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Report on the Project LINK Meeting

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CONTENTS

1. Introduction

The autumn 2005 meeting of Project LINK was held in Geneva, Switzerland from October 31 to November 2, 2005, jointly hosted by Department of Economic and Social Development (DESA) and the United Nations Conference on Trade and Development (UNCTAD). More than 100 participants from over 40 countries and several international institutions attended the meeting. The agenda of the meeting comprised two broad sections: economic outlook and economic policy issues. This report summarizes presentations and discussions during the meeting.

The LINK Global Economic Outlook prepared by the Economic Monitoring and Assessment Unit for the meeting, the LINK Country Reports prepared by country participants, and most of the documents presented at the meeting are available on the United Nations website (http://www.un.org/esa/policy/index.html) and the Project LINK Research Centre website at the Institute for Policy Analysis at the University of Toronto (http://www.chass.utoronto.ca/link/).

On the morning of October 31, Mr. Heiner Flassbeck welcomed the conference participants on behalf of UNCTAD. He pointed out that world economic growth currently lies in a comfortable range and is characterized by several features such as higher commodity prices, offering benefits to commodity-exporting countries but challenges to economies that depend on commodity imports. He concluded by mentioning that the conference provided a framework for discussing the implications of this and other issues for the world economy. Prof. Peter Pauly, Director of the Project LINK Research Centre at the University of Toronto, also welcomed the conference participants and presented a brief overview of the programme.

2. World economic outlook

2.1 Global economic outlook

Mr. Rob Vos (United Nations) started his presentation of the *LINK Global Economic Outlook* of the United Nations by stating that a slight slowdown was expected for the world economy in 2005 and 2006, with this slowdown being a general phenomenon across different country groups. Some qualifications are in place, however, as the economy of the United States for example still seems to be in a more robust state than that of Japan and the EU. Moreover, commodity-exporting economies in transition and developing countries have benefited from higher commodity prices, providing additional support for economic growth. By contrast, Latin America is expected to show the clearest signs of an economic slowdown over the forecast horizon. Trade volume is expected to increase by 7 percent in 2006, representing a slowdown from 11 percent in 2004 but still a better performance than in previous years. Oil prices are forecast to remain at their higher levels in 2005 and 2006, having reached approximately the level of the 1970s in real terms, but remaining below their levels from the 1980s. Compared to mainly supply-driven shocks in the past, the current shock has so far mainly been demand-driven and, hence, relatively less damaging to economic growth. Non-oil commodity prices have also been on an upward trend, creating a favourable environment for many developing countries. The benefits in this respect are, however, unevenly distributed, with middle-income primary goods exporters benefiting to a larger extent than those in the low-income category. Financial markets are a further positive factor in the global economic growth picture, with low interest rates and interest rate spreads offering favourable conditions in particular for the financial positions of developing countries. Rob Vos then highlighted the global imbalances and the increase in oil prices as well as house prices as three major issues that currently play an especially significant role regarding the outlook for global growth. On the global imbalances, he pointed out that investment anemia, rather than a saving glut must be regarded as the cause. Regarding investment, the question is as to whether this has fallen despite relatively high profits. In a possible adjustment scenario, exchange rate movements alone will not be sufficient. Instead, there is need for a global, gradual adjustment process in both surplus and deficit countries over a longer time horizon, requiring more intensive macroeconomic policy coordination at the international level than is currently the case.

Table 1. Gross domestic product and world trade
(Annual percentage change)

		November 2005 forecast [a]		May 2005 forecasts	
	2004 [b]	2005	2006	2005	2006
Gross world product	3.9	3.0	3.0	2.9	3.0
PPP weighted	4.6	3.7	3.6	3.6	3.5
Major developed economies					
Canada	2.9	2.7	2.6	1.6	2.8
Japan	2.6	2.1	1.9	0.7	1.5
United States	4.2	3.1	3.1	3.1	3.1
European Union (EU25)	2.4	1.6	2.2	2.0	2.4
France	2.3	1.5	2.1	2.0	2.2
Germany	1.6	0.8	1.2	1.0	1.8
Italy	1.0	-0.2	0.9	1.1	1.5
United Kingdom	3.1	1.7	2.3	2.7	2.5
Memo item: Euro Zone	2.0	1.2	1.9	1.6	2.1
Russia	7.2	5.8	5.5	6.0	5.2
Developing countries and regions					
Latin America and the Caribbean	6.1	4.7	4.1	4.5	4.2
Argentina	9.0	7.5	4.0	6.5	4.0
Brazil	5.2	3.5	4.0	3.8	4.1
Mexico	4.4	3.0	3.5	3.5	4.5
Africa	4.9	5.1	5.4	5.2	5.2
North Africa	4.8	5.1	5.7	5.1	5.0
Sub-Saharan Africa [c]	5.5	5.6	5.3	5.4	5.8
Nigeria	6.0	5.0	6.0	7.0	5.2
South Africa	3.7	4.5	4.4	4.0	3.8
South and East Asia	6.7	6.1	6.0	6.2	6.1
India	7.0	6.8	6.8	7.0	7.1
Indonesia	5.1	5.4	5.3	5.4	5.5
Korea, Republic of	4.6	4.0	4.3	4.0	4.3
Malaysia	7.1	5.5	5.6	6.3	6.4
Philippines	6.1	5.3	5.7	5.0	4.7
Thailand	6.1	4.0	4.2	5.5	5.7
China	9.5	9.4	8.8	8.8	8.3
Western Asia	6.5	5.3	5.1	5.3	5.0
Oil-exporting countries	6.0	5.9	5.5	5.8	5.4
Oil-importing countries	7.0	4.6	4.7	4.7	4.5
World export volume	10.8	7.1	7.4	7.2	8.1
Oil price (Brent, $/pb)	38.3	55.6	59.3	46.0	37.0

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[a] Pre-Meeting forecasts.

[b] Actual or most recent estimates.

[c] Excluding Nigeria and South Africa.

Mr. Thomas Helbling of International Monetary Fund (IMF) stated that global economic growth, while remaining solid, had become subject to greater risks. The current slowdown can be attributed to the increase in oil prices since 2003 and a return of economic growth rates to their trend level. The two main risks are the external imbalances and the imbalanced growth performance across regions, with the United States and China leading and the rest of the world following, and the higher level of oil prices and their implications for inflation. While the projections from April's *World Economic Outlook* remain largely unchanged, he pointed out several revisions to the growth forecast. Examples are an upward revision in the case of Japan due to stronger employment growth and more investment in light of solid corporate profits; a downward revision for growth in the United Kingdom because of higher interest rates and a weakening housing market; and downward revisions in Brazil due to tighter monetary policy and in Mexico because of the negative impact from global manufacturing and the United States auto sector. As the drivers of the global economic expansion, he identified still favourable macroeconomic policies; the positive shape of financial markets; improved corporate balance sheets; employment growth; and the positive performance of the economies of the United States and China.

The situation in global financial markets is still characterized by low or negative real short-term interest rates for the US and the euro area, and by unusually low long term interest rates around the world. Although it is unclear whether the latter is a temporary or a permanent phenomenon, financing conditions in emerging market economies might deteriorate if official intervention in some countries is reversed, or if financial inflows from Middle Eastern oil exporters decline. Overall, there is a real risk of global financial market tightening, although core inflation has so far been contained in industrial countries, and largely so in emerging economies.

Concerning the global imbalances, the current situation is neither characterized by a saving glut nor entirely by an investment drought; both global saving and investment rates are on a slight downward trend. They have been relatively stable in industrial countries (except for a decline in saving in the US), although one could talk of a saving glut in the emerging economies. The US current account deficit is expected to continue increasing in the outlook under the assumption of constant real exchange rate. The IMF does not expect a disruptive adjustment of the global current account imbalance, although the larger the imbalance grows, the larger the RER adjustment that will need to occur. However, even if no major disruptive adjustment occurs, there remains the risk of a significant slowdown in global growth, particularly in the US, as part of the adjustment mechanism.

Mr. Hans Timmer (World Bank) reported on global economic trends from the developing countries' perspective, drawing on the analysis in the forthcoming issue of *Global Economic Prospects*. As in 2004, developing countries in 2005 seem to be in "amazingly good shape", as their recent economic performance has been impressive in historical terms. In addition to strong GDP growth, average inflation rates came down by half in recent years, and fiscal policies have improved. There remain, however, some caveats and downside risks, such as higher oil prices, fickle financial markets, and barriers to trade and migration.

The impact of higher oil prices is now starting to harm the economies of many oil-importing countries, and the picture in non-oil commodity prices has recently deteriorated. While the oil price increase in the 2004-2005 period has been much larger than in 2002-2003, it has been compounded by a lower compensation from the prices of non-oil commodities, especially agricultural ones. The terms-of-trade impact therefore has been much larger. In order to analyze the welfare impact, the concept of Gross National Income (GNI) is more appropriate than GDP: in terms of GNI, the picture is less rosy for oil-importing developing countries, but better for developing oil exporters, when compared to assessments in terms of GDP.

Financial markets are currently supportive of developing countries' growth, owing to persisting low interest rate spreads. In historical perspective, however, there have been a series of large, unexpected shocks, reminding us that low spreads are not guaranteed.

Trade can be a strong growth engine for developing countries, as demonstrated by the strong increase in the value of textile exports to developed countries in the first half of 2005 (year-over-year), since the end of the Agreement of Textiles and Clothing. While acknowledging that the largest increase had been in China, at 40%, and that for some countries textile exports had in fact declined, Hans Timmer argued that there remained large possible gains, as textile exports to the Euro area were still severely restricted.

