benefits stopped rising in December 2001, and there have been fewer reports of corporate layoffs, while the trend in payrolls has improved. The relief from falling short-term interest rates is working its way through the economy, and their historically low levels may induce a revival of spending on capital in sectors where the investment cycle is short, such as electronic parts or computers.

Clearer indications of stabilization and recovery hinge largely on spending by households to underpin the long-term investment decisions of corporations. Real disposable personal income held up well in the recession, with a growth rate of 3.8 per cent in 2001. Compensation per hour worked in the business sector had been on a steeply rising trend in the second half of the 1990s, resulting in a growth rate of more than 8 per cent at the end of 2000. In 2001 the rate declined, but still reached 4 per cent, despite the sudden drop in economic activity and the reduction of company bonuses. The slow reaction of wages to rising unemployment contributed much to the stabilization of domestic demand up to the fourth quarter of 2001. Paradoxically, although profits per unit of sales may have suffered from the temporary stickiness of wages, overall profit levels benefited as consumers continued to spend their income, which kept the savings rate close to zero. But this trend changed dramatically at the turn of the year: the growth rate of hourly compensation slowed to about 2 per cent and firms cut back working hours in an attempt to stem the downturn in profit margins.

More fundamentally, a return to sustained growth might be hampered by some deep-rooted disequilibria in the United States economy. Private savings are still extremely low and financial default looms for many households, even if the

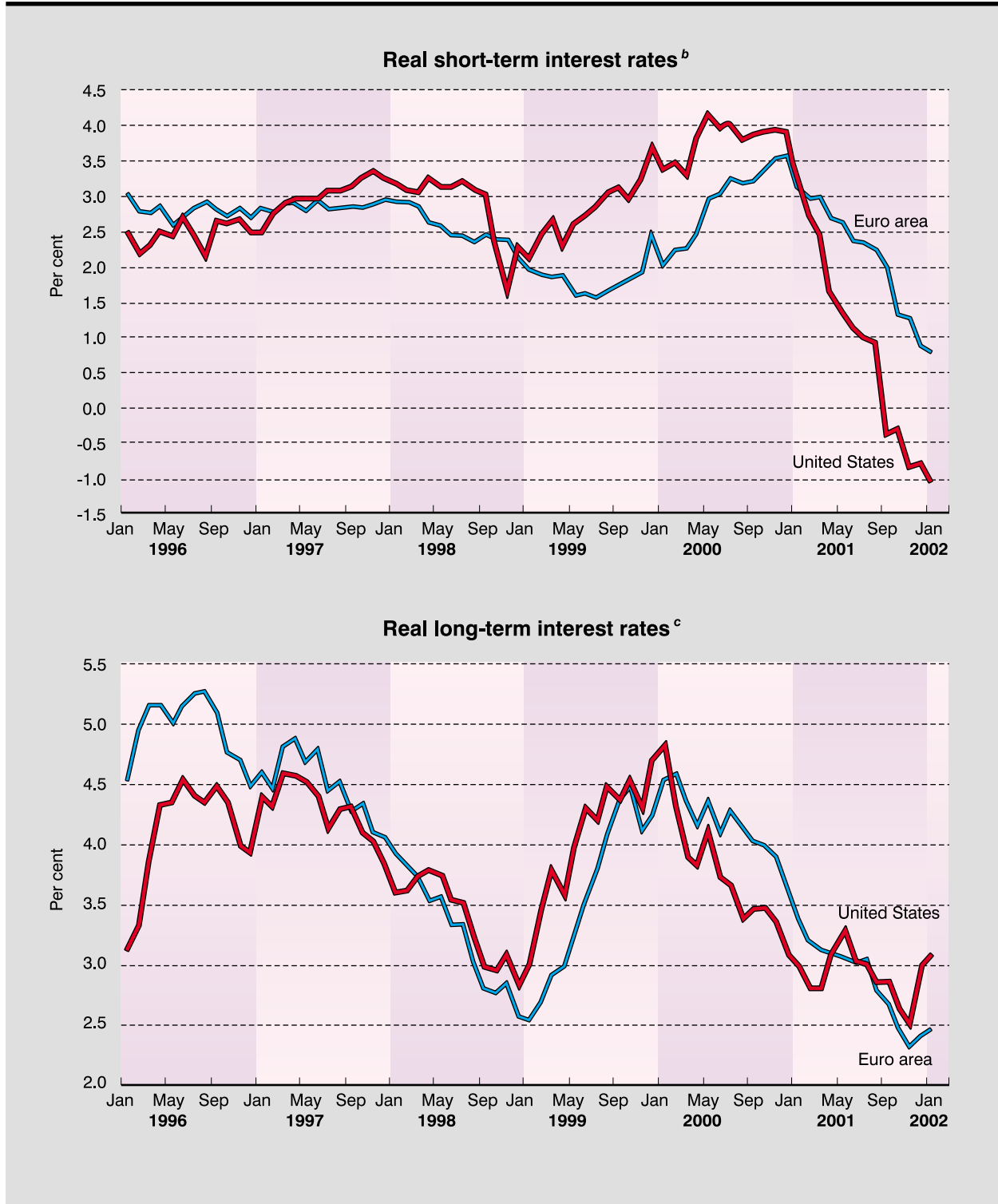
recession proves to be short-lived. The growth of real private consumption, at an annualized rate of 5 per cent in the last quarter of 2001, was similar to what was achieved during the boom, but the pace seems unsustainable in the face of existing macroeconomic trends and levels of household debt. A sustained recovery has to be compatible with a return of private households to normal spending habits. With real wages growing barely more than 2 per cent in 2002 and employment growth still subdued, the implied rise in the savings rate may deliver a growth of real private consumption of as little as 1 per cent per annum, and an acceleration to the rates achieved in the second half of the 1990s is not on the cards in the near future.

Moreover, investment expenditure is likely to be held down, for some time to come, by the effects of overinvestment in certain sectors and by imbalances in firms' balance sheets due to financial decisions taken and distortions in the values of assets and liabilities during the speculative boom of the 1990s. Lastly, the United States economy is suffering from an overvaluation of the dollar on most measures and a concomitant deficit in its current account. The economic slowdown relative to some of its trading partners has not led to the expected correction of imbalance. Imports, which were falling in 2001, are likely to recover in 2002, and the competitive position of United States producers can be expected to weaken further. The deviation of the dollar from its purchasing power parity rate is now comparable to that in the 1980s, when it led to the Plaza Accord. If the dollar remains strong at a time of continuing slow growth in Europe and stagnation in Japan, the current-account deficit of the United States is likely to widen. The consequent risk of a large eventual devaluation of the dollar might usher in a period of currency instability, which would present serious problems for macroeconomic management and could become a source of financial instability throughout the world economy.

United States monetary policy has played a major role in sustaining economic activity. Criticized for the timing of its last interest rate increase in autumn 2000, the Federal Reserve demonstrated, during the first half of 2001, its ability and willingness to act aggressively to avoid an extended phase of weak growth and rising unem-

Chart 1.2

**REAL SHORT- AND LONG-TERM INTEREST RATES IN THE EURO AREA  
AND THE UNITED STATES,<sup>a</sup> 1996–2002**



**Source:** UNCTAD secretariat calculations, based on Thomson Financial Datastream.

**a** Deflated by the core consumer price index.

**b** United States: Federal Funds middle rate. Euro area: one month euro offered rate (Datastream synthetic).

**c** United States: 10-year Treasury bond yields. Euro area: 10-year benchmark government bond yields.

ployment. With the headline inflation rate at 3 per cent but underlying inflationary dangers low, the policy rate was cut five times during the first half of 2001, and further cuts were made after 11 September. With money market rates lower than headline inflation, the real short-term interest rate is negative. However, long-term bond yields have not always followed the path of short-term interest rates, and in early 2002 they were much the same as a year before. This steepened the yield curve over the year, as markets appeared to discount an early recovery and the possible impact of the swing in the government budget on inflation. Nonetheless, throughout most of 2001 the nominal yield on the 10-year Treasury bond was less than the comparable European rate, although medium-term inflation forecasts for the rate and for growth rates were higher for the United States. Deflated by the core consumer price index, the real long-term interest rate in the United States stood at about 2.5 per cent in mid-2001, down from 4.5 per cent in early 2000 (chart 1.2).

However, the power of monetary policy to push the economy back onto a path of sustained growth may prove limited. Once the inventory drag has come to an end and firms start building up stocks in expectation of a cyclical recovery, the turning point will materialize, but the improvement in activity may not last. Indeed, those who hold a more pessimistic view of the implications of the recent United States performance for global recovery base it on the uneven recovery from the 1990–1991 recession that was characterized by a “double-dip” or even “triple-dip”. However, at that time the economy was emerging from a debt deflation process led by corporate investment, designed to restore productivity levels by downsizing, and resulting in what was called a “jobless” recovery (*TDR 1992*, Part Two, chap. II). The increase in investment was not supported by increased consumer demand, as households, faced with weak prospects for employment and income growth, continued to rebuild their balance sheets instead of spending, so that recovery faltered a number of times before sustained recovery took hold.

The present context is just the opposite: the consumer is taking the lead, even in conditions of falling employment, and it is the business sector that is failing to support this process with increased investment, because of low profitability, excess

capacity, the need to rebuild balance sheets, and funding difficulties. Despite record low interest rates, some small and medium-sized firms have indicated that they are subject to credit rationing, and banks’ commercial and industrial loan books have been shrinking, as accounting scandals have placed a premium on credit quality. Thus, if consumer demand slows down before business spending picks up, the recovery may falter. However, it is also possible that the swing in the Government’s fiscal position will provide a massive stimulus in the course of the year, which could turn the economy around and allow for a sustained, albeit modest, recovery.

## **2. Slow and erratic growth in the European Union**

The economic downturn started in the Euro area shortly after that in the United States (chart 1.1), and the pattern of this slowdown has been similar: investment and exports declined, followed by a fall in consumption. However, investment did not shrink as much as it had in the United States, where there had been an unprecedented boom in fixed capital formation during the 1990s. With faltering export demand and rising interest rates, economic growth in continental European Union (EU) countries has proved to be less robust than Governments had expected only two years ago. Growth in the Euro area stagnated in the course of 2001 and was set to remain at about 1.4 per cent for the year as a whole. Thus the rate of growth in 2001 did not differ much from that in the United States, and fell significantly from the 3.5 per cent reached in 2000. Within the EU, the United Kingdom, despite an overvalued currency and manufacturing recession, has been the only large economy to decouple from the region’s trend, as domestic demand has remained strong.

With economic slowdown, unemployment in Europe levelled off at some 8.5 per cent in 2001, after dropping from a peak of 11.5 per cent reached in 1997. The prospects are once again unfavourable, particularly in the bigger economies. Despite the emphasis on structural rigidities in discussions on unemployment in Europe, the cyclical nature of the European labour market has in fact been



quite similar to that of the United States, growth differentials explaining much of the divergences between the performance of the two areas.

