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Statement by Supachai Panitchpakdi, Secretary-General of UNCTAD, To the Annual Meetings of the IMF and the World Bank

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The global economy between promises and risks

Despite some moderation over the first half of 2005, the expansion of the world economy is continuing this year. After a growth rate of close to 4 per cent in 2004, it now appears realistic to expect an expansion on the order of 3 per cent for this year and 2006.

The fact that the expansion has been faster and more broad-based in the developing world than for many previous years is of particular importance. In 2004, strong per capita income growth continued in China and India, the two countries with the highest number of people living in absolute poverty. Indeed, since the beginning of the new millennium the performance of the world economy has been shaped by the increasingly important role of China and India. Rapid growth in these two large economies has spilled over to many other developing countries and established the East and South Asian region as a new growth pole in the world economy. Their ascent has also been accompanied by new features of global interdependence, such as a brighter outlook for exporters of primary commodities, increased South-South trade and rising exports of capital from the developing to the developed countries.

Economic performance has also been remarkable in Latin America in 2004. In several countries the return to faster growth was fuelled by export expansion. With regard to 2005 and beyond much, will depend on further developments on the markets for primary commodities, especially oil, minerals and metals. After the initial rebound from the deep economic crisis at the beginning of the decade, output growth is likely to settle at a rate above 4 per cent in 2005.

As a result of rising demand for primary commodities, Africa, the region that had been excluded from the benefits of globalization for many years, has shown improved growth performance since 2003 and is now in the third year of output growth above 4.5 per cent. For Africa as a whole, the growth rate will approach 5 per cent this year, thanks to continuing strong demand for a number of primary commodities exported from the region. But it should not be forgotten that the recently improved performance of the majority of African countries, especially in the sub-Saharan part of the continent, remains fragile, as it is dependent on the situation in the markets for a few primary commodities. Moreover, the international community must not become complacent about efforts in support of Africa, because even growth rates of close to 5 per cent in sub-Saharan Africa would be insufficient to attain the Millennium Development Goals.

In 2005, developing countries as a group are growing between 5 per cent and 5.5 per cent, down from 6.5 per cent last year. East and South Asia, and especially China, will again take

the lead, but some Latin American economies can also be expected to grow faster than the average.

Most of the deceleration in global output growth expected for 2005 is thus attributable to a slowdown in the developed countries. Since the early 1990s, the United States economy has served as the main engine of growth, but there is an increasing risk that it may run out of steam before other countries or regions are able to take over that role. Both the euro area and Japan continue to lack the dynamism needed to reduce domestic imbalances and to contribute to an adjustment of the global trade imbalance. Even worse, since the second half of 2004, output growth in the euro area has slowed down markedly, and earlier forecasts for 2005 have had to be revised downwards. While greatly benefiting from the global expansion over the past three years, and especially the Asian boom, neither the euro area nor Japan has managed to revive domestic demand, although there have recently been positive signs in the latter.

Global current-account imbalances have led to mounting political pressure on some surplus countries, especially China, to revalue their currencies. The pressure remains, despite China's decision in July to revise its exchange-rate regime. The attempts of many central banks in the developing world, particularly in Asia, to maintain stable exchange rates through intervention in the currency market is considered to be one of the major hindrances to a smooth unwinding of the imbalances. But most countries that intervene in this way are just trying to protect the international competitiveness of their producers against the effects of currency appreciation and speculative capital inflows. This situation underlines the need for renewed efforts to establish a truly multilateral exchange-rate system that meets the concerns of small, open and less developed economies.

In order to redress the economic imbalances, it is essential to avoid a marked slowdown, both in the developed world, where growth is depending excessively on the US economy, and in the developing world, where economies and currencies are particularly vulnerable to disturbances in the external environment. If a correction, especially to the external deficit of the United States, is sought through massive exchange-rate appreciation in China and other Asian developing countries, a deflationary impact on the world economy will be inevitable. Such a development would not only complicate China's attempt to integrate a vast pool of rural workers into its modernizing urban economy – thereby threatening the country's progress in reducing poverty – but would also reduce the chances of other developing countries to achieve the MDGs.

Deflationary effects stemming from an adjustment to global imbalances can be avoided only if domestic demand recovers in those economies whose surplus represents the bulk of the counterpart of the gigantic US external deficit. The surpluses of Germany and Japan are growing rapidly despite rising import bills for oil and other primary commodities. In 2004, Japan and Germany together accounted for $268 billion, or about 30 per cent, of the combined global current-account surplus for 2004. This compares with an overall current-account surplus of $193 billion for East and South Asia. China, the country that has come under the most intense pressure for revaluation, accounts for less than 8 per cent of the global current-account surplus.