It is estimated that global gains from migration will be US$356 billion by 2025. Developing countries stand to attain a larger share of this sum, as the gains from migration fall largely on the poorer people of the countries of origin. In this context, it should also be noted that a large part of the growing remittances volume stems from developing-to-developing country flows.

Mr. Pete Richardson from Organisation for Economic Cooperation and Development (OECD) presented an outlook for the global economy, focusing on the OECD countries. The speaker started from a summary of the *Economic Outlook* released by the OECD in June 2005 and then moved to the evaluation of more recent developments. As a background to the outlook released in June, the speaker referred to continuing oil and commodity price increases, mixed confidence in Europe, and some weakening in the world trade in the first two quarters of 2005. Macroeconomic policies in the US, Japan and the euro area are assumed to remain supportive.

The baseline scenario of the OECD assumes a recovery of the overall GDP growth in the OECD area to 2.5 per cent in 2005 and 2.75 per cent in 2006, although combined with a lack of momentum and divergence in Europe, while observing stronger activity in Japan. Strong growth is expected in non-OECD countries, notably in China in 2006. A soft landing is expected in the US. Inflation in general is expected to stay low, around 2 per cent in the US and 1.5 per cent in the euro area. Further widening of fiscal deficits will take place in the US and Japan, and current account imbalances will be rising, with the US current account deficit exceeding 6.5 per cent of GDP, according to the OECD.

In order to incorporate the most recent information, a number of changes in the underlying assumptions, notably in oil price and exchange rates, as well as in monetary assumptions and non-OECD developments were introduced to econometric simulation, in order to assess their impact on the GDP level and inflation for the US, Japan, euro area and the OECD in general. The speaker presented the following main results: Significant changes in oil prices will raise headline (but not core) inflation and reduce GDP levels in 2006. Expected movements in exchange rates will dampen US growth and inflation, but boost output and inflation in the euro area and Japan.

To conclude the presentation, the speaker presented a set of short-term indicator models for the largest OECD economies and a summary of the model projections, which assume some recovery in the eurozone (confirmed by high-frequency indicators). He also explained that global trade growth would decrease during the first half of 2006, but should recover during the third quarter, owing mostly to OECD and Asia. Export orders should increase for EU and Japan, as should the import demand of OPEC countries. However, exports to China are expected to weaken.

Mr. Ray Barrell from National Institute of Economic and Social Research, United Kingdom (NIESR) presented an outlook for the global economy. Starting from the key facts, the speaker stated that world GDP growth in 2004, at 5.1 per cent, was the fastest in almost thirty years. In the US, growth was linked to a recovery in investment, and strengthening took place also in the euro area and Japan. Some moderation followed, however, in 2005 and the world GDP growth rate will remain the same in 2006. Meanwhile, world trade growth slowed drastically in the first quarter of 2005 (especially import growth in the euro area), but is expected to return to its historical average rate. In the longer run, world trade growth is expected to stabilize in line with the world GDP growth rate at about 4.5 per cent.

The speaker mentioned basic forecast assumptions, such as projected oil price, key exchange rates and interest rates, and noted that the long-term interest rates had fallen both in nominal and in real terms in the major economies, especially in Europe. Focusing on this issue, he explained that long-run rates reflect expected growth rate, and in the European case the expectations take into account ageing society and poor trade and technology-related performance in the euro-area, without significant spillovers from US technological progress.

Export market shares meanwhile declined for the euro area by 10 per cent since the euro strengthened, and also for the US, while China's share increased by over 80 per cent in the last five years. Most of these effects are due to price competitiveness, but the shifts also depend on the product composition of exports. Turning to the issue of global imbalances, Ray Barrell suggested that the increasing deficit of the US is explained by trade factors, real returns, but most of all by excess domestic demand. According to the econometric simulation conducted on NIESR's global model (NIGEM), the impact of a 10 per cent revaluation in China will be short and is not a solution to the US current account problem, since the real exchange rate depends on structural parameters and not on the nominal rate. On the other hand, changing the structure of demand in China will reduce trade surplus but have little impact on the US.

Turning to the impact of higher oil prices, the speaker mentioned that differences among countries are due to different oil intensity of production and export exposure to the oil producers. On a global level, the impact of oil price is partially offset by stronger demand from oil producers, and especially the euro area benefits from the import demand in OPEC and Russia. In the long-run, however, higher oil prices worsen the current account for the OECD and change the saving-investment balance, and as a result real interest rates rise and reduce equilibrium output, according to the model simulation.

In the discussion, the question was raised why there are low spillovers in Europe from technological progress in the US, in spite of the presence of US-American companies in Europe. In his reply, Ray Barrell argued that multinational companies do not really transfer technology to the EU, but rather break through the trade barriers in order to increase their market share and sales in Europe. In fact, not much FDI went to the EU, and there is more evidence of technology transfer to developing countries, and especially China (based on UK data).

2.2 Outlook regarding commodity prices

Mr. William H. Meyers (University of Missouri) presented the outlook for agricultural markets. His forecasts are based on January 2005 market conditions and policies as well as Global Insight projections. Those projections assume, among other things, a continued appreciation of OECD currencies vis-à-vis the Dollar and a slower, albeit still strong, global GDP growth.

He projected corn prices to further decline in 2005/2006 because of higher-than-expected production and larger stocks. However, he expected prices to pick up in coming years, supported mainly by increasing feed use in Asian and Latin American countries. He also forecasted wheat and rice prices to follow the same patterns as corn prices in 2005/2006 and beyond. He projected the soybean price decline in 2004/2005 to be less dramatic than previously expected and even forecasted a slight rebound in 2005/2006 because of strong demand from China. He expected cotton prices to recover from the steep decline recorded in 2004. Continued increase in China's demand after the ending of textile quotas would be the driving force behind this recovery. Nonetheless, even though cotton prices are expected to rise steadily in coming years, their levels would still be below the 2003 levels.

Continuing the discussion on commodities markets, William H. Meyers indicated that Brazil and China were becoming the major players in world markets for many commodities: the first as a key exporter and the second as a growing import market. He illustrated his point by highlighting recent developments in soybean and cotton markets, where Brazilian exports had surged in line with expanding Chinese imports.

He then turned to World Trade Organisation (WTO) negotiations and disputes and their potential impact on agricultural markets. He indicated that the current Doha round is at a critical stage and could significantly impact agricultural markets. He added that WTO rulings in cotton and sugar and perhaps other commodities might bring further policy changes, as in Step 2 US Cotton subsidies.

William H. Meyers concluded his presentation by underlining major caveats associated with the outlook. Those relate to the Doha Agenda and its outcome; WTO rulings in cotton (US), sugar (EU) and others; unilateral policy adjustments in response to WTO rulings; impacts of large countries such as Brazil and China regarding policy and technology changes; and trade impacts of Sanitary and Phytosanitary Standards (SPS) issues associated especially with BSE and Avian Influenza.

In his presentation on the world oil market, Mr. Robert Kaufmann (Boston University) looked into the determinants of the recent steep increase in international oil prices. According to him, the main reason is the fact that we are currently living off infrastructure that was built between the post-World War II and the 1970s. Over the last 35 years, investment incentives were insufficient, as the increase in global demand during 1970-2000 was much slower than in the period 1960-70. In addition, while the previous price shocks increased non-OPEC output, OPEC production has been below the level reached in the late 1970s ever since. The main determinant for oil production is currently the degree of OPEC capacity utilization: While OPEC capacity has not increased over the last 30 years; the degree of capacity utilization has gone from about 60 per cent in 1985, to 95 per cent today. Owing to this lack of spare capacity, OPEC has lost control over prices at the margin.

Another important determinant of international oil prices are OECD stocks: There has been a steady decline in stocks over the past 20 years in terms of days of forward consumption, although with a slight increase in absolute levels. A further bottleneck lies in US refinery capacity -- for many years there has been a lack of incentives to build capacity because US demand has been below its peak of the late 1970s. Meanwhile, outside the US, demand has gradually crept up to meet the available refining capacity, which has only registered a modest increase.

In addition to these tight market conditions, the impact of the 2005 hurricane season in the US has driven up oil prices. The disruption was much larger than in the 2004 season, and affected both crude oil production and refinery throughputs. As of November 2005, production has not returned to normal levels, unlike in the year before. With almost no spare capacity, any loss of supply, even if temporary, directly impacts the market.

Another question that Robert Kaufmann tackled was the question of production peak. While the world is not going to run out of oil, the production pattern over time is expected to roughly adjust to a bell-shaped curve. In this vein, Hubbert's (1956) prediction of a production peak for the US was correct in predicting the timing of the peak, although he underestimated somewhat the actual level of production at the peak[1].

When applying Hubbert's bell curve for estimates of the global peak, it turns out that the timing of the peak of the bell-shaped curve is relatively insensitive to the volume of recoverable production. Therefore, uncertainty about the total volume of oil left only changes the estimate of the timing of the peak in a maximum of ten years. This implies that, once the peak is reached, even dramatic increases in oil prices have no strong effect. Thus, once we are beyond the peak, it is estimated that the world would need the equivalent of a "new Saudi Arabia" every 5-10 years just to keep up. Current trends are, however, that oil majors are using cash to buy own stock, rather than to expand capacity. This makes economic sense, as adding capacity could ultimately hurt OPEC member states: if the decline in prices were to overcompensate the increase in production, there would be a loss of revenue.

According to Robert Kaufmann, global production will probably peak in about 20 years. Therefore, timely investments starting now will be critical for what things look like once the peak has been reached.