The strongly negative impact of the fall in global demand on European development contrasts considerably with expectations. At the beginning of 2001, Europe seemed to be well placed to decouple from the United States. As pointed out in *TDR 2001*, investment should have been less influenced by rising yields in capital markets, consumers should have been less constrained by declining equity prices in view of the lower share of equity in wealth, and tax cuts in the most important countries should have stimulated private domestic demand. However, these positive factors had a weaker impact than expected, and other factors worked in the opposite direction.

One such factor was the oil price hike, which hit consumer spending just when the tax cuts had been expected to raise disposable income. The fall in demand resulting from this shock, however, was much smaller than the loss of real income, because many countries benefited from additional demand on the part of the oil-exporting countries. German exports to members of the Organization of the Petroleum Exporting Countries (OPEC), for example, surged by 50 per cent between the first quarter of 1999 and the second quarter of 2001.

More importantly, fiscal policy was designed to prevent any impact of tax cuts on budget deficits, so that public expenditure was reduced proportionately, thus offsetting the positive effects of the cuts on aggregate demand. The Stability and Growth Pact has forced governments to pursue deficit targets with insufficient regard to their cyclical positions. Discretionary fiscal action to stabilize the economy, such as advancing the introduction of tax cuts, was ruled out by the European Commission and the European Council with respect to Germany, owing to its weak fiscal position. Even the question of whether automatic stabilizers should be allowed to work seems to be unresolved within the Euro area. Europe's inability to bolster global demand in face of the United States slowdown and its undue reliance on exports thus appear to be, in part, the result of frictions in the coordination process of policy-making in the Euro area.

There are several other reasons why Europe has been much more affected by the slowdown in the United States than was generally expected. First, the relatively low share of trade in Europe's GDP (17 per cent) does not fully reflect its exposure to the world economy. As pointed out in *TDR 2001*, for European transnational corporations (TNCs) the share of sales by their affiliates in the United States grew significantly in the 1990s, so that lower sales in the United States now have a direct impact on their profitability. Second, private consumption in the larger European economies has remained flat as employment growth has stalled and wage agreements in the second half of the 1990s have resulted in extremely moderate increases in the largest countries. In the five years up to 2000, total domestic demand grew by nearly 5 per cent per annum in the United States but by only half that rate in the Euro area. The growth rate of nominal compensation per employee in the Euro area was below 2 per cent between 1996 and 2001, and real compensation barely grew. Thus, the income expectations of households in many EU countries have been understandably subdued, thereby restricting consumer demand and growth (box 1.1).

With core inflation and unit labour costs low, and second-round effects on wages from the oil price increase absent, European monetary policy could have acted vigorously to counter the negative demand spillovers from global markets. This was a classical case of a non-idiosyncratic, common external shock for the members of the Euro area, requiring a common monetary policy response to stabilize the economy without violating the inflation target. However, the ECB was reluctant to cut policy rates as aggressively as the Federal Reserve had done in the United States. It had followed the Federal Reserve in the two years up to the beginning of 2001, raising the interest rate in seven steps from 2.5 per cent to 4.5 per cent. Its monetary policy stance was considered to be neutral since high interest rates were associated with a weakening of the euro. However, while the weak euro helped maintain the pace of activity in the Euro area by attracting foreign demand, from a global perspective the European monetary policy was restrictive, as it prevented the region from adding to global demand. Furthermore, while the policy of the Federal Reserve was directed towards slowing down an overheated domestic

economy with full employment, the recovery in Europe had just begun from conditions of low employment and relatively slow growth. Again, the Federal Reserve reacted promptly with cuts in its short-term interest rates in several big steps to attain a historically very low level, with falls that more or less mirrored the decline in industrial production. The ECB, by contrast, responded late and in a way not so clearly linked to conditions in the real economy (chart 1.3).

To a significant extent as a result of these policy divergences, the European objective to eventually outstrip the United States in terms of growth and employment has not been met. Moreover, the absence of dynamic growth and investment at the beginning of the recovery entails the risk of further increases in long-term unemployment. With low demand for labour, a growing number of people without jobs will find it increasingly difficult to reintegrate the job market.

The outlook for the Euro area as a whole is still uncertain. Investment in machinery and equipment is unlikely to grow rapidly. Loans to the private sector continue to be on a downward trend despite the monetary relaxation, which is indicative of a lack of confidence on the part of investors and consumers. Private consumption remains flat owing to slow growth in wages and stagnant employment. In the absence of an economic revival based on internal sources, the Euro area appears to be awaiting a positive demand impulse from the United States. However, even if the United States economy recovers vigorously, the short-term spillovers for Europe are likely to be limited.

Recent economic performance and policy in the United Kingdom resemble more closely those of the United States than those of the Euro area. After a boom that lasted for almost as long as that in the United States, with substantial improvements in employment, the economic slowdown has been limited. Unemployment is still falling and inflation is low after discounting the one-off effects of the rise in oil prices and soaring house prices. Nevertheless, the monetary authorities cut official interest rates in four steps, from 6 per cent at the end of 2000 to 4.5 per cent in October 2001. The strong pound adversely affected the manufacturing sector, and led to a “twin-speed economy” where falling exports were accompanied by

strong domestic consumer demand. The latter was driven by rising real wages, a low savings rate in the last phase of the boom, and lending supported by the boom in housing property. So long as the consumer boom continues, there is little danger that the manufacturing recession will tip the economy into an overall recession in 2002. In the medium term, however, the dynamism of consumer expenditure is vulnerable for reasons similar to those applying to the United States, in particular because of its dependence on buoyant house prices.

### **3. *Recession in Japan***

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Japan is the only large economy to have experienced three fully-fledged recessions since the beginning of the 1990s (chart 1.1). Restrictive monetary policy at the end of the period of the “bubble economy” in 1991 resulted in the first big setback; a huge real appreciation of the yen and the Asian financial crisis were associated with the second deep and long recession in 1997/1998. The recovery in 1999 and in the first half of 2000 was short-lived: since the second quarter of 2001, Japan has been back in deep recession and the short-term outlook is bleak. Employment has been falling and unemployment has edged up to 5.5 per cent, a rate far beyond the politically acceptable level of a few years ago. Persistent deflationary tendencies were highlighted by another fall in wholesale and consumer prices in 2001, following their temporary stability in 2000.

The Japanese central bank returned to its zero-interest-rate policy in March 2001 and injected more liquidity into the financial markets in face of the accelerating downswing of the real economy and worsening balance sheets of companies and banks. The number of bankruptcies increased in 2001, and companies were reporting record losses. The banking system faced further deterioration in the quality of its assets, stemming from problems arising at major firms owing to recession and deflation. However, it is increasingly recognized that the weakness of the financial sector is as much a symptom as a cause of the weakness of the real economy.

**Box 1.1****WAGES, CONSUMPTION AND GROWTH**

Examination of the path of nominal and real wages, real consumption, and real growth in major industrialized countries since 1995 points to a close relationship between wage and GDP growth (charts a–c). The countries with the smallest increases in nominal wages per head also recorded the smallest increases in real wages. In Japan, real wages rose at an annual average rate of only 0.7 per cent, and in Germany – the country with the weakest growth performance in Europe – real wages did not rise at all. In the United States and the United Kingdom, on the other hand, nominal and real compensation per employee have been rising more strongly, with an annual average for real wages of more than 2 per cent since 1995 in the United States and 2.5 per cent in the United Kingdom. France has taken a middle position, with real wages growing at an average rate of 1 per cent.

The countries with the most vigorous growth in real wages have also experienced sharp falls in household savings ratios (chart d). In the United States this ratio began to fall at the end of the recession in the early 1990s, and the decline accelerated after the Asian crisis. In the United Kingdom, the savings ratio fell from nearly 10 per cent in the early 1990s to around 8 per cent in 1998 and only around 4 per cent in 2001. In Germany the savings ratio declined from 14 per cent to 10 per cent between 1990 and 1997 and remained at that level thereafter. Only in Japan, did the ratio of savings to disposable income follow an upward trend in the 1990s, rising from 12 per cent to 15 per cent after the Asian financial crisis.

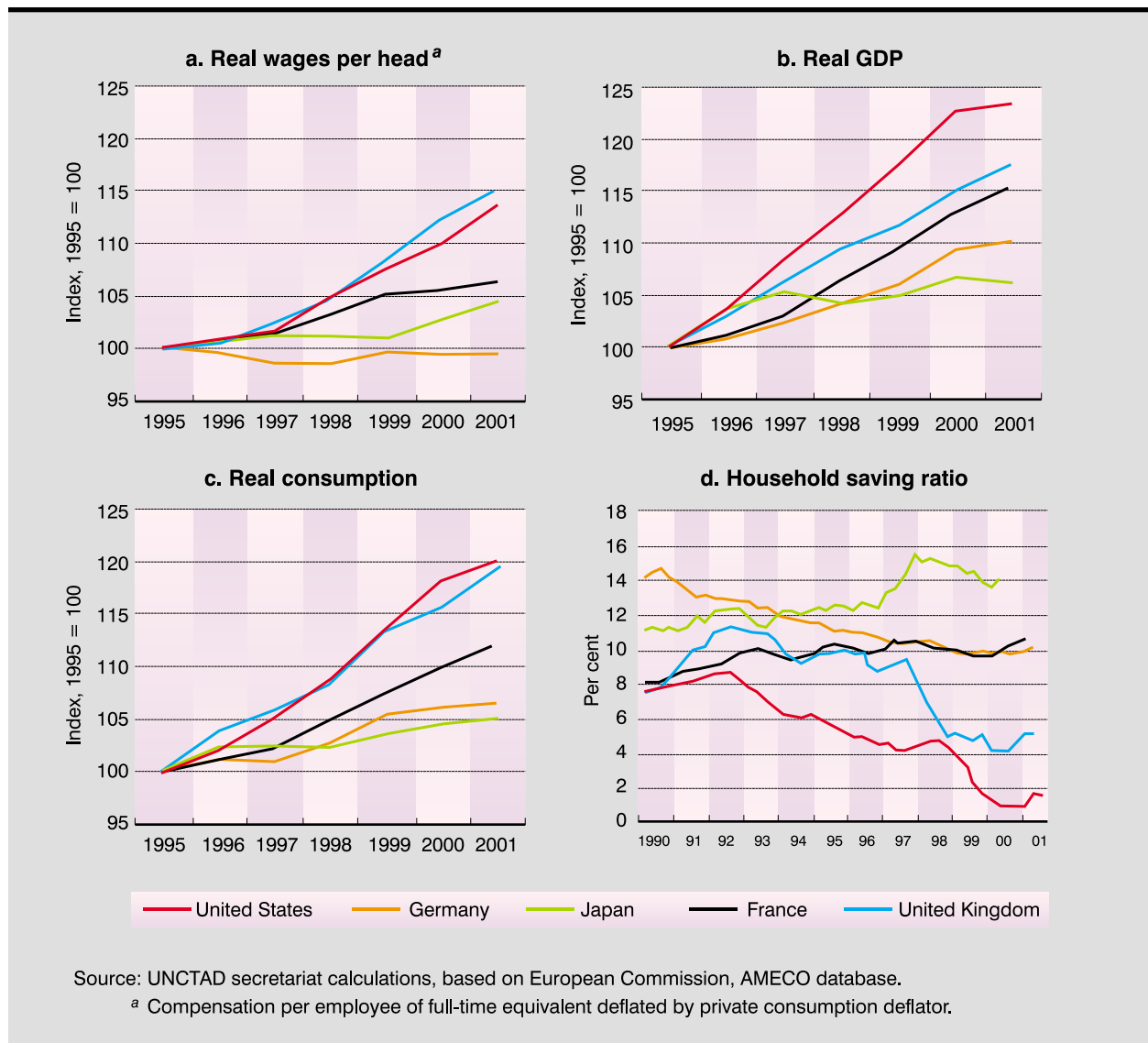
Declining savings ratios have significantly contributed to GDP growth in the United States and the United Kingdom. However, in the future these countries cannot rely on a further reduction in the households savings ratio for domestic demand growth. The decline must eventually reach a floor, and household borrowing is limited by the quantity and quality of collateral available to households, such as financial assets and residential property. Such limits highlight the case for macroeconomic policies and real wage increases in line with productivity growth in the industrial world directed at achieving a more balanced pattern of GDP growth among its major economic areas than that experienced since the mid-1990s.