The other big question mark about economic prospects is the future course of oil prices, which have more than doubled since mid-2002. In the developed countries, we have not thus far seen any strong impact of oil prices on economic activity or inflation, as was the case in the 1970s. Thanks to more efficient use of energy and the structural decline in the share of industry in GDP, they have come to be much less oil-dependent than they were then. Neither

have there been any significant "second-round" effects that could result from nominal wage adjustments and higher interest rates.

By contrast, at over $60 per barrel, oil prices are placing an increasingly heavy burden on many developing countries, which, if they are not among the poorest, have become more oil-dependent as a result of successful industrialization. In Brazil, for example, oil intensity of domestic production is 40 per cent higher than the OECD average; in China and Thailand it is more than twice, and in India almost three times, as high as in the OECD countries. Under these circumstances, inflationary pressures may indeed result from further rising oil prices and may jeopardize the sustainability of recent growth.

The balance-of-payments and terms-of-trade effects of the oil price rise has been mitigated in many oil-importing developing countries, and compensated in some, by higher export earnings of these countries themselves. This is true for the fast-growing economies, particularly in East and South Asia, which have benefited from a rapid expansion in the volume of their exports, as well as for a number of developing countries exporting other primary commodities, which have enjoyed increasing global demand and rising prices, largely for the same reasons as the oil exporters.

Fast growth in East and South Asia is causing changes in international trade with respect to both product composition and direction of trade. The implications of these changes vary across developing countries depending on the product composition of a country's external trade, especially the shares of manufactures and primary commodities in its exports, and the dependence on imports of fuels and industrial raw materials. Thus, the same factors that improved the terms of trade of some groups of developing countries, especially the higher prices of oil and mineral and mining products, led to a worsening of the terms of trade in others.

In many Latin American and African countries the positive effect of price movements on the purchasing power of exports was reinforced by an increase in export volumes; whereas in others, gains from higher export unit values were compensated, or even over-compensated, by higher import prices. Since 2002, economies with a high share of oil and minerals and mining products in their total merchandise exports have gained the most from recent developments in international product markets. The terms of trade of countries with a dominant share of oil exports increased by almost 30 per cent between 2002 and 2004, and those of countries with a dominant share of mineral and mining exports by about 15 per cent.

Developing countries for which manufactures are the dominant category of exports and which are at the same time net importers of oil and minerals and metals have been subject to a deterioration in their terms of trade in the past two or three years. The deterioration could well become a longer-term feature in their external trade, due to higher commodity prices, but also to falling prices for their exports of manufactures relative to the prices of manufactures they are importing from the developed countries. Indeed, the terms-of-trade losses of exporters of manufactures among the developing countries are partly explained by the pace of the catch-up process in some of these countries, particularly in China and India. This process has been driven by higher productivity in the export sectors, which has given them a competitive edge.

The variations in the global pattern of demand and their impact on individual countries have led to a redistribution of income, not only between developed and developing countries, but also, to an increasing extent, between different groups of developing countries. However, it is important to recognize that a change in the distribution of real income does not necessarily

imply absolute losses. As long as output growth is strong enough, all countries can gain in real income, with some gaining more than others, depending on the structure of their exports and the international competitiveness of their producers: a terms-of-trade deterioration can be compensated by rising export volume. The probability of this happening is much greater if exports consist of manufactures, for which the price elasticity of demand is high, than if they consist of primary commodities. And that probability is also greater in a favourable external environment characterized by sustained global demand growth and improved access to developed-country markets.

The pace of development in the populous Asian economies, and especially in China, requires an acceleration of structural change in many other countries, developing and developed alike. In some sectors – such as the clothing industry and, more generally, in activities at the low-skill end of the economy -- the adjustment pressure is stronger than in others where there is less competition from low-wage producers with relatively high productivity. Fears are widespread in many countries that the pace of structural change could result in higher unemployment and lower output. However, given the commitment of all countries to develop a global partnership for development, it would be inappropriate for the developed countries to respond to the new challenge with protectionism. This would also be counterproductive, since most of the earnings of developing countries from their exports to the developed world are translated into higher import demand for advanced industrial products, thus flowing back directly or indirectly to the latter.

Further developments on the markets for primary commodities will depend on how much and how fast additional supply capacity will be created by recent new investments, but will also depend on how commodity demand from developed countries will be affected by a correction of the existing trade imbalances. While booming demand from the Asian late industrializers has been a key factor behind the recent rise in primary commodity prices, developed countries still account for two thirds of non-fuel commodity imports, and in real terms commodity prices are still more than one third below their 1960-1985 average.