2.3 Regional economic outlook

United States

Prof. Lawrence Klein (University of Pennsylvania) presented the economic outlook for the *United States*. He pointed out that the United States, China and India are currently often cited as the three locomotives of the world economy. However, the United States economy is faced with serious problems that are obscured by positive headline numbers so that it cannot be regarded as a locomotive at the moment.

[1] M. King Hubbert: *Nuclear Energy and the Fossil Fuels.* Drilling and Production Practice (Spring 1956) pp.5-75. American Petroleum Institute.

With potential economic growth of 4.0 per cent, the growth figure of 3.8 per cent for the third quarter of this year appears to indicate a solid performance of the economy, but the numbers will be subject to two revisions and, hence, have to be treated with caution. Moreover, the apparently solid performance of the United States economy has also to be seen in the context of erratic government spending, a recent fall in industrial production, and a high level of consumption in fixed capital. The latter is due to depreciation, compounded by hurricane damages. Considering the methodology of measuring economic activity, he pointed out that the Net National Product (NNP) would be a more suitable benchmark than GDP and that the former has recently shown a negative growth rate. He then presented a series of variables that painted the picture of an economy that is growing at a solid, but not necessarily satisfying pace, and that is faced with numerous problems. More specifically, the housing market seems to be slowing down, but is unlikely to experience a decline in prices similar to that in the IT sector several years ago. On foreign trade, he noted that the trade deficit appears to have bottomed out in 2005, although the indications for this are still only preliminary and have to be confirmed by stronger data over the next 6 to 12 months. Regarding the labour market, he noted that employment did not show a vigorous increase and seemed to have leveled off; unemployment has fallen in most months since 2003; and increases in hourly earnings exceed the target inflation rate, but have not given rise to inflationary pressure so far. On the fiscal policy side, the fiscal deficit fell in 2005 compared to the previous year, but this was owed mostly to the one-off effect of special tax legislation so that without any policy changes, the deficit is likely to increase in 2006.

Japan

Mr. Kanemi Ban (Osaka University) gave a presentation on the economic outlook for *Japan*. According to the Tankan survey, confidence has increased especially in manufacturing in late 2004 and again in late 2005 when exports increased after having fallen in 2004. The production index has fallen since 2005 especially in IT-related sectors, while the inventory ratio has stopped worsening. Both consumer price inflation and producer price inflation have stopped declining due to increased energy prices since February 2005.

In the manufacturing industry, the output prices of coal, petroleum, iron and steel have increased. In contrast, growth in the transportation and electric machinery sectors has remained flat due to higher oil prices. The unemployment rate has decreased since early 2004, reaching 4.2 per cent in September 2005.

The Bank of Japan may soon end its of loose monetary policy as liquidity increases, its current account increases and the previous decline in bank loans moderates. Deflation is expected to end in April 2006, but the zero-interest rate policy may continue until the end of 2006. Government bond yields have increased from 1.35 to 1.55 per cent from September to October.

GDP growth in 2005 is 2.1 per cent down from 2.6 per cent in 2004, as net exports declined, but private demand increased. The latter will, however, decline in 2006 and 2007, especially private consumption as taxes will increase and deflation is ending.

In sum, Japan is recovering slowly. Firms suffer from the oil price hike but benefit from favorable market conditions. This is an appropriate time for fiscal consolidation through increased tax revenues. Consumption will slow down in 2006 although taxes will increase in 2007.

Western Europe

Mr. Ray Barrell (NIESR) discussed the regional outlook for *Western Europe*. Growth in the euro area was expected to be 1.3 per cent in 2005 down from the 1.8 per cent in 2004, due to the oil shock and a delay in a pickup in spending. Growth was expected to rebound to 1.9 per cent in 2006 as net exports improved and spending accelerated. The range of growth performances was large in the region - from 0 per cent in Italy to 3 per cent in Spain, but this dispersion was expected to narrow. Growth has been slow for awhile with the question of when strong growth would return.

Looking at the sources of growth, external demand remained supportive. In the fourth quarter there was a rise in demand of 9 per cent from the EU's export markets, particularly from those recycling oil export revenues, Russia, OPEC and Norway, but also from China. Of the major economies, however, only Germany had a positive contribution to growth from net exports. Generally it was domestic demand that was the main driver, but this was held back in many cases by the fiscal situations.

Inflation has risen to 2 per cent, but this figure is distorted by a change in methodology in the Netherlands, which cuts 0.2 per cent off the euro area rate, so the real figure should be around 2.3 per cent. Inflation was rising during a period of slow growth. Germany and France have below average inflation, but they are wealthier than average so this is consistent with the Balassa-Samuelson effect. With an European Central Bank target of 1.8 per cent, inflation in Germany at 1.6 per cent is relatively high.

The 3 per cent deficit limit for fiscal policy remains in force but the penalty mechanism has been abolished. Tightening is needed in some countries. In the past, Germany cut taxes to shrink the state, without much success. In France, which like Germany is at the top of the cycle, government spending actually increased. For 2006, it is expected that there will be a tightening of a quarter per cent of GDP in countries that exceed the 3 per cent limit. Many accounting tricks were used in the past but this has by now become more difficult.

Overall, the outlook is one of slow growth, increasing inflation, and fiscal tightening. Concerning monetary policy, interest rates are expected to increase sooner rather than later. This, combined with the continuing fiscal tightening, generates a sluggish outlook.

A simulation was performed assessing the impact of shocks which occurred since the spring forecast: the euro depreciated, long term interest rates fell, and the oil price increased. This should have generated an increase in euro area GDP, but the outcome was the reverse. The main reason for this downward revision to growth was slower trade. Looking at the evolution of export market shares, the euro area has lost 10 per cent of its market share since 2000; while Germany's share has remained largely constant, and might even have increased, Spain lost a little, France lost 10 per cent, Italy lost more than 20 per cent. Competitiveness in Italy and Spain has deteriorated through wage and price inflation as well as the euro. In Germany there has been no change, because the country specializes in hi-tech investment goods. Italy's sharp decline in market share is due to its unfavourable product mix.

The importance of trade shares is owing to their effect on trend growth rates, which have dropped for most countries in the EU. A further contributing factor to the decline in trend growth is the higher international oil price. Structural problems in the German labour markets contribute to an even stronger reduction in that country. As trend growth in the EU is slowing, there is a risk that governments could revert to policy measures to boost demand. This could increase inflationary pressures, especially against the backdrop of the current low interest rates; hence, the case for a rise in interest rates is getting stronger.

In the UK, growth was surprisingly weak. The oil price shock has reduced the supply capacity of the economy, so that despite the recent weakness it would be risky to lower interest rates. Inflation is rising and above midpoint of the target range.

Mr. Ray Barrell examined the effect of shifting inflation expectations. These should be anchored on the inflation target depending on the credibility of the central bank, but there is a possibility that they could drift. Firstly, looking at an endogenous shock to expectations - inflationary expectations were increased by 1 per cent - inflation rose by 0.5 per cent, the central bank raises rates by 0.6 per cent, and growth slows. Secondly, looking at the effects of a $10 increase in oil prices, the effect on output and inflation was much stronger if expectations drifted - from growth dropping by 0.2 per cent to growth slowing by 0.4 per cent and a higher inflation outcome. So currently it would be risky for fiscal or monetary policy to stimulate activity because of the possibility that expectations might drift.

Country Participant comments:

Mr. Roland Doehrn (RWI) commented on Germany, noting that at that time the makeup of the new government was unclear. Labour market reforms had occurred but they were not well designed. The incentive to work had not increased and it was more a passive labour market policy. There had been no real change in structure such as changing the dismissal law. The outlook, given the recent short term indicators, was not bad. The third quarter had been good, so that growth for the year as a whole was as good as could be expected. The pick up in inflation was stronger than expected due to the oil price, and there was a danger that inflation expectations might rise.

Mr. Carlo D'Adda (University of Bologna and Prometeia), agreed that the Italian product mix was unfavourable, but that the change to higher quality products was taking time. Recent data showed some small improvement.

Mr. Adolfo Castilla (Adolfo Castilla y Asociados, S.L.) made some points on Spain. There was no significant fiscal impulse and Government finances were weak, representing a drag on the economy.

Mr. Norbert Walter (Deutsche Bank) presented a paper in which he asked the question *Recovery in Europe: Will it Eventually Materialize?* His answer was no, despite the fact that it was very difficult for EU not to have a recovery. He noted that the world economy had moved out of the soft patch in the cycle, but there were questions on oil and other commodity prices. Monetary and fiscal policies were, however, less uncertain. He stated that the world economy would perform strongly for the firsts three quarters of 2006, but then there could be trouble. The price of oil was high but this would not last: investment was increasing; conservation was increasing; other energy sources were now more competitive and hence were picking up. In his view, therefore, the peak of oil prices was over. In addition there were compensating factors. European exports to oil producers had picked up a lot and alternative energy use was up with the oil intensity of growth cut in half since the 1970s.

Looking first at the dynamics of the world economy, the US and recently especially China were leading the way; their incremental contribution to growth was very large. On policy, in the US the Fed has a new chairman and interest rates would continue to rise perhaps more than anticipated by the market, with a question as to what this would mean for the rest of the world. In Japan the zero interest rate policy would continue through 2006 but then rates would rise. This meant that in 2006 the interest rate differential vis-à-vis Japan would increase, pushing the US dollar further up and the current account balance further down. To get the current account deficit down to three per cent of GDP by 2010 would require a tremendous exchange rate change or fiscal change, and these were not in current policy. On these grounds, Norbert Walter speculated that the US dollar could reach 150 to the euro and 80 yen to the dollar in 2007-08.