Japan was adversely affected by the slowdown in the United States just when it expected to escape the deflation in which it had been trapped for so long. With a relatively strong yen at the end of 2000, collapsing world markets for technology products and falling exports, Japanese companies faced a difficult environment once again. The rebound of non-residential investment, the main source of hope in 1999 and 2000, has faltered. Orders for machinery and equipment dropped sharply in 2001. Overall growth fell, with all components of aggregate demand shrinking. Exports and private investment have been declin-

ing at double-digit rates. Since both the corporate and the public sector had been under severe financing constraints, it had been hoped that rising private consumption would lead to recovery, but that was not so.

The leading indicators point to difficulties for a quick turnaround. In the absence of short-term policy instruments the Japanese economy depends, to a very large extent, on world economic developments and a depreciation of the yen/dollar exchange rate. Indeed, the Government and the central bank seem to have been leaning towards

## Box 1.1 (concluded)



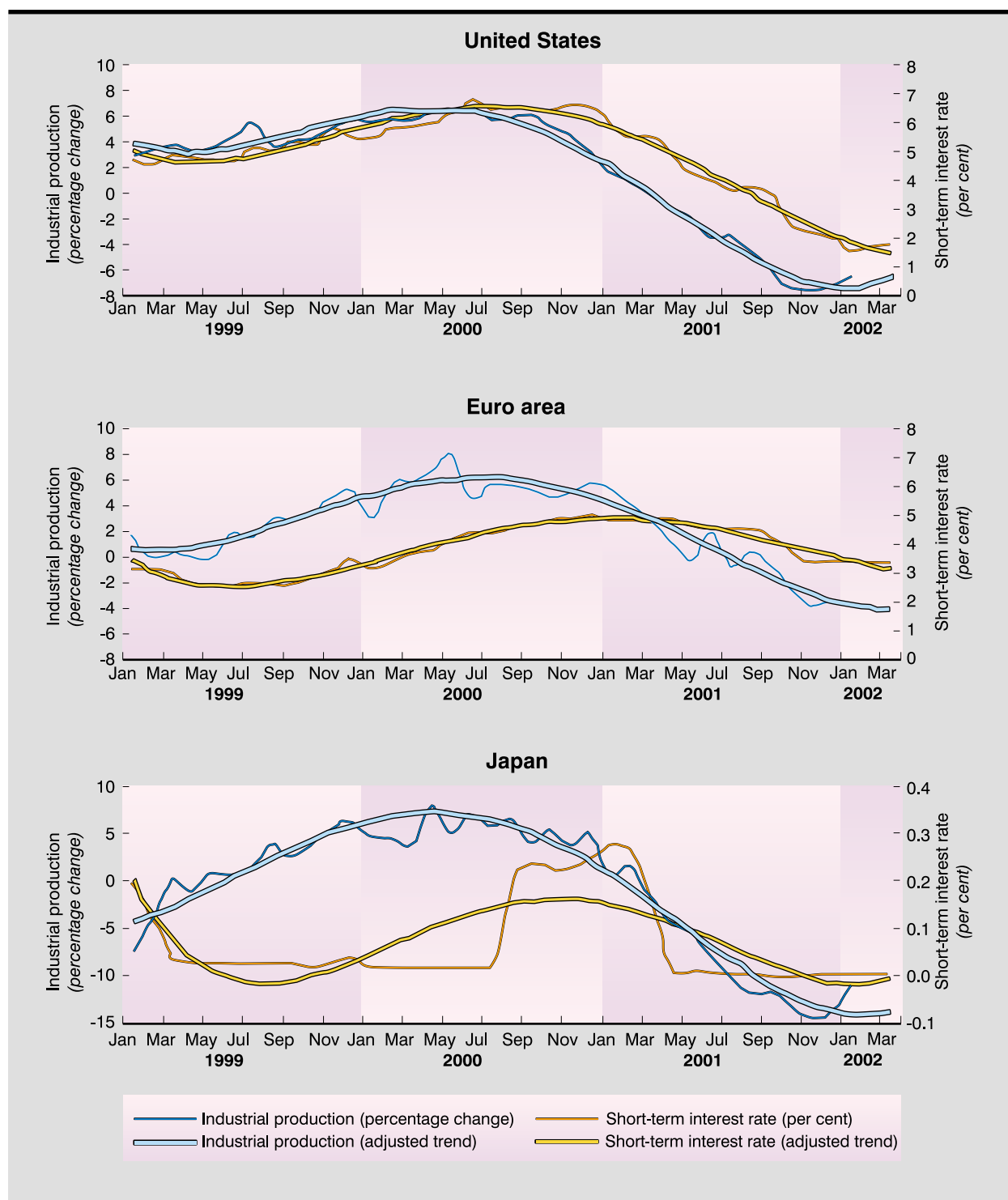
the policy of a weak yen. If there should be a quick recovery of domestic demand in the United States and Europe, a lower dollar/yen rate might help Japan to avoid a sharp recession, but the effects on its competitors in East Asia could be destabilizing. And there is the possibility of other countries of the region responding by depreciating their own currencies.

The stabilization of the Japanese economy and its return to a non-deflationary growth path depend crucially on a recovery of household spending. Until sustained recovery is achieved, this may

require some alteration of the Japanese system of employee compensation, which is based on links to levels of enterprise profits. In normal economic conditions this system has the advantage of providing firms with flexibility regarding their costs, but during a severe recession it tends to add to downward pressures on demand. Japan is the only OECD country where, according to data from the Bank of Japan, even the nominal earnings of employees have been shrinking for a number of years, due to the system of profit-related earnings (such as bonuses). Such earnings fell sharply in 1998 and 1999, recovered slightly in 2000, and have dropped

Chart 1.3

**MONETARY RESPONSE TO ECONOMIC SLOWDOWN: GROWTH OF INDUSTRIAL PRODUCTION AND SHORT-TERM INTEREST RATES IN THE UNITED STATES, THE EURO AREA AND JAPAN, JANUARY 1999 TO MARCH 2002**



**Source:** UNCTAD secretariat calculations, based on Thomson Financial Datastream.

**Note:** Short-term interest rates are: Federal Funds middle rate for the United States, one-month euro offered rate for the Euro area, and overnight middle rate for Japan. Growth of industrial production refers to percentage change over the same month in the previous year.

again since the beginning of 2001. As the number of employees has also been falling, total employee compensation has been shrinking since 1997.

As a result, private consumption expenditure has been largely flat since 1995 (box 1.1). Although falling prices are capable of increasing real earnings despite the drop in nominal wages, expectations of further falls, combined with economic insecurity, can lead to a wait-and-see attitude among consumers. This can have a dampening effect on profits and bonuses, thereby

provoking a vicious circle of falling prices, falling profits, falling wages and still further falling prices. At the same time, the government budget in Japan is not sensitive to overall macroeconomic performance, owing to a relatively low tax ratio and the ineffectiveness of automatic stabilizers on the spending side, such as unemployment benefits. Consequently, the task of stabilization is left largely to monetary policy. But in the present deflationary situation, there is little scope left for action on this front, thus leaving recovery in Japan dependent on external demand.

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### **C. International trade, financial flows and developing countries**

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The slowdown in the United States economy has affected the growth performance of many developing countries through a sharp reduction in their export earnings. Overall, GDP growth in the developing countries (excluding China) fell from close to 5 per cent in 2000 to little more than 1 per cent in 2001 (table 1.2), mainly due to a sharp deceleration in most of Latin America and Asia. China was less affected, maintaining a growth rate above 7 per cent. Elsewhere in Asia, only the Indian economy maintained the rate of the preceding year; in Latin America the exception was Ecuador. Growth performance in Africa remained unchanged in 2001, but was again insufficient to achieve per capita income growth for the region as a whole.

In international capital markets there has been an increase in risk premiums and less willingness by investors to lend to developing countries at a time when their external financing needs to meet rising current-account deficits have been growing. Even before the introduction, following the September events, of more stringent and transpar-

ent reporting on financial transactions to fight illicit financial flows, capital flows to emerging markets in 2001 were forecast to fall to levels not seen since the early 1990s. This decline has been accompanied by considerably higher borrowing costs for several countries and the exclusion of others from international capital markets.

Despite the apparent stabilization of the global economy by the end of 2001, risks due to contagion and negative spillovers persist. During the global liquidity crisis, following the Russian default in 1998, falling commodity prices and the flight of capital to safe havens helped to stabilize expenditure in the United States and elsewhere in the industrialized world. However, the major negative macroeconomic shock in 2001 came from the industrialized world itself, particularly from slower growth in the United States, and there have been few favourable feedback effects.