Although continuing growth in East and South Asia and recovery in other regions of the developing world is likely to sustain demand for primary commodities, the basic problems of instability in these prices, and their long-term trend to deteriorate in real terms vis-à-vis the prices of manufactures, especially those exported by developed countries, remain unsolved. At the same time, there is a risk that the recent recovery of primary commodity markets could lead to a shift away from investment – both domestic and foreign – in the nascent manufacturing sectors of commodity-exporting countries in favour of extractive industries. While higher investment in that area may be beneficial in terms of creating additional supply capacity and raising productivity, this should not come at the expense of investment in the manufacturing sector. Exporters of primary commodities that have recently benefited from higher prices and, in some cases, from higher export volumes, have to continue their efforts towards greater diversification within the primary commodity sector, as well as upgrading their manufacturing and services sectors. The recent windfall gains from higher primary commodity earnings provide an excellent opportunity to step up investment in infrastructure and productive capacity – both essential for boosting development.

At the national level, this poses the question of the sharing of export revenues from extractive industries, which has always been a central concern in development strategy. Higher global demand and international prices for fuels and mining products have been attracting additional FDI to these sectors in a number of developing countries, and this may increase the scope in these countries for mobilizing additional resources for development. By contrast, government

revenues from taxes on profits in these sectors have typically been very low, partly as a result of policies in place since the early 1990s to attract FDI by offering fiscal incentives. In this regard, it is important to avoid potential host countries engaging in "a race to the bottom".

Recent upward trends in the markets for fuels and mineral and mining products as a result of growing demand from East and South Asia provide an opportunity to review the existing fiscal and ownership regimes.

At the international level, the recent increase in the prices of some primary commodities and the improvements in the terms of trade of a number of developing countries may not have changed the long-term trend in real commodity prices or altered the problem of their volatility. Even in times of rising prices it should not be forgotten that sharp fluctuations in commodity prices constrain the ability of many developing countries to attain a path of stable and sustained growth and employment creation that benefits all parts of their population and allows them to attain the MDGs. Commodity price instability is not in the interest of either producers or consumers. At its last spring meeting, the IMFC explicitly recognized the importance of stability in the oil market for global prosperity and the need for greater dialogue between oil exporters and importers. Such considerations should not be limited to the oil sector. Primary commodities other than oil may be less important for the developed countries, but they are often equally, if not more, important for those countries that depend on their exports. Recognition of this fact is all the more important since many of the poorest developing countries depend on the exports of a few non-oil primary commodities. Consequently, in the spirit of a global partnership for development, the international community might consider reviewing mechanisms at the global or regional level that serve to reduce the instability of prices of a wider range of commodities, not just oil, so as to mitigate the impact on national income in the exporting countries.

In the short term, however, the central policy issue remains the correction of global trade imbalances. Efforts to achieve development goals in the medium to long term must not be seen in isolation from short-term developments and cyclical aspects of the performance of the global economy. International initiatives to alleviate poverty and reach the MDGs could easily be frustrated in the absence of a smooth unwinding of the global economic imbalances that will allow the "Asian Miracle" to continue, along with its positive repercussions for other developing countries. The catching-up process in China and India has had positive economic effects for most developing countries, enabling them also to make progress towards the MDGs. Any disruption of the process would risk sharpening global price competition for manufactures exported by developing countries, while weakening the economic growth resulting from this mounting Asian demand.

The developments in the markets for a number of primary commodities of critical importance to the export earnings of developing countries have also contributed to an improvement in external debt indicators. Moreover, further progress under the HIPC Initiative, and particularly the decision taken by the G-8 at Gleneagles to support 100 per cent cancellation of outstanding obligations of HIPCs to the IMF, IDA and African Development Fund, has helped to improve both the external environment and the fiscal outlook for a number of the poorest countries. But in order to bring real gains for the poorest countries, it is essential to ensure that the funds earmarked for this debt relief process be additional to existing aid commitments.

The HIPC Initiative has unlocked resources that are critical for progress towards the MDGs, but they still fall far short of what is needed. In order to allow developing countries to

achieve the MDGs without a new increase in debt ratios, it is necessary to provide for 100 per cent debt cancellation for HIPCs and more debt reduction for other low- and middle-income countries. Debt ratios of many developing countries are highly sensitive to commodity price developments, and long-term sustainability of debt therefore depends on further growth and export prospects of the debtor countries. Again, maintaining the growth momentum of the world economy and smooth, non-deflationary correction of the existing global imbalances will be a critical factor in efforts to achieve debt sustainability. But as recent experience shows, it will not be enough to attain the growth rates required for all developing countries, especially those in sub-Saharan Africa, to achieve the MDGs. Further acceleration of growth in these countries and a solution to their structural problems requires additional ODA in the form of grants, in concert with increased access to export markets.

Regarding the prevention and solution of sovereign debt problems, the inclusion of collective action clauses in an increasing number of developing-country bond issuances, and the efforts by private creditors to develop a voluntary code of conduct, are important steps forward. Nevertheless, the multilateral financial institutions, borrowers, and lenders alike need to continue working towards the establishment of more efficient mechanisms for resolving debt problems of middle-income countries, including international arbitration or mediation mechanisms, which would bring debtors together with official and private creditors in a collaborative and constructive dialogue aimed at resolving debt problems in an expeditious and timely manner.

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