A major problem in the European Union was that there was too much savings and too little investment. Firms were saving rather than investing, the government could not expand (with demographics arguing against fiscal expansion), and with pessimistic consumer sentiment, consumption was slow. Business sentiment was satisfactory, mostly because exports were strong. But exports were the only category of final demand that was strong, owing to strong world demand and the decline in the euro since the beginning of 2005. Exports were expected to grow by 6-8 per cent and remain strong for the next two to three quarters.

Consumption was a major problem. Real wage growth was very poor, employment had increased moderately but in very low wage and in part-time jobs, so that it would take a very long time for income to increase. Wealth effects were divergent across the European Union. House prices supported consumption in some countries such as the UK, Spain and Netherlands but importantly not so in Germany, where there was zero change. Nevertheless, the house price bonanza was over; the UK was already slowing; in the Netherlands it was over; in Spain it would last a bit longer. This meant that the differences in wealth effects would disappear.

Capacity utilization was very low and there had been very little change over the last few years, one reason behind the poor investment performance. However, despite the low capacity utilization, there should still be some investment due to depreciation.

Headline inflation was 2 per cent, while core inflation stood at 1.4 per cent. So there was no reason for the ECB to raise rates. Rates were currently very close to those implied by a Taylor rule (2.5 per cent), but there was lots of talk of tightening. Norbert Walter strongly argued against this, saying that this would raise the risk of deflation, a danger heightened by the fiscal policy constraint. Further tightening would risk an appreciation of the euro, pushing down exports, the only source of growth.

The forecast for growth in the European Union was 1.5 per cent for the medium term, with investment weak and continuing strength in exports, which would be fine if there was no ambition, but he believed that potential growth could be higher. This would require working harder and longer.

On the German situation, he noted that there was a question of whether the election and the resulting grand coalition would be an opportunity, but he argued that it would result in a continuation of the status quo. The key issue was the fiscal deficit and it required that spending be reduced but instead it was most likely that taxes would increase. In addition, tax reform was necessary; the income tax needed to be lowered and the system made simpler. He argued that health spending needed to be privatized. Education was another area that needed to be made more competitive. Demographics was a major problem, there was no population growth, so that the ratio of young people to the total population was declining. He questioned how much immigration was possible, especially given the difficulties of non-similar cultural backgrounds.

In the discussion, Mr. Wladislav Welfe (University of Lodz) asked whether unemployment in Europe was likely to be reduced over the medium-term. In a similar context, Ray Barrel (NIESR) commented that while it was true that US productivity was higher than European, the reverse was true when measured with respect to person hours. In addition, Hans Timmer (World Bank) asked about the effect of East Germany, and whether it was a problem or a solution (through new investment and infrastructure). He also wondered about possible benefits of immigration, as it could help to keep the population young.

In response, Mr. Norbert Walter answered that there were big differences in unemployment trends across Europe. The UK was helped by strong output growth, in Denmark growth was not so strong but unemployment had declined, and in Germany unemployment was beginning to fall. In 5 years, the baby boom generation would start to retire so that unemployment would fall. Concerning productivity differentials, he argued that the European high productivity per hour worked was a function of the high rate of unemployment. If the economy added more low skilled employment, productivity per hour would decline. With respect to East Germany, he replied that it was a big part of the problem. At entry the eastern Länder tried to quickly catch up to western wage levels, contributing instead to an increase in unemployment. On immigration, he argued that it could not help maintain the demographic structure, but could slow the aging demographics, and it was mutually beneficial.

EU-8 and Southeastern Europe

Mr. Rumen Dobrinsky from Economic Commission for Europe (ECE) presented a short-term macroeconomic outlook for the *new EU members and Southeastern Europe*. Most of the new EU members, according to the speaker, preserved their dynamism in 2005, but average GDP growth slowed after a peak in 2004, and the pace of growth remained uneven in the region, with the Baltic States remaining the fastest growing economies of the EU-8. Export growth strengthened on the basis of new FDI-led export capacity and shifts in the export structure to more value-added production. Moreover, the countries' export shares in world markets increased. Domestic demand, meanwhile, has moderated. Macroeconomic policies can be viewed as neutral even though monetary policies remained to some extent supportive, since pressure from the European Commission to comply with the EU fiscal rules caused some lowering of the fiscal deficits. Inflationary pressures in the EU-8 remained subdued, since the effect of high energy prices was marginal and there were no policy-induced inflationary pressure. The outlook for the region for 2006 is favourable, taking into account economic sentiment indicators, although there are some risks associated with delayed recovery in the eurozone, which may dampen export expansion; significantly higher than expected energy prices; and challenges to achieve fiscal consolidation.

In Southeastern Europe, according to Rumen Dobrinsky, economic growth remained vibrant, and the EU accession countries benefited from rising investor and consumer confidence and solid inflows of FDI. Continuing expansion of export-oriented productive capacity and improved financial intermediation as well as robust consumer spending and housing construction were among the factors boosting these economies. Successful post-conflict reconstruction and macroeconomic stabilization in other countries of this sub-region also contributed to better economic performance.

Robust domestic demand, supported by a credit boom, was the major driving factor in Southeastern Europe. Owing to tight fiscal policies it is mostly attributed to the private sector. The downside of such growth pattern is a widening of the current account deficits. Policy response to these deficits is complicated, since interest rates hike can be counterproductive, and so far various types of credit restrictions were implemented in the sub-region. If domestic demand does not cool down, further fiscal restraint may be needed. Major risks for the sub-region therefore include excessive reliance on domestic demand as a source of growth and potential problems with debt sustainability. Possible policy tightening may constrain economic activity.

During the open-floor discussion, the question was raised whether the new EU members are considering adopting direct inflation targeting policy, as in the EU. Another participant wanted to know whether there was any specific reason why the Baltic States were the fastest growing region in the new EU and whether this was a macroeconomic policy related issue.

In reply, Rumen Dobrinsky clarified that direct inflation targeting was already in place in a number of the new EU members. The strong growth in the Baltic States was owing to their favourable geographic location, significant FDI inflows from their neighbours, and to consistent policies, for example, maintaining fiscal balance.

CIS region

Mr. Rumen Dobrinsky went on to present the economic outlook of the *CIS region*. Despite some slowdown after two years of exceptionally strong growth, the CIS remains the fastest growing sub-region with an average GDP growth of 6.3 per cent in 2005. This outcome reflects a moderation of growth in the largest economies, namely the Russian Federation and Ukraine. The external conditions have been both positive and negative. While on the positive side oil and gas reached new heights, softening steel prices and declining cotton prices have had a negative effect on growth of the countries which export those commodities. The ongoing pro-cyclical loosening in fiscal policy and the expansionary monetary policy in commodity exporters have also been supportive of growth in the CIS.

Mr. Rumen Dobrinsky discussed the main sources of growth in the CIS, emphasizing the vulnerability of some countries in this region related to heavy reliance on commodity exports. Ongoing surge in domestic demand is another growth factor in many countries, which is leaking to large imports, due to the still low response of domestic supply. On the macroeconomic policy side, monetary policy in the commodity exporters of this region remains under strain due to the Dutch disease as large foreign exchange inflows fuel rapid monetary expansion and the central banks in those countries refrain from massive sterilization to prevent excessive real exchange rate appreciation. There are pressures for fiscal loosening as well, owing to the difficulties to assess the actual fiscal stance in the absence of data on structural balances in some countries. The Stabilization Funds in Azerbaijan, Kazakhstan and the Russian Federation have absorbed part of the oil-export revenues, but policy pressure to use it for current spending remains.

Finally, the speaker discussed the sustainability of the current growth pattern in the CIS, emphasizing the risks and the challenges ahead. He noted that the current sources of high growth rates may soon dry out as long as there are limits to growth of commodity exports. The insufficient level of investment in the non-commodity sectors does not allow for broadening the growth base, which still remains narrow and vulnerable to external shocks. Long-term growth prospects in the region hinge on the success in diversifying economies and on economic reforms.

On the question regarding inflation targeting that came up in the discussion, Rumen Dobrinsky noted that some countries in the CIS region are also considering this option though they are facing structural problems.

Mr. Andrei Roudoi**,** (Global Insight) gave a presentation on the *Sustainability of Economic Growth in Russia*, focusing on the potential of the Russian economy to sustain growth at the pace of 6.0 – 7.0 per cent per year. He analysed economic growth in the Russian Federation for the period 1999-2004. Growth for that period was faster than in many developing countries, such as Brazil, Mexico and India, but slower than that in China.

Economic performance in 2004 was argued to be the best in the post-war history of the Russian Federation. In 2005, however, the economy experienced a slowdown despite the higher prices for oil and gas, which according to Andrei Roudoi is generally considered the main determinant of growth. He provided estimations about the relationship between oil prices and GDP growth, arguing for a high correlation till the middle of 2004. Meanwhile, on-going real appreciation of the rouble has dampened the positive effect of higher oil prices and prevented faster growth. He also argued that the Russian authorities seem to be reluctant to accelerate growth of money supply as it is already high.

Another growth factor – rising capacity utilization, which made a strong contribution to growth in the period after the Russian crises in August 1998 - seems to have exhausted its potential as well. In addition, despite the relative high rates of growth of fixed investment, there is still insufficient capital due to the low base. Demographic changes are also negatively affecting growth, which - coupled with problems in labour mobility - may have long-term consequences on growth sustainability.