Thus developing countries did not benefit from inflows of capital seeking alternative destinations or higher returns as the prospects for

Table 1.2

## OUTPUT GROWTH IN SELECTED DEVELOPING AND TRANSITION ECONOMIES, 1997–2002

(Percentage change over previous year)

Region/economy	1997	1998	1999	2000	2001	2002 forecast		
						1990–2000 average	Economist Intelligence Unit	IMF
Developing economies	5.3	1.1	3.4	5.4	2.1	4.3	.	4.4
Developing economies, excluding China	4.7	-0.0	2.7	4.9	1.1	3.6	.	.
Latin America	5.2	1.8	-0.2	3.9	0.4	2.9	.	1.7
of which:								
Argentina	8.1	3.9	-3.2	-0.5	-3.8	4.7	-8.4	-1.1
Brazil	3.2	-0.1	0.8	4.5	1.7	2.2	2.5	2.0
Chile	7.4	3.4	-1.1	5.4	3.1	6.0	2.2	3.0
Colombia	3.4	0.5	-4.3	2.8	1.5	2.4	2.0	2.4
Ecuador	3.4	0.4	-7.3	2.3	5.2	1.5	4.1	3.8
Mexico	6.8	4.9	3.5	6.9	-0.3	2.8	1.4	1.2
Peru	6.7	-0.4	1.4	3.6	0.1	3.7	3.0	3.7
Uruguay	4.9	4.6	-3.2	-1.1	-2.3	3.1	-2.5	.
Venezuela	6.4	-0.1	-7.2	3.2	2.7	1.5	-1.5	1.8
Africa	3.0	3.2	2.6	2.7	2.7	2.2	.	3.5
of which:								
Algeria	1.1	5.1	3.3	2.4	3.0	1.4	2.8	3.4
Cameroon	5.1	5.0	4.4	4.2	5.5	1.0	4.8	.
Côte d'Ivoire	6.6	4.5	2.8	-2.6	-0.9	2.9	3.0	.
Egypt	5.5	5.6	6.0	3.2	2.5	3.9	0.8	3.3
Ghana	4.2	4.7	4.4	3.7	3.9	3.9	4.3	4.0
Kenya	2.1	1.6	1.3	-0.3	1.3	1.7	1.4	1.4
Morocco	-2.2	6.8	-0.7	-1.2	5.0	2.0	3.0	4.4
Nigeria	2.7	1.8	1.0	3.8	3.0	2.2	3.1	1.8
South Africa	2.5	0.6	1.2	3.4	2.1	1.3	2.3	2.3
Tunisia	5.4	4.8	6.2	4.7	4.0	4.3	4.0	5.3
Zimbabwe	2.8	3.7	0.1	-4.2	-7.5	2.3	-5.0	.
Asia, excluding China	4.7	-1.7	4.6	5.8	1.2	4.4	.	.
Asia	5.6	0.6	5.3	6.4	2.8	5.4	.	5.6
of which:								
China	8.8	7.8	7.1	8.0	7.3	9.3	7.3	6.8
Hong Kong (China)	5.0	-5.1	2.9	10.5	0.2	3.3	1.7	1.0
India	4.6	6.8	6.5	5.2	5.4	5.0	5.5	5.2
Indonesia	4.7	-13.0	0.3	4.8	3.0	3.7	3.7	3.5
Iran, Islamic Republic of	3.4	2.2	2.5	6.1	4.1	3.6	3.6	4.8
Israel	3.2	2.6	2.2	6.4	-0.5	4.6	1.1	1.7
Malaysia	7.3	-7.4	5.8	8.3	0.1	6.2	2.7	2.5
Pakistan	1.0	2.5	4.0	4.4	3.3	3.5	3.3	4.4
Philippines	5.2	-0.8	3.2	4.0	3.4	2.4	2.5	3.2
Republic of Korea	5.0	-6.7	10.7	4.8	2.7	5.2	3.5	3.2
Saudi Arabia	2.7	1.6	0.4	4.5	1.7	1.9	0.3	1.6
Singapore	8.2	0.4	5.3	9.9	-2.2	6.7	1.3	1.2
Taiwan Province of China	6.8	4.7	5.7	5.9	-2.2	5.5	1.7	0.7
Thailand	-1.7	-10.2	4.2	4.4	1.5	3.9	2.0	2.0
Turkey	7.5	3.1	-5.1	7.2	-8.2	2.8	2.1	4.1
Transition economies	1.9	-0.9	2.7	6.0	4.3	-3.0	.	3.6
of which:								
Belarus	10.4	8.3	3.4	5.8	3.5	-1.9	2.0	1.5
Bulgaria	-7.0	3.5	2.4	5.8	4.5	-2.5	3.4	3.8
Croatia	6.8	2.5	-0.4	2.9	3.5	-1.8	3.0	.
Czech Republic	-1.0	-2.2	-0.2	2.9	3.5	-0.4	3.7	3.1
Hungary	4.6	4.9	4.5	5.2	3.4	0.3	3.6	3.5
Kazakhstan	1.7	-1.9	1.7	9.8	13.0	-5.0	6.3	7.0
Poland	6.8	4.8	4.1	4.0	1.3	3.3	1.6	2.2
Romania	-6.6	-4.9	-3.2	1.6	4.5	-2.2	3.5	4.6
Russian Federation	0.9	-4.9	3.2	8.3	5.5	-5.1	3.5	3.6
Slovakia	6.2	4.1	1.9	2.2	3.0	0.3	3.4	3.1
Slovenia	4.6	3.8	5.2	4.6	3.3	1.4	3.2	3.0
Ukraine	-3.0	-1.9	-0.4	5.8	7.3	-8.6	4.5	5.0
Uzbekistan	2.5	4.4	4.4	4.0	4.5	-0.8	2.5	.

Source: World Bank, *World Development Indicators* (various issues); EIU, Country forecasts (various issues); IMF, *World Economic Outlook* (December 2001); and national sources.

profits in financial markets in industrial countries deteriorated. Furthermore, the lower incomes due to the slowdown in exports and falling petroleum prices reduced fiscal receipts for many developing countries, and by cutting expenditures to keep their budgets in balance they further aggravated the downturn in economic activity. Finally, substantial declines in inflation rates and, indeed, the absolute levels of consumer prices, in a large number of developed and developing economies, such as Argentina, China, Hong Kong (China), Japan, Republic of Korea, Singapore and Taiwan Province of China, in conditions of excess production capacity and excess supplies, have tended to limit corporate profitability and have reduced the likelihood of a return to high investment rates. Although declining inflation paved the way for more aggressive anti-cyclical policy, most developing countries had little scope for autonomous action because of balance-of-payments constraints. However, some Asian countries loosened their fiscal stance and continued to pursue interest rate reductions designed to support domestic spending. Consequently, their cyclical growth performance was markedly better at the end of 2001 than that of the rest of the world.

### **1. Trade flows and balances**

The slowdown of global growth during 2001 was accompanied by an even more marked deceleration of growth of international trade (table 1.3). According to preliminary estimates, after expanding by about 14 per cent in 2000, export volumes from developing countries rose by less than 1 per cent in 2001. This slowdown affected almost all major regions. The economic impact of these declines was reinforced by downward pressure on export prices, leading to a pronounced deterioration, by an estimated 3 per cent, in the terms of trade of developing countries in 2001. In Latin America, this was due to falling prices of primary commodities, which bulk large in the exports of many countries in the region. In Asia, the worst affected was the information technology (IT) sector, involving products such as semiconductors and consumer electronics. Despite the increasing optimism that the downturn in the developed economies outside Japan would be reversed in

early 2002, growth in the volume of world trade is expected to recover to only about 2 per cent in 2002 from the 1 per cent for 2001 (IMF, December 2001, table 1.1).

Developing countries are particularly vulnerable to this sharp slowdown in the growth of world trade. With the value of exports falling more rapidly than that of imports, the current-account surplus attained in 2000 by developing countries as a whole almost disappeared in 2001. Latin American earnings on exports of goods and services are estimated to have fallen by 3.4 per cent, while imports fell by 1.5 per cent. The projected continued weakness in import and export values for 2002 suggests that there is little prospect to increase their earnings from trade. Although many Asian economies continued to show surpluses, supported by improvements in their export markets at the end of the year, for all Asian developing countries taken together the current-account surplus was sharply down in 2001, and is forecast to fall further in 2002.

The changing patterns of trade in the 1990s and the growing role of the United States as a market for developing countries has meant that the shrinking economic activity in that country had a more rapid and direct impact on developing countries. A significant share of the exports of several Latin American countries went to the United States in 1998: for Mexico, it represented over 85 per cent, for the Andean Community over 40 per cent, for Central America over 36 per cent and for the Southern Common Market (MERCOSUR) over 15 per cent. Exports to the United States were equivalent to over 25 per cent of GDP in the Dominican Republic and Mexico, and more than 10 per cent in Costa Rica, Ecuador and Venezuela. Rates of growth of Mexican exports to the United States, which had been above 25 per cent per annum until the end of 2000, turned negative by February 2001, and the rates declined even further for Central America and South America over the same period (ECLAC, 2001, tables 4.1 and 6).

Intraregional trade also contributed to the worsening of the export performance of developing countries. For example, trade within the western hemisphere declined by about twice as much as trade with countries outside the area, on ac-



Table 1.3

## EXPORT AND IMPORT VOLUMES, BY REGION AND ECONOMIC GROUPING, 2000 AND 2001

(Percentage change over previous year)

Region/economy	Export volume		Import volume	
	2000	2001	2000	2001
World	11.5	0.8	11.3	0.9
Developed economies	10.3	0.4	9.1	0.3
of which:				
Japan	9.4	-5.0	10.9	0.3
United States	9.5	-3.0	13.4	-1.8
European Union <sup>a</sup>	11.6	2.8	10.6	2.7
Transition economies	16.1	8.4	15.0	11.3
Developing economies	13.7	0.5	16.8	0.8
of which:				
Africa	7.3	2.5	7.5	4.6
Latin America	11.0	2.5	14.0	3.0
West Asia	-19.9	-4.0	20.2	0.3
East and South Asia	21.5	0.3	18.3	-0.4
China	31.0	5.0	31.0	11.3

**Source:** UNCTAD secretariat calculations, based on UN/DESA, *World Economic Situation and Prospects 2002*; EIU, Country forecasts (various issues); JP Morgan, *World Financial Markets*, Fourth Quarterly Report (2001a).

<sup>a</sup> Including intra-EU trade.

count of the continuing recession in Argentina within MERCOSUR and the impact of the United States recession on trade within the North American Free Trade Area (NAFTA). While intra-regional trade in NAFTA fell by 5 per cent, its trade with the rest of the world fell by only 2 per cent in the first three quarters of 2001. However, trade in the Andean Community and in Central America did not follow this trend, and this, in part, explains their above-average growth performance (IADB, 2001).

In Asia, where recovery after the 1997 financial crisis was driven by exports, owing to the rapid expansion of investment in the IT sector, the fall in United States demand led to stagnation in export growth, a rapid deterioration of current-account positions and declining growth rates in early 2001 in all countries except India and China.

Just as in the run-up to the Asian crisis, the precipitous fall in the prices of semiconductors had a sharply negative impact on the terms of trade, while export volumes to the major developed country markets continued to fall. Annual rates of increase of electronics and semiconductor exports, based on monthly figures, fell by about 30 per cent and 60 per cent, respectively, during the last quarter of 2001. Obviously, some of this was due to the disruptions in air transportation after 11 September. Indeed, by the end of the year prices had stabilized, and there were reports of sharply improved export orders, resulting from the demand to replenish inventories which had been kept at low levels in developed markets throughout 2001.<sup>1</sup>

The adverse impact on the region of the slowdown in the United States has been exacer-

bated by the return of recession in Japan. The Asian Development Bank has estimated that for its members the value of exports fell by 5 per cent in 2001, compared to an increase of over 20 per cent in 2000. Similarly, the value of merchandise imports, which grew by almost 25 per cent in 2000, is estimated to have declined by 3 per cent in 2001. Overall, the aggregate current account balance for the region, in surplus since 1997, is expected to remain positive but to fall as a share of GDP from 3.4 per cent in 2000 to 2.3 per cent in 2001, and to further erode in 2002 as recovery fuels import demand (ADB, 2001).

The decline in merchandise exports was estimated to be more than 15 per cent for Taiwan Province of China, 10 per cent for the Republic of Korea, and about 5 per cent each for Hong Kong (China), Malaysia, Singapore and Thailand. These economies, all with high shares of IT exports to the United States, experienced periods of negative quarter-on-quarter growth even before 11 September, and their largest declines in industrial production occurred in the first half of 2001. Indonesia managed to preserve its current-account surplus owing to only a marginal decline in exports and a sharp contraction in imports.

The September events and the increased security arrangements introduced in international transportation also had a very strong negative impact on the already declining trend in earnings from tourism for many developing countries. In the last four months of 2001 worldwide arrivals dropped by 11 per cent, with substantial decreases in every region. Particularly hard hit among developing regions were South Asia (24 per cent), the Middle East (30 per cent), East Asia and the Pacific (10 per cent), and, in the Caribbean region, the Bahamas and Jamaica (4 per cent). In Latin America, international arrivals dropped nearly 10 per cent in Argentina and Brazil, and 5 per cent in the Dominican Republic, Mexico and Uruguay. In the Middle East, arrivals in Egypt, which account for a quarter of the total for the region, decreased by about 16 per cent for 2001 as a whole. Despite declines in the last quarter, international arrivals to Africa increased by 3 per cent in 2001, with Morocco and Tunisia accounting for most of that gain (WTOR, 2002).

## 2. Commodity prices

The commodity prices of greatest importance to developing countries were especially hard hit by the events of 11 September; most of the major commodity price indices were showing substantial declines in 2001 and remained below the levels of 1997 (table 1.4). While prices are expected to recover during 2002, there seems to be some inconsistency between the reaction to the events of 11 September of financial markets, which have recovered their losses, and commodity markets, which appear to be expecting a more sustained period of depressed demand.

Prices for some food commodities had risen in 2000 from low levels in 1999, but this recovery slowed down in 2001. The prices of tropical beverages fell by more than 20 per cent during the year, with large declines in coffee and tea. The marked improvement in cocoa prices was largely due to temporary supply factors. The performance of various oil seeds was mixed: soybean and sunflower oils maintained their earlier increases, while the prices of copra and coconut oil were down substantially and palm oil by somewhat less by the end of the year. Prices of grains improved, but those of rice continued to decline in 2001. After declines early in the year, sugar prices recovered as weather-related production shortfalls in Australia and Cuba more than offset the unexpectedly rapid recovery of production in Brazil. Agricultural raw materials and minerals, ores and metals were all hard hit by declines in global industrial production, although the metals group was showing signs of recovery by the end of 2001. Copper prices, of particular importance to a number of developing countries, fell by over 10 per cent. Cotton prices also fell by over 20 per cent in 2001, and natural rubber (especially important to India, Indonesia, Malaysia and Thailand) declined by a range of 5 per cent to more than 10 per cent, depending on the producer.

The price of oil over the past two years has displayed a stability and resilience not seen since the first half of the 1980s. It remained between \$24 and \$30 a barrel from the first quarter 2000 to the third quarter 2001. This stability and resil-

Table 1.4

<b>WORLD PRIMARY COMMODITY PRICES, 1997–2001</b>					
<i>(Percentage change over previous year)</i>					
<i>Commodity group</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
<b>All commodities<sup>a</sup></b>	<b>0.0</b>	<b>-13.0</b>	<b>-14.2</b>	<b>1.9</b>	<b>-2.9</b>
<b>Food and tropical beverages</b>	<b>2.8</b>	<b>-14.3</b>	<b>-18.3</b>	<b>1.0</b>	<b>0.0</b>
<i>Tropical beverages</i>	33.3	-17.3	-20.9	-13.2	-22.0
Coffee	54.7	-28.5	-23.2	-18.1	-27.2
Cocoa	11.2	3.7	-32.1	-22.2	22.7
Tea	35.1	4.3	-7.0	6.8	-20.2
<i>Food</i>	-3.5	-13.8	-18.1	5.9	4.0
Sugar	-4.9	-21.2	-30.0	30.5	5.6
Beef	4.0	-7.0	6.1	5.7	10.0
Maize	-25.3	-13.4	-5.5	-1.0	4.2
Wheat	-22.6	-19.9	-10.9	3.5	9.2
Rice	-10.7	1.3	-18.6	-18.1	-15.2
Bananas	4.3	-3.1	-9.9	-2.3	38.8
<b>Vegetable oilseeds and oils</b>	<b>-0.9</b>	<b>7.1</b>	<b>-23.3</b>	<b>-22.8</b>	<b>-8.5</b>
<b>Agricultural raw materials</b>	<b>-10.3</b>	<b>-10.8</b>	<b>-10.3</b>	<b>0.0</b>	<b>-2.9</b>
Hides and skins	-19.8	-22.7	-27.6	73.8	41.1
Cotton	-8.9	-8.3	-22.9	3.5	-20.9
Tobacco	15.6	-5.5	-7.0	-3.3	0.1
Rubber	-28.3	-29.8	-12.6	7.9	-14.1
Tropical logs	-5.5	-1.2	-7.2	-3.1	4.6
<b>Minerals, ores and metals</b>	<b>0.0</b>	<b>-16.0</b>	<b>-1.8</b>	<b>12.0</b>	<b>-9.9</b>
Aluminium	6.2	-15.1	0.3	13.8	-6.8
Phosphate rock	7.9	2.4	4.6	-0.4	-4.5
Iron ore	1.1	2.8	-9.2	2.6	4.5
Tin	-8.4	-1.9	-2.5	0.6	-17.5
Copper	-0.8	-27.3	-4.9	15.3	-13.0
Nickel	-7.6	-33.2	29.8	43.7	-31.2
Tungsten ore	-9.3	-6.4	-9.3	12.1	45.5
Lead	-19.4	-15.3	-5.0	-9.7	4.9
Zinc	28.4	-22.2	5.1	4.8	-21.5
<b>Crude petroleum</b>	<b>-6.0</b>	<b>-31.8</b>	<b>38.7</b>	<b>55.6</b>	<b>-13.3</b>

**Source:** UNCTAD, *Monthly Commodity Price Bulletin* (various issues).

<sup>a</sup> Excluding crude petroleum.

ience have been made possible by two key developments on the supply side of the market: first, unusual discipline and adherence to individual production quotas by OPEC members,<sup>2</sup> and, second, coordination of global oil production cuts between OPEC and other key oil exporters. OPEC

producers continued to adjust their supply with the aim of meeting a price target of \$22–\$28 a barrel for the OPEC basket. In the aftermath of the events of 11 September, oil prices softened, dropping to about \$18 a barrel in November and December, from around \$24 in August. Prices sub-

sequently rose slightly in January and February 2002 as the new supply cuts by OPEC and others took effect.

Global oil supply<sup>3</sup> in 2001 is estimated to have been 77.0 million barrels per day (bpd) or 0.1 million bpd above the 2000 level. OPEC supply fell by 0.7 million bpd, but was replaced by a slightly bigger increase in non-OPEC production. There was a slowing in the growth in world oil demand: following an increase of 0.7 million bpd in 2000, it rose by only 0.1 million bpd – the smallest year-on-year increase in over a decade. This total was accompanied by marked regional variations, with declines in North and Latin America, Japan and Australia, but increases in almost every other region. The slowdown in the growth of world oil consumption led to a rise in inventories, OECD commercial oil stocks rising significantly above the levels of 2000. This increase in stocks is likely to exert downward pressure on prices, particularly in the second quarter of 2002, when seasonal demand for oil is likely to be low. However, the eventual recovery in the world economy and continuing political tensions in the Middle East are expected to support firmer oil prices.

The effects of the declines in the prices of primary commodities were strongly felt in Latin America, where fiscal revenues and export receipts are sensitive to such price movements. In this region most major export commodities experienced substantial price declines, including petroleum (a major item for Colombia, Ecuador, Mexico and Venezuela), copper (a major export for Chile), and coffee (a major export for Brazil), but there was some recovery for orange juice and sugar prices. The unfavourable effects of these price falls were evident in Mexico, where they reinforced the slowdown in GDP growth due to declining exports. The decline in petroleum receipts produced a shortfall in projected government revenue and, despite the introduction of a programme of subsidies for coffee producers designed to offset declines of market prices below costs, cuts in government expenditures have been announced to meet projected fiscal targets. In Colombia export growth was negative, and in Ecuador economic recovery was reversed in the last quarter of 2001 as a result, in large part, of weaknesses in the markets for coffee and petroleum.

But international commodity markets did not affect commodity-exporting countries uniformly in 2001. In Africa, where export earnings are still mainly determined by the behaviour of primary commodity prices, the major benefit has been in the recovery of cocoa prices – which may, however, be short-lived as new supplies come onto the market – and the increase in sorghum prices, driven by its use as a substitute for offal in animal feeds. The Russian Federation avoided stagnation of its exports and economic growth during much of 2001, as a sharp recovery in the country's real effective exchange rate, supported by buoyant export prices, was accompanied by a large current-account surplus. This helped maintain the country's growth rate at about 4 per cent until the last quarter of the year, when growth turned negative.

### **3. Financial markets and capital flows**

Capital flows to developing countries in 2001 remained at low levels, prolonging the downward trend that has persisted since the 1997 Asian financial crisis (table 1.5). The preliminary estimates of net private capital inflows to developing countries, made by the international Monetary Fund (IMF) at various times during the year, have been highly volatile, ranging from negative in the autumn to low but positive later in the year (IMF, October 2001, table 1.2). Estimates for the more restricted group of 29 emerging-market economies covered by the Institute of International Finance (IIF) broadly confirm the most recent IMF estimates.<sup>4</sup> In 2001, Latin America was the largest recipient of inflows, despite a substantial decline in flows to Argentina. Other regions, with the exception of the Middle Eastern countries and Turkey, also received positive inflows.