Mr. Andrei Roudoi argued that the effects of all those factors, however, might be offset by domestic developments in the short run. In particular, the deterioration of investors' confidence seems to be over and there is an ongoing improvement in construction; and the stock price index is growing faster than in 2004. There are plans to increase exports of commodities other than oil and the strong currency might have had a less substantial impact on growth than expected (estimates of the author do not provide clear evidence on the negative effect of the rouble appreciation on growth, while its immediate effect is positively correlated with imports). Fiscal policy has been generally tight in recent years but there are signs of relaxation, which according to Andrei Roudoi could contribute to strong economic growth in 2006. In conclusion, he pointed out that the economy of the Russian Federation is likely to grow at a pace of around 5 – 6 per cent for the next 2 or 3 years.

Among the issues raised during the discussion by conference participants were the problems of the Dutch disease as an interpretation to what has happened in the Russian Federation in 2005. Andrei Roudoi responded that though real appreciation of the rouble has affected some sectors, there are still sectors successfully competing in international markets. Rumen Dobrinsky disagreed with some points in the presentation, especially on the fiscal policy stance. He noted that we still did not know whether fiscal policy was relaxed in 2005. There are two channels of fiscal spending in the Russian economy – through government spending and through the Stabilization Fund – and we have to look at the developments there. He argued that determining fiscal relaxation/tightening depends much on the point of neutrality. Another question was raised about the monetary policy in the Russian Federation, which according to Andrei Roudoi had two targets – to prevent further appreciation of the rouble and to keep inflation at a rate which is preliminary set by the Government.

Africa

Mr. Janvier Nkurunziza from Economic Commission for Africa (ECA) presented the regional outlook for *Africa* and analysed one of the main challenges the continent is facing, namely high unemployment rates in most African countries and the persistent link between high unemployment and poverty.

GDP was expected to expand further in 2005 and 2006, reflecting to a large extent stronger performance in oil producing countries. On the downside, political instability in Côte-d'Ivoire and Zimbabwe and macroeconomic problems in Seychelles made these countries the worst performing economies in the region.

Higher commodities prices, particularly oil prices, and better macroeconomic environment (low inflation, current account and fiscal surpluses, increasing FDI and lower debt stocks) were the main factors behind the overall improved outlook. Despite the inflationary push of higher oil prices, average consumer price inflation in Africa remained stable, increasing from 7.8 per cent in 2004 to an expected 8.3 per cent in 2005. The apparent limited effect of stronger oil prices was due to the low weight of oil in the consumer basket of most countries.

Fiscal and external balances for the region were expected to improve in 2005 thanks mainly to increased hydrocarbon revenues and rising FDI inflows to the continent. The debt situation is also expected to improve, with Africa's external debt declining from US$293 billion in 2004 to US$285.8 billion in 2005. More favourably, the G8 proposal to write off the multilateral debt of many African countries at the Gleneagles Summit in June 2005 would lessen their debt burden in years to come.

The medium-term outlook for Africa is positive. GDP for the continent will accelerate to 5.3 per cent in 2006, which will be the highest rate recorded in a decade. Various risks of the outlook outlined in the presentation included, on the upside, the prospects of more aid and debt relief, higher commodities prices and export volumes, stronger agricultural production, continued sound macroeconomic policies and stronger world demand. On the downside, the main factors were continued higher oil prices and their detrimental impact on net oil importing countries, deterioration in terms of trade, political risks stemming from lingering conflicts and adverse weather conditions.

On the issue of employment and poverty reduction, it was stated that stronger economic growth had failed to reduce poverty significantly in Africa. The poverty rate, estimated at 46 per cent, has not declined over the past two decades and appears to be the highest in the world. The poor relationship between economic growth and poverty reduction was largely attributed to the fact that growth had been driven mainly by capital-intensive rather than labour-intensive sectors. Poverty levels within a large percentage of the working populations in many African countries were high, which suggests that employment generally tends to be concentrated in low-productivity sectors. The second factor that explains the poor link between growth and poverty reduction is that growth, although high in recent years, falls well below the benchmark estimate of 7 per cent estimated by ECA and other organizations required to make a significant dent in poverty levels in Africa. The third explanatory factor is the highly uneven distribution of income (Africa has the second-highest Gini coefficient, after Latin America) which means that the benefits of growth are not spread evenly and equitably.

Concluding his presentation, Janvier Nkurunziza raised five key questions which are central for Africa's future development: (1) Why isn't poverty more responsive to growth? (2) How should Africa reduce its dependency on unpredictable weather and oil prices? (3) How could oil resources be used to diversify African economies? (4) How should second-generation reforms be consolidated? (5) How could higher rates of investment be attracted in the "right sectors"?

Ms. Charlotte du Toit (University of Pretoria) presented a report on economic developments in *South Africa*. Real GDP growth accelerated to 4 per cent in 2005 from 3.8 per cent in 2004. Growth in 2005 was based primarily on strong consumer demand as a result of lower tax and interest rates, greater access to financial services and corresponding growth in credit expansion. The Government announced GDP growth targets of 6 per cent to be achieved by 2010. However, potential growth, based on potential employment, savings and investment trend growth and South Africa's ability to attract FDI realistically put a ceiling on GDP growth of 4 per cent over the forecast period. South Africa's official unemployment rate was 28 per cent, but this number excludes people who have become discouraged and stopped looking for work. An expanded definition that includes the discouraged puts the unemployment rate at 41 per cent, presenting a severe drag on growth prospects. These high unemployment rates are attributed to structural rigidities in labour markets traced to inflexible labour laws. The high unemployment rates are further complicated by a large influx of illegal and unskilled workers from neighbouring countries and significant "brain drain" to the rest of the world. South Africa is expected to record a deficit on its current account, but portfolio and FDI inflows bolster currency reserves which – along with increasing gold reserves - currently provide 15 months of import cover.

Ms. Suzana Maria de Fatima Camacho Monteiro (Banco Nacional de Angola) presented an updated report on developments in the *Angolan* economy and post-conflict rehabilitation of various sectors and activities.

Mr. Richard Eyiah (Claydord Consult) mentioned that *Ghana* was achieving some measure of success in reducing inflation despite high international oil prices. Ghana also made significant progress in fiscal consolidation. With promised debt cancellation from the G-8 countries, Ghana would no longer depend on the IMF for budget support. However, the combined effects of declining prices of the country's main commodity exports (cocoa, timber and gold) and high oil prices are expected to lead to current account deficits over the forecast period 2005-2009.

In the question and answer session that followed the presentations it was acknowledged, in reply to questions from Mr**.** Désiré Vencatachellum (African Development Bank) that HIV/AIDS continues to have a negative impact on the economies of some African countries, as skilled personnel are lost at a faster rate than is possible to replace them. Regarding loss of trade preferences in sugar, textiles and other preferential arrangements, it was also acknowledged that this development will cause loss of market shares in global markets to the detriment of African economies.

On FDI flows, Mr. Kodjo Evlo (Université de Lomé) commented that African countries should also focus on minimizing corruption, improving governance and reducing market distortions, in addition to policy targeting as recommended in the presentation, to increase FDI flows to Africa. It was also suggested that African countries should address the social and distributional impact of reform policies since this was largely missing from earlier structural adjustment programmes.

Mr. Kenneth G. Ruffing (OECD) indicated that the joint report of the African Development Bank and the OECD, the *African Economic Outlook (AEO) 2005*, generally agreed with the analysis and outlook presented at the meeting. The AEO believes, however, that too much emphasis was being placed on FDI inflows to stimulate Africa's development. Instead, more attention should be focused on private-sector development of small- and medium-scale enterprises which are missing from most African economies. The AEO refers to this phenomenon as the "missing middle" between large informal sector in some countries on one end of the scale of economic activities, and large state- or foreign-owned enterprises on the other end. Development of the missing middle would encourage increased investment, both domestic and foreign.

East Asia

Mr. Hiren Sarkar from Economic and Social Commission for Asia and the Pacific (ESCAP) presented the regional outlook for Asia. *East Asia* is expected to see an acceleration in economic growth from 4.3 per cent in 2005 to 4.9 per cent in 2006, while inflation is forecast to remain at around 3.4 per cent. However, the phasing-out of subsidies on petroleum products in several economies will pose a significant upside risk to the inflationary outlook, increasing the likelihood of a continuation of the moderately tighter monetary policy stance in the region. He noted several downside risks to the economic outlook for the region, especially the possible emergence of more protectionist trade policies in export markets; the still low level of interest rates, giving rise to the continued risk of asset price bubbles; the high level of foreign exchange reserves in several economies; a widening of the gap between savings and investment; and a more serious outbreak of avian flu. Looking at individual economies, he pointed out that China is likely to see continued strong economic growth, despite a slight slowdown in its expansion from 9.2 per cent this year to 8.3 per cent in 2006. The Republic of Korea, by contrast, will experience an increase in economic growth from 3.6 per cent this year to 4.8 per cent in 2006, based on sound macroeconomic fundamentals and solid external demand. Hong Kong SAR's economic growth will, to a limited extent, be negatively affected by the slowdown in China's growth, resulting in a deceleration of its economic expansion from 5.9 per cent in 2005 to 4.7 per cent in 2006. The anticipated upturn in the global electronics cycle will underpin stronger growth in both Taiwan Province of China and Malaysia, while Singapore's economic growth will be supported by a combination of strong exports, policy initiatives aimed at opening up new foreign markets for exporters, and positive macroeconomic fundamentals.