The rapid deceleration in the United States economy countered by the swift relaxation of monetary policy had been expected to encourage capital flows to emerging markets for reasons similar to those applying in the early 1990s. The decline in interest rates in the United States during 2001 was indeed much more rapid than it had been during the recession of 1990–1991, and the absolute reduction was slightly larger (450 basis points over three years in 1991–1993, compared

Table 1.5

**ESTIMATES OF NET CAPITAL FLOWS TO DEVELOPING AND  
TRANSITION ECONOMIES, 1998–2002**

(Billions of dollars)

Type of flow/region	1998	1999	2000	2001	2002
<i>Estimates of the Institute of International Finance (IIF)</i>					
<b>Net private capital inflows</b>					
Total	141.5	143.2	169.0	115.1	144.2
<i>by category:</i>					
<i>Private creditors</i>					
Commercial banks	-53.6	-48.9	-5.9	-21.8	-3.9
Non-bank private creditors	60.9	28.6	27.6	-10.2	17.5
<i>Equity investment</i>					
Direct equity	120.7	147.7	132.5	148.8	117.1
Portfolio equity	13.4	15.8	14.8	-1.7	13.5
<i>by region:</i>					
Africa/Middle East	6.8	10.3	5.0	7.1	9.3
Asia/Pacific	0.2	29.8	66.9	44.4	53.1
Europe	36.6	34.6	38.9	15.8	30.7
Latin America	97.9	68.4	58.3	47.8	51.1
<b>Memo item:</b>					
Resident lending/other, net <sup>a</sup>					
Total	-143.2	-121.7	-146.1	-87.7	-105.0
Africa/Middle East	0.6	-5.7	-8.3	-4.0	-3.8
Asia/Pacific	-76.4	-59.6	-90.9	-27.0	-50.4
Europe	-25.7	-23.7	-38.4	-33.0	-31.7
Latin America	-41.8	-32.7	-8.5	-23.6	-19.2
<i>Estimates of the International Monetary Fund</i>					
<b>Net private capital flows</b>					
Total	69.6	59.6	8.9	20.1	59.8
Net direct investment	155.4	153.4	146.2	162.4	142.6
Net portfolio investment	-4.2	31.0	-4.3	-13.0	13.7
Other net flows <sup>b</sup>	-81.6	-124.8	-133.0	-129.4	-96.6
Africa	10.0	11.9	7.0	9.5	10.0
Net direct investment	6.9	9.0	7.2	21.4	11.0
Net portfolio investment	3.7	8.7	-1.8	-6.3	4.2
Other net flows <sup>b</sup>	-0.7	-5.8	1.6	-5.8	-5.2
Asia <sup>c</sup>	-53.4	-7.6	-12.2	1.4	-3.1
Net direct investment	59.9	51.9	46.8	43.7	41.7
Net portfolio investment	-15.3	13.8	3.7	-4.7	3.8
Other net flows <sup>b</sup>	-89.4	-74.4	-66.4	-46.0	-50.1
Middle East and Europe	11.8	-1.1	-22.4	-29.2	-0.7
Net direct investment	6.3	5.4	7.2	6.5	8.4
Net portfolio investment	-13.2	-4.2	-15.1	-9.6	-5.2
Other net flows <sup>b</sup>	18.6	-2.3	-14.6	-26.1	-3.8
Western Hemisphere	71.7	43.6	37.9	38.8	39.5
Net direct investment	60.7	63.8	62.5	64.1	50.0
Net portfolio investment	16.5	9.8	4.6	4.0	7.6
Other net flows <sup>b</sup>	-5.5	-30.0	-29.2	-29.3	-18.0
Transition economies	21.0	13.8	2.2	7.6	15.0
Net direct investment	21.6	23.4	22.5	26.7	31.5
Net portfolio investment	4.0	2.8	4.3	3.6	3.5
Other net flows <sup>b</sup>	-4.6	-12.4	-24.7	-22.7	-20.0

**Source:** IIF, *Capital Flows to Emerging Market Economies* (2002); IMF, *World Economic Outlook* (December 2001).

<sup>a</sup> For explanation of this term, see note 4 to the text.

<sup>b</sup> Comprises other long-term net investment flows, including official and private borrowing.

<sup>c</sup> Includes crisis countries, other Asian emerging markets and Hong Kong (China).

with 475 basis points in 2001 alone). However, the interest rate reduction in the early 1990s followed a decade of historically high rates in the United States, and it induced many investors to shift their investments to emerging foreign markets in order to maintain high returns. The attraction of these investments was supported by the rapid rates of economic expansion in Asia and the apparent success of adjustment policies in Argentina and Mexico in the early 1990s, and in Brazil in 1994. Liberalization of financial markets in these countries also increased their attractiveness as investment alternatives. By contrast, the current United States slowdown is occurring after a series of global financial and liquidity crises, including a particularly severe market disruption in 1998 and massive losses in global equity markets in 2000. The increasing uncertainties during 2001 concerning the potential default on Argentina's debt and the threat of contagion to other emerging markets have reinforced investors' aversion to external investments.

Furthermore, as a result of increased global economic integration and the greater role of external trade in the economies of developing countries, the downturn in the United States has had a more rapid negative impact on their growth and export performance than in the past. Thus, in contrast to the situation in the early 1990s, growth in developing countries today is more directly linked to that of the United States and provides little scope for diversification to investors seeking higher risk-adjusted rates of return. As shown in chart 1.4, international investors have been especially wary of Argentina, Turkey and Venezuela: spreads in Argentina rose from levels in the range of 600–800 basis points at the beginning of 2001 to more than 4,000 basis points in early December, and those of Turkey fluctuated throughout this period between about 700 basis points and more than 1,100. Higher risk premiums have also been demanded for countries, such as Brazil, that are considered subject to contagion. On the other hand, Mexico was viewed as protected from spillovers from Argentina, and benefited from increased capital inflows due to its upgrading to investment grade status. By contrast, the spread on Russian bonds decreased sharply from levels of over 1,000 basis points at the beginning of the year; and spreads on bonds for Asian borrowers, many of which suffered from the 1997 financial

crisis, also remained mostly below 250 basis points throughout 2001 as their improved current-account surpluses enabled them to repay bank debt. This suggests that international investors' behaviour increasingly reflects discrimination between the conditions facing different borrowers.<sup>5</sup>

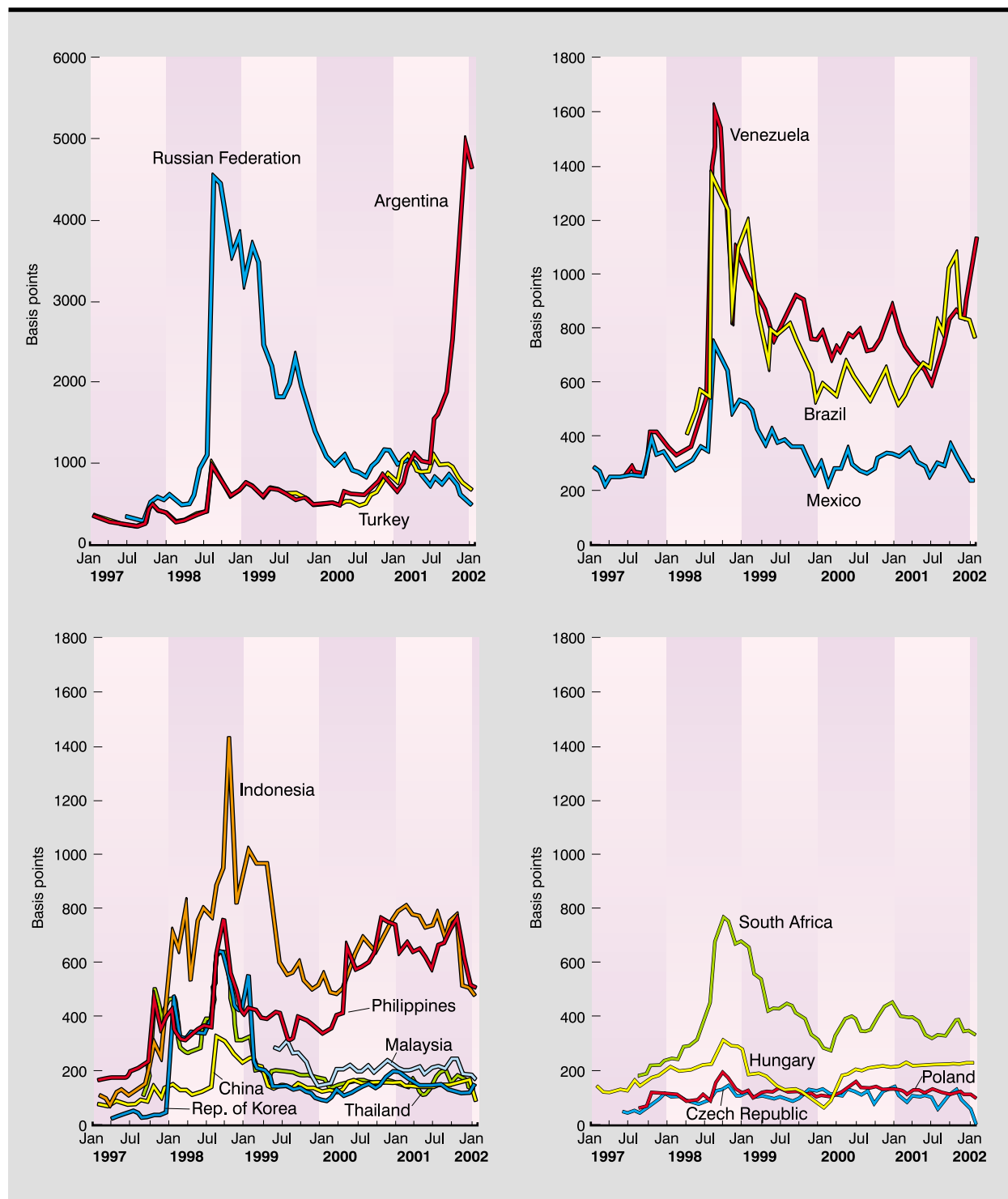
In many Asian countries recovering from the 1997 crisis, large external surpluses have been a source of increased deposits with international banks. Since 1998 repayments to banks by borrowers in all developing countries have exceeded new loans to them, and the total exposure of BIS-reporting banks to such economies is now more than \$200 billion lower than in 1997 (table 1.6). The only region for which the exposure of banks reporting to the Bank for International Settlements (BIS) increased during the first two quarters of 2001 (after allowance for the effects of movements in exchange rates) was Latin America.<sup>6</sup> A large proportion of the sharp fall in the exposure of these banks to West Asia was due to a contraction of \$7.4 billion (or 60 per cent of the total) vis-à-vis Turkey. Net repayments to BIS-reporting banks by borrowers in East and South Asia and in oil-exporting countries in West Asia have been accompanied by a large build-up of deposits by the two regions, which reflects substantial current-account surpluses; they have thus been a substantial net source of funds to the international banking system.