South Asia

Mr. Hiren Sarkar (ESCAP) continued his presentation with the outlook for *South Asia*, where growth is expected to be robust, with ESCAP forecasts of 6.9 per cent in 2005 and 7.0 per cent in 2006. Inflation, which in 2005 was fuelled by the phasing out of domestic fuel price subsidies, is expected to decline in most countries in 2006, as the pass-through abates and monetary policies continue their cautious tightening stance. The major downside risk for the region would be a continuation of high oil prices, resulting in increased current account deficits and continuing inflationary pressures. In his discussion of individual economies, Hiren Sarkar noted that India remains a significant driver of regional growth in both 2005 and 2006, sustained by robust performances across sectors and by enhanced government spending on infrastructure projects. As in most South Asian oil importers, India's current account balance is expected to post a deficit in both years. Pakistan registered the highest growth in two decades in 2005 and is expected to remain strong in 2006. As in India, growth was broad based, but large scale manufacturing continued to be the main driver. Inflation spiked in 2005, fuelled by strong domestic growth and high oil prices, but is expected to come down in 2006.

Mr. Salahuddin Ahmad (School of Business, University of Liberal Arts Bangladesh) briefly outlined the economic outlook for *Bangladesh*, which enjoyed solid growth of around 5.5 per cent in 2004 and 2005, with a slight increase expected for 2006. Overall growth in manufacturing was satisfactory, not least in the manufacturing of garments and knitwear for the export sector. Salahuddin Ahmad stressed that while this came somewhat as a surprise to many analysts who had expected the Bangladeshi textiles industry to be hard-hit by the phasing out of the Agreement on Textiles and Clothing (ATC), it was really in line with policies and investments to enhance productivity and product quality. In the future, however, there is a risk that infrastructure bottlenecks could hamper further growth in this sector.

Mr. Dilli Raj Khanal (Institute for Policy Research and Development, Kathmandu) contributed an assessment of *Nepal's* economic situation and outlook, which he described as precarious, owing mainly to the political instability which had increased since the royal takeover in February 2005. While agricultural output remained relatively stable, construction and tourism suffered from the insecurity, and trade was additionally hit by the phasing out of the ATC. Garment exports from Nepal declined by more than 40 per cent, affecting export earnings as well as employment. In the outlook, remittance inflows will continue to be the main support for domestic consumption, and growth prospects are expected to remain bleak unless the political conflict is resolved.

Ms. Pami Dua (Delhi School of Economics) presented some of her work on the medium-term growth perspectives and the problems in forecasting of the *Indian* economy. A second leading question in her presentation was India's vulnerability to the external environment, particularly related to exports.

Firstly, Pami Dua showed that variations in India's annual GDP growth continue to stem mainly from the agricultural sector, which depends heavily on the monsoon rains as irrigation covers only 40 per cent of the gross cropped area. While agriculture contributes only around 25 per cent of total GDP, the livelihoods of more than 60 per cent of the population still depend on it, thereby translating into volatile domestic demand patterns. Although service sector growth and the increasing prowess of the industrial sector have contributed to a reduction in growth volatility, the vagaries of the monsoon still present a formidable forecasting problem. As such, Pami Dua explained, baseline forecasts are based on the assumption of normal rainfall and an assumed agricultural trend growth rate of 3.5 per cent, and simulations of different monsoon turnouts are used to create alternative scenarios.

Secondly, she analyzed export and current account vulnerability, assessing possible effects of external shocks on the Indian economy. India's exports have shown a strong growth performance in the last years, while the composition of main export destinations has changed significantly. As exports to the United States and to Europe have declined, there was an increase in the exports to East and to Western Asia. Hence, a slowdown in the advanced industrial countries would affect India's exports less than only a few years ago. Within Asia, China has emerged as the main destination for India's exports, while Japan and Hong Kong, SAR are becoming less important. Concerning the composition of export goods, vulnerability has increased, as both commodities and textile and engineering goods are cyclically sensitive. However, the services sector has by now become the main driver of exports, with the ratio of service exports to total exports doubling over the last 20 years. Concerning imports, India's vulnerability has increased on account of its dependence on oil-imports, but it has decreased because of enhanced intra-Asian trade and because of rising non-oil imports. In the medium-term outlook, Pami Dua expects the external sector to show sustained growth, but with a widening trade deficit and continuous deficits on the current account.

During the discussion, Lawrence Klein (University of Pennsylvania) raised the question whether the estimates presented for India included a feedback from cotton production to manufacturing of textiles and clothing, whether services exports also counted healthcare services, and whether there was a noticeable feedback of IT services into overall production efficiency; all of these questions were answered in the affirmative by Pami Dua. Another question concerned the increase in the Indian oil import bill, which was mainly owing to higher prices, and not so much to higher import volumes, as Pami Dua clarified.

Western Asia

Mr. Fadhil Mahdi from Economic and Social Commission for Western Asia (ESCWA) presented the economic outlook for *Western Asia*, where growth is being led by the countries of the Gulf Cooperation Council (GCC) which are benefiting from higher international oil prices. The More Diversified Economies (MDE) are, however, also growing more rapidly than in recent years (with the exception of 2004), partially owing to intraregional spillover effects from workers' remittances and tourism. Aggregate growth of the GCC countries is estimated at 6.2 per cent for 2005, and 6.4 per cent for 2006, whereas growth is estimated at 4.3 per cent and 4.4 per cent for the MDE, respectively. Overall, the Western Asia region (excluding Egypt), is estimated to grow by5.8 per cent in 2005 and 6.2 per cent in 2006. This compares very favourably with 1.8 per cent before the current oil price boom.

Total oil export revenues of the Western Asia region are estimated at US$283 billion for 2005 – representing an increase of US$68.8 billion over 2004. For 2006, they are projected at US$303 billion under the low oil price scenario (US$52 per barrel), and US$332 billion under the high oil price scenario (US$57 per barrel).

Governments in the oil-exporting countries have used conservative budgetary assumptions for oil prices in 2005 and 2006, which results in an "expenditure lag" that will cause the fiscal impact of the boom in these economies to spread over time. Budgetary assumptions are currently in the range of US$21-27. Hence, growth in the current cycle has largely been private-sector-led, with the public sector lagging behind.

Although the current economic momentum is expected to continue as long as oil prices remain high, there are some downside risks. Extremely rapid growth in stock market capitalization and real estate prices across the region indicate that asset bubbles may be forming, with the associated risk of a sudden burst should heavy real estate investment lead to a supply glut, or if oil prices were to decline dramatically. Overall, the current economic boom in the region is fragile, as it is based on a single commodity rather than on improvements in productivity.

Inflationary pressures in the region increased during 2005, as liquidity increased strongly - particularly in the GCC - despite sterilization policies, and there has been rapid growth in private sector credit. Official inflation measures in many countries in the region don't reflect this, but anecdotal evidence of higher inflationary pressures includes increases in housing rents in Jordan and UAE, as well as in public sector salaries in many countries; in Iraq, high inflation is largely associated with the supply side (cost-push inflation).

The region has one of the highest unemployment levels worldwide, and it is particularly high in the conflict-affected economies. In Saudi Arabia, the nationals' unemployment rate has declined due to labour "nationalization" policies as well as strong economic growth. In the GCC, labour markets are segmented between nationals and immigrants, preventing adequate absorption of the native labour force.

Continuing with some individual country outlooks, Fadhil Mahdi highlighted the situation in *Iraq*, where ESCWA expects GDP growth of around 6 per cent for 2005 and 12 per cent in 2006. The country is, however, still affected by supply disruptions in the energy sector, destroyed infrastructure and restrictions on mobility. Also, unemployment remains very high as a result of the conflict, and is currently estimated at 26 per cent. On a different note, Iraq managed to build up foreign exchange reserves of US$7.9 billion in 2004, about 3.2 months of imports, and the New Iraqi Dinar has gained remarkable stability, largely owing to the new Central Bank auction system.

Palestine's economy is currently stagnant, and the country relies on workers' remittances to ameliorate the low levels of income. The "separation wall" contributes to the economic weakness by partitioning markets and obstructing labour and goods mobility. Unemployment was 28.6 per cent in 2004, up from 14.1 per cent in 2000.

Growth in *Lebanon* is estimated at 2 per cent for 2005, but the political turmoil over the past year is estimated to have cost the economy more than 1 per cent of GDP. Tourist inflows have contracted remarkably in 2005, and with one of the world's highest debt-to-GDP ratios, there is risk of devaluation and further deterioration of the economy.

Mr. Fadhil Mahdi concluded his presentation by drawing attention to economic policy challenges in the region. As main priorities in the GCC, he identified the channeling of surpluses towards productive activities and human development objectives, while building financial reserves to prepare for periods of low oil prices; curbing of speculative lending by banks through interest rate policy; controlling of inflationary pressures; and building of larger regional markets through investment in the region. In the MDE countries, Yemen should seek to relax regulatory restrictions to investment in order to benefit from the spillover of the current oil boom, and encourage lending through improving interest rate regulations. His recommendation for Syria was to relax restrictions on private investment and encourage economic diversification in order to reduce dependence on depleting oil reserves.

As policy priorities for countries in conflict, especially Iraq, he pointed out the need to achieve political reconciliation; to raise financial resources for labour-intensive growth programmes; to relieve critical bottlenecks in the economy (such as oil refining and electricity); to invest in oil production capacity; to promote development banking; and to pursue a waiver of war reparations.

Latin America and the Caribbean

Mr. Andre Hofman from Economic Commission for Latin America and the Caribbean (ECLAC) presented the economic outlook for *Latin America and the Caribbean*, which performed well in 2004 and will continue to do so in 2005 but at a slower rate. The region is expected to grow 4.5 per cent and 4.3 per cent in 2005 and 2006, respectively, owing to growth especially in South America (4.5 per cent), while Mexico and Central America will lag behind at 3 per cent. Thus, growth is heterogeneous across the region, which is, however, experiencing four consecutive years of growth for the fist time since the beginning of the nineties, and GDP per capita is growing stronger than before.