Financing for developing countries in the form of export credits also declined in the first two quarters of 2001. Most of the decrease of \$6.1 billion was due to borrowers in Africa and Eastern Europe.<sup>7</sup> Newly announced international syndicated credit facilities for developing countries, other than those from offshore centres, amounted to about \$45 billion in the first three quarters of 2001, indicating that the figure for the full year will be substantially below the \$94 billion granted in 2000 (BIS, 2001b, table 10). As noted in *TDR 2001*, after the financial crises of the second half of the 1990s the maturity profile of outstanding bank loans was substantially lengthened. This adjustment now appears to have run its course, but there remain variations among developing countries in the average proportion of total exposure with a maturity of up to and including one year: for example, from about 43 per cent for countries in Europe to about 54 per cent

Chart 1.4

### YIELD SPREADS<sup>a</sup> OF SELECTED INTERNATIONALLY ISSUED EMERGING-MARKETS BONDS, JANUARY 1997 TO JANUARY 2002

(Basis points<sup>b</sup>)



Source: UNCTAD secretariat calculations, based on Thomson Financial Datastream.

<sup>a</sup> Differential between the yield on a representative bond issued by the borrowing country and one of the same maturity issued by the government of the country in whose currency the borrower's bonds are denominated.

<sup>b</sup> One basis point equals 0.01 per cent.

Table 1.6

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING <sup>a</sup> AREA VIS-À-VIS DEVELOPING AND EASTERN EUROPEAN COUNTRIES, 1997–2001										
	1997	1998	1999	2000	2001 (1 <sup>st</sup> half)	Stocks				
						1997	1998	1999	2000	end-June 2001
						Percentage rates of increase <sup>b</sup>				
<b>Total<sup>c</sup></b>	<b>8.9</b>	<b>-12.9</b>	<b>-7.7</b>	<b>-1.4</b>	<b>-0.8</b>	<b>1083</b>	<b>943</b>	<b>871</b>	<b>858</b>	<b>852</b>
<i>of which in:</i>										
Latin America	11.6	-3.3	-5.6	5.1	3.8	298	288	272	286	297
Africa <sup>d</sup>	19.6	14.1	-2.7	-8.9	-3.3	70	79	77	70	68
West Asia	25.2	19.1	6.3	10.6	-9.8	89	105	112	124	112
East and South Asia <sup>e</sup>	0.9	-30.2	-17.1	-9.6	-0.8	520	363	300	272	269
Central Asia	34.0	15.7	26.0	-4.5	-4.5	3	3	4	4	3
Eastern Europe <sup>f</sup>	26.9	-0.9	-1.0	-4.4	-0.6	97	96	95	91	91
Other Europe <sup>g</sup>	37.5	12.7	13.9	23.1	-1.4	8	8	10	12	12
<b>All borrowers<sup>h</sup></b>	<b>17.5</b>	<b>2.0</b>	<b>3.2</b>	<b>13.1</b>	<b>6.0</b>	<b>8 642</b>	<b>8 816</b>	<b>9 101</b>	<b>10 291</b>	<b>10 912</b>

**Source:** BIS, *International Banking and Financial Market Developments* (various issues).

**a** Including certain offshore branches of United States banks.

**b** Based on data for end-December after adjustment for movements of exchange rates.

**c** Excluding offshore banking centres, i.e. in Latin America: Aruba, Bahamas, Barbados, Bermuda, Cayman Islands, Netherlands Antilles, Panama and West Indies UK; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in East and South Asia: Hong Kong (China), Singapore and Vanuatu.

**d** Including residual amount specified in source for Africa and West Asia.

**e** Including residual amount specified in source for East and South Asia and Central Asia.

**f** Including residual amount specified in source for Eastern Europe and Developing Europe.

**g** Malta, Bosnia and Herzegovina, Croatia, Slovenia, The Former Yugoslav Republic of Macedonia, and Yugoslavia.

**h** Including multilateral institutions.

for those in Africa and West Asia (BIS, 2001a, tables 3–6).

The pace of issuance of debt instruments by developing countries fell between 2000 and the first three quarters of 2001, issuers from Latin America accounting for more than 50 per cent of total figures (table 1.7). Net issuance in the first three quarters of 2001 reflected a sharp turndown in the third quarter, with very little new issuance after 11 September, following two quarters of increases from the negative level of the last quarter of 2000. Gross issuance of debt securities was also at a lower rate in 2001, but the proportionate decline was smaller than for net issues.<sup>8</sup> Activity in this market also involved a first international bond issue by Egypt, and a major external and internal

debt swap by Argentina for obligations with longer maturities, as well as lesser ones by Brazil and Mexico.

Estimates provided by the IMF and IIF for net foreign direct investment (FDI) flows in 2001 suggest that they broadly withstood unfavourable pressures exerted by increased uncertainties and lower global economic growth (table 1.5). Net FDI flows to China and Mexico increased in 2001 (in the latter case reflecting the purchase of Banacci for \$12.5 billion by Citigroup), but these rises were offset by declines for Argentina and Brazil. Announced international equity issues by developing countries (mainly in East and South Asia) amounted to about \$9 billion in the first three quarters of 2001, a rate of issuance sharply lower than



Table 1.7

**INTERNATIONAL ISSUANCE OF DEBT SECURITIES<sup>a</sup> BY DEVELOPING  
AND TRANSITION ECONOMIES,<sup>b</sup> 1997–2001**

(Billions of dollars)

	Gross issues <sup>c</sup>					Net issues				
	1997	1998	1999	2000	2001 <sup>d</sup>	1997	1998	1999	2000	2001 <sup>d</sup>
<b>Developing countries</b>	<b>117.3</b>	<b>76.2</b>	<b>79.3</b>	<b>78.3</b>	<b>55.4</b>	<b>82.1</b>	<b>37.3</b>	<b>34.8</b>	<b>38.5</b>	<b>11.2</b>
Africa	0.8	1.3	2.2	2.4	4.2	4.3	0.4	1.4	0.9	3.1
Latin America	64.0	43.0	48.0	43.1	32.2	41.1	22.5	27.1	27.9	7.6
Asia	44.3	14.8	23.9	27.1	10.9	27.7	-1.3	4.2	8.6	-4.3
Europe	8.2	17.1	5.2	5.7	8.1	9.0	15.7	2.1	1.1	4.8
World	1 508.6	1 657.2	2 305.0	2 661.6	2 330.8	560.4	681.1	1 241.2	1 246.0	771.4

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

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

**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.

in 2000, when the figure for the year as a whole was over \$40 billion (BIS, 2001b, table 18). Provisional estimates of IIF in table 1.4 show a total negative figure for foreign portfolio equity investment in emerging-market economies, significantly below that for international equity issues. This points to the likelihood of substantial net foreign disinvestment in local equity markets in 2001.

Perhaps because the widely expected depreciation of the dollar failed to materialize, generalized volatility in the exchange rates of developing countries was largely absent in 2001, with the exception of those of Argentina, South Africa, Turkey and Venezuela in early 2002. After the abrogation of Argentina's Convertibility Law a floating exchange-rate regime has become by far the most common feature in emerging-market economies. Argentina introduced a free float after a short experiment with the two-tier exchange rate system, and the currency depreciated to slightly above 2 pesos to the dollar from the parity. After continued depletion of its foreign exchange reserves Venezuela ended its band in Feb-

ruary 2002 and replaced it with a floating rate, a step followed by a sharp depreciation of nearly 20 per cent on the first day of the float. In Asia, Malaysia continued to maintain a fixed dollar exchange rate, while easing rules concerning property ownership by foreigners and removing the 10 per cent levy on profits from portfolio investments repatriated within a year. China continued to pursue a policy of a quasi-fixed exchange rate, managing its currency within a narrow band of plus or minus 0.3 per cent of the previous day's average, while tightening controls over domestic institutions' external borrowings. Amongst the emerging-market economies of Eastern Europe only Hungary now maintains an exchange-rate band, but one that was made increasingly flexible in two stages during the year, accompanied by a wide-ranging liberalization of capital-account transactions. By contrast, South Africa responded to the large depreciation of the rand through a more rigorous enforcement of existing exchange controls. In general, movements in exchange rates during 2001 produced no large shifts in the competitive positions of different emerging regions.

As for yield spreads on international bonds, the contagion effects of the financial crises in Argentina and Turkey were limited in the equity and currency markets of emerging-market economies. In the early summer of 2001 the currencies of both Hungary and Poland were subject to downward pressures associated with instability linked to sentiment towards the situation in the two crisis-ridden countries, but this was not sustained. Even within Latin America itself contagion effects have, so far, been limited: Mexico's currency, for ex-

ample, remained exceptionally strong throughout 2001, and exchange rates in Brazil and Chile have tended to recover from their lows in late summer. The eventual impact will depend on how Argentina's difficulties unfold and on its Government's policy response, on the way in which this process is transmitted to other Latin American economies through trade and financial links, and its effects on the sentiment of international investors and lenders towards the region.

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## **D. Economic prospects**

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Developing countries faced an increasingly difficult global environment throughout 2001. The decline in their average annual rate of growth, from over 5 per cent in 2000 to about 2 per cent in 2001, was accompanied by an even sharper deceleration during the year. Some Asian economies, such as Malaysia, Singapore, Taiwan Province of China and Thailand, were already experiencing negative growth at the beginning of 2001 as the demand for their IT exports fell sharply. In Latin America, Argentina and Mexico registered declining GDP throughout the year, while Brazil's growth was stagnant until the last quarter, when it also turned negative.

However, there were signs that the situation had stabilized in most of Asia and parts of Latin America by the end of the year. As a result of increasingly active policies to stimulate domestic demand, most Asian economies returned to positive growth in the fourth quarter of 2001. In Latin America, the Andean Community, except Colombia, followed a different trend, with a quarterly growth rate, calculated on an annual basis, of over 3 per cent. Some of the transition economies also

diverged from the global trend, but the Russian Federation showed a decline in the fourth quarter.

The United States economy also performed better than expected. As noted above, there was a rebound in growth at the end of 2001 owing to a rise in consumer spending driven by exceptionally favourable financing conditions, discounted prices, prepaid tax rebates and interest rate reductions on mortgages which could be refinanced at historically low rates. Another factor supporting recovery in the United States was the increase in orders for intermediate goods and electronic items within NAFTA and of electronic and IT products from Asia, driven by the desire of many firms to protect themselves, through higher inventory levels, against possible disruptions of delivery schedules in the aftermath of 11 September. Fourth-quarter growth of almost 1.5 per cent and evidence of an end of the inventory cycle suggest that the basis for a recovery in the first half of 2002 may be in place.