Argentina's growth is settling into a new path not only owing to the recuperation process but also to increasing capacity, but it has not yet reached equilibrium. *Chile's* domestic demand's steady path will continue. *Venezuela's* growth is due to recuperation and an oil bonanza while *Peru's* growth is owed mainly to strong external and domestic demand. *Brazil* will grow by 3.8 per cent in 2006 and 3.5 per cent in

2005. After a slump in he first quarter of 2005, growth recuperated in the second quarter as inflationary pressures decreased and monetary policy became looser, and the fiscal situation improved. *Mexico* will grow only by 3 per cent in 2005 as the manufacturing sector is hurt by fewer exports to the United States. Some recuperation is expected for 2006 (3.5 per cent) as public investment in infrastructure increases. The *Caribbean* grew below average except in Trinidad and Tobago (owing to the oil boom).

Recent growth has been driven by export demand especially of commodities resulting in highest levels of growth in many years. Terms of trade have improved, and are likely to continue to do so in the near future. The region's trade and current account enjoyed a third year of surplus. Domestic demand is also increasing, mainly owing to investment while consumption is steady.

Inflation is easing and remains stable except in the Southern Cone, where inflation has been above target in Chile and Argentina. Fiscal measures are needed in the latter. Monetary policy has been restrictive up to now especially in Chile and Mexico, but will loosen as inflationary pressures decrease.

An element of concern is the appreciating real exchange rate especially in Brazil, where problems in competitiveness will rise if trends in commodity prices are reversed and inflationary pressure increase. Risks to the growth forecast may also come from a possible sharp slowdown in trade partners (e.g. US), in case of a disorderly adjustment of global imbalances; from a reversal in commodity prices; or from a sudden and drastic hike in international interest rates. Concerns have also arisen about a Dutch Disease effect from high remittances.

On the upside, sovereign risk ratings have decreased drastically to historical lows throughout the region, including Argentina. Debt ratios have improved somewhat in terms of exports and GDP, although debt problems continue to exist in Mexico and Brazil.

Mr. Arturo O'Connell (Banco Central de la Republica Argentina) commented on the economic outlook for *Argentina*, where GDP is growing at 4 percentage points - above the peak of 1998. The expansion is no longer a recovery - which was led by the devaluation, but is now set to moderate. Unemployment has decreased but is still high despite labour-intensive growth. Exports, especially those of manufactured goods, increased. Controlling inflation will remain a challenge.

Ms. Cristina Rodriguez (Metroeconomica) commented on the economic outlook for *Venezuela*, for which she expects higher growth rates than forecasted by ECLAC, owing to an expected 40 per cent increase in public investment. In 2005, foreign exchange reserves increased as exchange controls were relaxed. Consumption also recovered, owing to increased employment and higher government transfers. Inflationary pressures did not emerge despite a fiscal deficit, as price increases were kept low by the anchored exchange rate and by price controls. Business expectations are lower as the international oil market looks less positive.

3. Economic policy issues

3.1 Unwinding global economic imbalances

Mr. Heiner Flassbeck (UNCTAD) introduced the problem of global imbalances by emphasising its complex nature. The traditional view focuses on the potential role of significant real exchange rate movements in contributing to higher savings (especially in the United States) and increased investment spending (particularly in emerging economies in Asia). In contrast, Heiner Flassbeck argued that the starting point should be a closer analysis of different shocks affecting surplus countries in the past and their effects on their domestic economies and external balances. In this vein, he presented evidence on selected countries that have in the past either posted continuous surpluses or moved from deficits to surpluses by analysing how their economies responded to the different shocks that they have experienced over time.

While the major global current account deficits are concentrated only in a few countries, such as Spain, Australia, Italy, and - most notably - the United States, the corresponding surpluses are spread out among a larger group of countries. Among the surplus countries, Japan leads with a huge current account surplus, followed by the economies from the euro area (in particular Germany), China and the oil-exporters. While the recent oil price shock explains the switch in the latter group of countries from current account deficits throughout the 1990s to surpluses in the past few years, the other countries were subject to a number of diverse shocks in the period between 1980 and 2004. In the continuation of his presentation, Heiner Flassbeck focused his attention on these countries' experiences in order to try and derive more general lessons about possible rebalancing mechanisms.

In Japan, which has been a traditional surplus country since the 1980s, the biggest ever real appreciation of the currency in the beginning of the 1990s, of around 50-60 per cent, had no effect on surpluses. In other words, the exchange rate shock was simply absorbed. The fact that the appreciation did not remove the current account surplus is explained largely by the squeeze of corporate profits, which kept export prices at the same level. According to the speaker, this possibility of an exchange rate shock absorption was the lesson to be learned from Japan.

In Germany, after a period of big surpluses in the 1980s till the end of 1990's, there was a sudden sharp drop into deficit until 2000, when the current account returned to a surplus position. The shock, as argued by Heiner Flassbeck, was the German reunification, with the associated deindustrialization in East Germany, where 50 per cent of the current account deficit accrued. France followed a different path – from a current account surplus to a deficit in 2004. A closer look at the private saving, or government dissaving, however, reveals a common trait of both countries: Saving rates in terms of household and government savings have not changed much, but major changes occurred in corporate savings. A large increase in German corporate savings was owed to a major real depreciation in Germany compared to other euro area countries, which in turn was due to productivity increases and low inflation rates.

In the third case, China, which is not a traditional surplus country, the large surpluses of the recent years are the result of an untypical shock. While the real exchange rate for the overall economy remained relatively constant, significant structural changes in this country's economy caused a real depreciation in its most important sector, manufacturing. As massive FDI inflows over the past few years have lead to a productivity increase by 10-15 per cent, export prices for manufacturing goods could decline in spite of rising wages. In tandem, corporate profits and corporate savings increased, bolstering saving rates in spite of a decline in household savings.

The Republic of Korea is an example of a country which has been affected by a major shock – the 1997 Asian financial crisis – which turned around its current account balance. Before the crisis, Korea posted a substantial deficit, driven by high foreign savings and a large government deficit. After the sharp real currency depreciation during the crisis, increased corporate profits accounted for an upward shift in corporate savings, and a shift of the current account into surplus. Argentina experienced a similar shock in 2001-2002 when foreign inflows stopped abruptly and the economy was deprived of the means to invest. This, however, didn't last long, as national savings increased quickly, substituting foreign inflows and helping to turn the current account into surplus. Although no detailed data is available, chances are that the main factor behind this increase of gross savings was again increased corporate savings, as corporate profits increased in response to the devaluation shock. Brazil was provided as another example where real depreciation (in 2001) triggered a turnaround of the current account from deficit to surplus. Again, corporate profits must have increased, and investment quickly returned to normal levels.

According to Heiner Flassbeck, the examples of Korea, Argentina and Brazil show how real exchange rate adjustments can indeed cause expenditure switching, away from imports and back to exports, turning around the current account and benefiting the domestic sector. This behaviour is in line with exchange rate theory, but not with the savings-investment point of view.

As for the United States, recent global economic developments have not been sufficient to dent the current account deficit. The fall in real exchange rates has not been enough to offset the growth differences between the US and the major industrialised surplus economies (Japan and Germany), where an increase in domestic absorption would be possible but is politically unwanted. In contrast, an increase in domestic absorption would be anything but impossible in fast growing China. Thus, the US's major trade partners continue to post surpluses and to provide the country with large financial inflows which substitute for household and government savings and help finance the growing deficit.

During the discussion, Mr. Pingfan Hong (United Nations) expressed reservations on key issues raised in the presentation on global imbalances. While he agreed that there was a variety of factors affecting current account imbalances, such as cyclical, structural and institutional, he found it hard to believe that all of these factors should have nothing to do with savings and investment. Raising further methodological issues, Hans Timmer (World Bank) argued that the analysis should not start by looking at the determinants of savings and investment behaviour but first consider the real exchange rate effects and then move to behaviour, as the economic logic goes first from prices to exchange rates and then to behaviour.

In response to the first concern, Mr. Heiner Flassbeck noted that the savings-investment identity was just an identity and did not imply causality. If one includes systematically companies' profits into the model – and they become endogenous – then other factors have to be included in order to explain imbalances. As for the methodological concern, he argued that shocks such as the oil price shock were really exogenous to the system. Also, wages were under the strong influence of governments, as there were laws allowing governments to intervene in setting the wages. FDI represented another exogenous variable that affected savings and investment behaviour.

Further questions were raised during the discussion as to how the imbalances could be reduced, and, in particular, whether a combination of different measures would be appropriate, and if so, what such a combination should be. In his reply, Heiner Flassbeck emphasized that in the case of China, the problem was not an economy wide currency undervaluation but only in specific sectors as a result of increased competitiveness owing to FDI. It was hence unclear whether a general revaluation would be an appropriate policy response. In contrast, Germany and Japan should clearly let their currencies appreciate, but this was not possible for Germany as a member of the European Monetary Union. Both Germany and Japan should, however, stop any attempts to permanently improve competitiveness by pushing their economies on a deflationary path and depressing domestic demand.

Prof. Lawrence Klein (University of Pennsylvania) noted that in each of the presented country cases, one could find something reasonable to explain why there were countries with big surpluses and deficits. He gave two examples – Japan and China - where the reasons behind the high savings rates were largely related to the low immigration rate and military burden in the former and to the low relative wage rate in the latter.