As a result of the turnaround in much of the developing world and the better-than-expected performance of the United States economy, growth

forecasts made for 2002 for all regions of the world, which had been revised significantly downwards after the events of 11 September, are now widely believed to require some upward correction.<sup>9</sup> Expectations that government measures in Japan could produce recovery there proved unfounded, but by the last quarter of 2001 statistical evidence suggested that external demand had stabilized. In the Euro area, there were some indications by the beginning of 2002 that a recession could be avoided. For many of the more export-dependent economies, notably in Europe, growth forecasts for 2002 have been revised upward.

Still, the implications of the better-than-anticipated performance in the United States need to be interpreted with care. First, it reflects largely once-for-all adjustments that cannot be expected to continue over time. Second, household expenditures, though higher than expected, have again reduced the household savings rate and increased indebtedness. Third, there has been little evidence that business firms have completed the process of balance-sheet restructuring and adjustment to excess capacity that has kept investment expenditures low. Indeed, the recent accounting scandals indicate that these problems may have been more widespread than was originally believed. There is little evidence that the economic imbalances that were identified before the slowdown – such as the high levels of consumer and business indebtedness, substantial overinvestment in the IT sector, the negative impact of the fall in equity prices, and the difficulties in financing new business ventures – have been eliminated. In addition, they are now joined by falling employment levels and increasing uncertainty over future incomes. Thus the ability of these one-off factors to overcome the impediments to sustained recovery will depend on whether they are sufficiently persistent to convince producers that they need to increase their investment in new productive capacity. As yet, there are no signs of any such conviction.

A likely scenario is one in which the United States economy does not substantially improve its fourth quarter rate of expansion in the new year, but subsequently stabilizes at a low, but positive, rate of growth, as the recent rise in consumption expenditures fails to ignite a recovery in investment, and continued declines in employment produced by corporate downsizing and cost-

cutting eventually cause consumers to cut back spending and restore their debt to more sustainable levels. Such a scenario is not favourable to a rebound in global growth. In Japan prospects for recovery now seem to be based on external demand: consumers, unlike those in the United States, have not taken the lead in the recovery process, but rather seem to be retarding it by reducing their spending. For some time, Japan has been attempting, with little success, to shift the base of its growth to domestic demand but it has faced substantial inertia; the behaviour of wages noted above has certainly played an important role in restraining consumption. From a longer-term perspective, given the ageing of the population and the absence of immigrants, there may also be more deeply rooted social reasons preventing domestic expenditure rising to levels needed to achieve faster growth.

It is also quite likely that the stimulus from growth in the United States will not be enough to boost the European economies, and more vigorous domestic measures may be needed to ensure a return to the rates of expansion experienced in 2000. However, as noted above, the current interpretation of the Stability and Growth Pact suggests that Euro-area countries may not be able to provide the kind of fiscal stimulus needed. Furthermore, if monetary policy continues to focus exclusively on inflation, the prospect of a rapid recovery in Europe becomes increasingly remote.

Thus the industrial countries seem unlikely to return quickly to the 3 per cent growth that is necessary to support a strong increase in employment and income in the developing world. It is also unlikely that there will be substantial increases in demand for developing country exports, a major recovery in commodity prices, or a strong increase in capital inflows to offset these tighter external constraints. The indications are consequently of a persistence of slower economic growth in developing countries, with only a few managing to sustain expansion at rates similar to those of the early 1990s.

In Asia, only China and India are fully expected to weather the reversal in the global economy. Other countries in Asia, which are heavily dependent on exports, have recently relied more on internal demand for their expansion, but

this may not be sufficient for sustained growth in the absence of a recovery in world trade. Thus the outlook for the region is a moderate improvement from the low levels of 2001.

In Latin America, as noted above, Mexico has been particularly hard hit by the slowdown in trade: in 2001 it recorded its first recession since the financial crisis of late 1994 and its prospects in 2002 depend on recovery in the United States. Mexico's growth may also be limited by the strong peso – supported by FDI inflows that are attracted by its investment grade rating – which is rapidly eroding the advantages for international producers of the country's *maquiladora* export industries based on cheap labour. Already some high-tech firms have started to shift production to Asia and China, and closures of some automobile factories have been announced. In Brazil, the end of the energy crisis will be a positive factor, but the country is facing a sharp decline in capital flows and it will be affected by any further economic or political uncertainty in Argentina. Since most Latin American countries continue to carry large debt burdens, they are vulnerable to rising international interest rates and declining capital inflows. As a consequence, growth in the region as a whole is not expected to improve much over 2001.

European transition economies, where strong exports to Western Europe helped lift growth in 2001 and in early 2002, also look increasingly vulnerable to slow growth in the Euro area. Relatively buoyant growth in the Russian Federation had been seen as a partly offsetting factor for the region, but recently the expansion in that country has slowed along with lower oil exports. Thus the weaker-than-anticipated performance of the EU is likely to mean that growth in Eastern Europe will also be lower than anticipated. Other developing countries, particularly those in Africa that are heavily dependent on commodity prices, are unlikely to experience much recovery. As already noted, the adverse effects of the events of 11 September on transport and insurance costs are likely to have a particularly damaging impact on exports. For some producers of key commodities, such as oil, favourable price movements could eventually strengthen growth prospects, but much will depend on the impact of a still unpredictable political situation. The immediate rise in the price of oil after the events of 11 September to over \$30 per

barrel has so far been followed by a sharp drop beyond the lower limit of the OPEC price range, and prospects for a return to higher prices are currently not encouraging.

Given the prospects for exports and current-account balances for most developing countries, the unfavourable outlook for external capital flows assumes increased importance. Least affected by these conditions will be the emerging-market economies in East and South Asia, most of which have recently been running current-account surpluses and have relatively high ratios of foreign exchange reserves to their short-term external debt. Consequently, their demand for external financing from banks is likely to be limited, while their restored creditworthiness may increase their access to portfolio inflows. By contrast, most Latin American countries require external financing in order to meet deteriorating current-account deficits owing to falling export volumes and declining commodity prices. Recently, most transition economies of Eastern Europe (except the Russian Federation) and South Africa have also experienced deficits. For these countries, if inflows of private capital continue to remain at their recent low levels, this could present a more important constraint on growth. For most other developing countries, especially the least developed and landlocked, which have little or no access to international capital markets, official flows remain crucially important.

As noted earlier, the low private capital flows to both emerging-market economies and other developing countries represent a prolongation of the trend observed since 1997. However, the threat of a global liquidity crunch due to contagion seems muted. The spillover effects of the record sovereign bond default by Argentina have so far been limited to the temporary closure of an Argentine-owned bank in Uruguay and to the impact on affiliates of Latin American firms operating in Argentina, although the last major domestically-owned Argentine bank is currently seeking investors to shore up its capital position; should it fail, the impact on financial institutions in the region may be more substantial.<sup>10</sup>

The contraction in international banks' exposure to Asian countries since the region's financial crisis, rather than contagion, accounts for

the continuing low levels of private capital flows to developing countries. Elsewhere, bank lending has been a relatively minor source of funding for borrowers since the 1982 debt crisis. The most important forms of capital inflow have varied among countries but have consisted mainly of international bond issues, portfolio equity flows and FDI. Thus, recovery of flows to those borrowers most in need of external finance is likely to depend less on bank lending than on sustained bond and portfolio equity finance and the maintenance of FDI flows. However, as the types of special purpose entities increasingly associated with reliance on security financing have been a major feature of the recent accounting difficulties at large United States firms, this may not augur well for a substantial rise in this kind of cross-border borrowing and investment, since the operations of recipients often lack transparency. Further, global equity markets remain depressed despite the increase in global liquidity, and investors are increasingly wary of the potential for bubbles. It is therefore unlikely that either bonds or equity financing will offset lower bank lending, which means that reduced levels of capital flows to de-

veloping countries are likely to persist, even if the level of FDI is maintained. However, current forecasts of FDI flows point to substantial declines for 2002 (table 1.5).

Thus it seems that neither the rate of growth of world trade nor the pace of capital flows from developed to developing countries will return to the levels seen during the sustained global boom of the 1990s. Factors which had been seen as the major sources of support for growth in developing countries are unlikely to be adequate for enabling them to achieve their growth potential and for increasing the per capita incomes of their growing populations. In the context of slow global growth, increased market access could provide a useful boost to activity in developing countries, and increased use of regional trade and financing mechanisms may provide some relief for lower capital inflows and protection against possible financial instability. But a large number of developing countries will continue to require substantial official financing if they are to be protected from the effects of an external economic environment that is likely to remain difficult. ■

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## Notes

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- 1 128 bit DRAM prices, which in 2001 had fallen to a low of about \$1 from nearly \$7 at the end of 2000, had recovered to over \$4 by February 2002.
- 2 OPEC succeeded in avoiding a price collapse by reducing its production quota by about 5 million bpd between February 2001 and January 2002. This reduced members' output to very low levels and has increased OPEC's shut-in spare capacity to over 7 million bpd. Such a massive volume of oil ready to be produced at any time will hang over the oil market during the near future, and oil prices in the period ahead will, to a large extent, depend on the ability of OPEC to stick to its agreement on production quotas, combined with continuing restraint on the part of other key producers.
- 3 Oil supply comprises crude oil, condensates, natural gas liquids (NGLs), oil from non-conventional sources and other sources of supply.
- 4 Differences between these two 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 vast 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.
- 5 Increased discrimination on the part of investors is manifest in the prevalence of downward trends in bilateral correlation coefficients between the yield spreads on the international bonds of emerging-market economies in recent years. This trend, which is indicated in estimates by the UNCTAD secretariat for the bonds used for chart 1.4, is consistent with findings in Cunningham, Dixon and Hayes (2001: 177–179).
- 6 However, this increase disappears on an alternative basis of calculation involving consolidated financial reporting or reallocation of exposures through credit mitigation and other techniques from the country of the borrower to that of the counterparty assuming the ultimate risk (BIS, 2001a, table 6).
- 7 These estimates, which allow for movements of exchange rates, are based on Joint *BIS-IMF-OECD-World Bank Statistics on External Debt*.
- 8 Preliminary data, which include issuance in the fourth quarter, indicate a decline for the year as a whole in comparison with 2000 (IIF, 2002: 11).
- 9 Between May and December IMF's *World Economic Outlook* reduced its 2001 forecast for the world economy from 3.2 per cent to 2.4 per cent and for 2002 from 3.9 per cent to 2.4 per cent.
- 10 The reasons for this limited contagion appear to be linked to the long period over which the crisis unfolded, which furnished economic actors sufficient time to hedge default risks. There are also indications that exposure to Argentina was not a significant element in trading strategies and risk management policies of the kind which, for example, via the resulting portfolio reallocation, transmitted the effects of the Russian crisis to the markets for Hungarian and Brazilian securities (CGFS, 1999: 15). The substantial foreign ownership of domestic banks may also have played a role.