3.2 Foreign direct investments in Africa

Mr. Hilary Nwokeabia (UNCTAD) presented a review of FDI inflows to Africa, which was based on UNCTAD's *World Investment Report* issued in September 2005. The purpose of the presentation was to respond to two key questions: Whether FDI is flowing to the industries where it is needed most in Africa; and what role policies of recipient countries can play in targeting FDI flows to sectors that would enhance employment creation and poverty reduction.

FDI flows to Africa remained buoyant in 2004 and constituted the largest source of external finance for the region. The main driving forces behind this performance were increased investment in natural resource exploration and production, buoyant commodities markets, continued liberalization of FDI policies and higher investment returns in the continent. The region's top recipients were predominantly oil exporting countries such as Nigeria, Angola, Equatorial Guinea, Sudan, Egypt and Algeria. However, some non-oil producing countries, including Democratic Republic of Congo, Morocco and Tunisia, were also large recipients of FDI.

FDI policy responses at national, regional and global levels focused mainly on liberalizing legal frameworks, improving fiscal regimes and securing foreign exchange retention. However, targeting of FDI inflows to achieve diversification, either into value chains or agriculture where most of the poor are employed, was not sufficiently taken into account in national policies. None of 114 FDI policy measures examined in 2005 contained provisions for targeting FDI inflows. All were designed to address broad legal, fiscal and monetary arrangements to enhance stability of the FDI flows.

According to the speaker, the prospects for 2005 were encouraging. FDI flows to Africa were expected to double in the next few years, reflecting strong global economic growth; higher prices for commodities such as oil, gold, platinum and diamonds; improved corporate returns and continuing improvement of the investment climate. However, most FDI was, again, likely to flow to the oil industry. Against this backdrop, there was the need to use FDI inflows to promote diversification into areas such as processing and manufacturing of primary products that would have positive spillover effects on human capital, employment, productivity and incomes.

3.3 Quality of life: Comparing India and China

Prof. Lawrence Klein (University of Pennsylvania), Mr. Sudip Ranjan Basu (UNCTAD) and Mr. A.L. Nagar (National Institute of Public Finance and Policy) presented a joint work on *Quality of Life: Comparing India and China*. In their analysis, they combine different indicators of economic, social and political well-being to construct an overall quality of life indicator which is comparable over time and across countries. In contrast to conventional wisdom, their analysis suggests that improvements in the quality of live between 1980 and 2003 were not significantly different in China and in India.

Since quality of life is a latent variable which is not readily measurable, the authors identify a number of indicators whose variation is supposed to explain the variation in quality of life. These indicators are normalized and used to construct five principal components, assuming a linear relationship between components and the pertaining individual indicators. The five principal components are “education and health”, “infrastructure”, “social participation”, “institutional quality” and “living standard” - the latter determined solely by real GDP per capita (measured in purchasing power parity). The overall quality of life index is then obtained as the weighted average of the principal components, where the weights are assigned according to the amount of variation in the overall index that is explained by each component.

An analysis of the changes in the main components over time (between 1980 and 2003) reveals that while all of them have risen over this period in both China and India, marked differences exist between components as well as between countries. For instance, the “education and health” indices for both countries show a linear positive trend over the entire time period, with China outperforming India. On the other hand, the increase in the “infrastructure” index is stronger in India than in China, driven mainly by the indicator for “road length”. The “social participation” index is relatively volatile for both countries, with apparent structural breaks in the mid 1980s for India and in the late 1980s for China (when women’s participation started to increase dramatically). Not surprisingly, the overall increase in this index between 1980 and 2003 was stronger in China than in India. The “institutional quality” index is the only index that shows a reversal in trend growth for China after rising considerably until the mid-1990s while for India, it is also volatile and shows only a moderate increase over the entire period.

Overall, the combined quality of life indices in both China and India show an increasing trend over the entire period. While the growth rate of the index is slightly higher for China than for India, this difference is not statistically significant, rebutting the conventional wisdom that China is outperforming India.

During the discussion, several conference participants voiced concerns over selection, quantification and weighting of individual indicators, pointing out specifically the issues of political freedom and inequality. Mr. Stephen Hall (University of Leicester) also questioned the comparability of scaled indicators which by definition must have the same start- and endpoints. In addition, Robert Vos (United Nations) noted that the use of constant weights for individual indicators might distort the results, as it was likely that these weights were time-variant.

In response, Lawrence Klein (University of Pennsylvania) clarified that the main idea behind the presented work was to improve on the UNDP Human Development Indicators (HDI), which use rather arbitrary weights for individual components. The presented measuring and weighting methods were chosen in accordance with limitations of data availability and statistical limitations. He added that absolute levels of indicators were taken into account, as the data had been adjusted for different ranges.

3.4 Official reserves and currency management in Asia

Mr. Avinash Persaud (Intelligence Capital Ltd., London) began his presentation on *Official Reserves and Currency Management in Asia* by stating one of his key conclusions, namely that the remedies currently proposed to rebalance the global economy would prove irrelevant for the imbalances while presenting a severe risk for Asian economies. In particular, he referred to the common argument of a saving glut that considers the deficits in the US economy a positive phenomenon, helping to absorb excess liquidity in the global economy. As he pointed out, however, saving rates across Asia have been largely stable, while there has been a marked fall in investment. Consequently, it seems hard to argue in favour of a saving glut, when in fact the Asian economies and the global economy are characterized by an investment shortfall. One commonly proposed remedy is currency appreciation, even though various examples show that exchange rate changes on their own tend to be ineffective. In the case of Japan, for example, currency appreciation was not accompanied by an increase in consumption and investment, but instead by a deflationary trend. Against this backdrop, he again emphasized his main conclusion that many remedies that are currently under discussion are potentially dangerous and harmful for the global economy, and that the only effective solution would be measures aimed at achieving higher investment rates.

In reply to a question, Avinash Persaud pointed out that the global financial system itself seemed stable, but that there were substantial risks, especially for financial markets. The current account deficit of the United States was merely the symptom of the imbalances, while their underlying cause was an excessively expansive monetary policy over the past years in reaction to the weakening of the stock market.

3.5 Economic aspects of a global pandemic

Mr. Clark Abt (Abt Associates Inc.) gave a presentation on the *economic aspects of a global bird flu pandemic*. The presentation was structured into four main parts: the impact of the pandemic on the world economy and population; the necessary measures to reduce risks and losses; the potential impact on macroeconomic indicators; and the conclusion.

First, he indicated that the global bird flu pandemic in its human-to-human contagious variant constituted the greatest threat to the world economic and population today and over ears to come. He illustrated his view by pointing to the estimates of potential material and human losses. The economic losses, in the current state of unpreparedness, are forecast to range between 71 to 3,000 billion dollars for the United States, and 300 to 12,000 billion for the world economy, representing between 1 to 30 per cent of US GDP and 1 to 25 per cent of world GDP, respectively. The potential death toll, according to the speaker, would vary between 0.1 million to 50 million in the US and 10 to 100 million worldwide.

Second, Clark Abt presented possible long- and short-term solutions. Long-term measures include immediate massive investment in effective vaccine and anti-viral mass production sufficient to treat up to 3 billion people in 2-3 years. With respect to short-term solutions, he suggested the recourse to non-pharmaceutical measures. He added that those measures entail, among other things, worldwide surveillance networks to provide early warning, public awareness through education, pre-stocking of non-perishable foods in homes and workplaces. More importantly, he recognized that an effective way to lower the risk of bird flu mutation into human-to-human contagious flu would be to limit or reduce contagion from poultry to human beings.

Third, he indicated that the most impacted would be the poor and densely populated countries. Concerning the impact on macroeconomic variables, he showed that national debt and fiscal deficit would probably rise, while employment, labor productivity, and consumption would decline.

Mr. Clark Abt concluded with both optimistic and pessimistic tones. He recalled that the bird flu pandemic threat to economies and populations is current, grave and abiding. He went on to point out, however, that there was more bioscience knowledge today than ever before to prevent, control and mitigate the pandemic. He ended his presentation by insisting that political will and international interdisciplinary cooperation were needed to make good use of the existing bioscience knowledge.

During the discussion, Peter Pauly (University of Toronto) highlighted the need to think through the economic issues related to the pandemic in more detail. Steven James (Department of Finance, Canada) expressed concern about what he called overly pessimistic estimates of the economic impact of a global bird flu pandemic. He backed his view by pointing to the meagre economic impact of the 1918 worldwide flu pandemic. He attributed this rather benign outcome to potential reallocation effects.

3.6 Raúl Prebisch memorial lecture: South and East Asia: Leading the world economy

Prof. Lawrence Klein (University of Pennsylvania) held the *2005 Raúl Prebisch Memorial Lecture* on *South and East Asia: Leading the World Economy*. As Professor Klein pointed out in his introduction, the tradition of project LINK and its close cooperation with UNCTAD and the UN Secretariat has evolved from its early stages when the focus was on the major industrial countries, to a broader analysis of the total world economy today. This broadening of perspective does justice to the vision of Raúl Prebisch, former Secretary-General of UNCTAD, whose main interest was improving the status of the developing countries in the world economy.

In his work, Raúl Prebisch established the distinction between the "industrial center" (the advanced countries) and the "periphery" (the developing countries).[2] Within this framework, he stressed the structural imbalance between center and periphery in terms of income elasticity of imports – a high income elasticity of imports from the center in contrast to a low income elasticity for agricultural imports from the periphery – as the major obstacle to development, which could only be overcome through import substitution strategies.

According to Lawrence Klein, however, the current global economic picture shows a somewhat different and more encouraging pattern, in which developing countries enjoy much stronger economic growth than the advanced industrial countries. Adding a third group of countries, namely the former centrally planned economies – now economies in transition –, he argued that the world's new growth locomotives were precisely from this latter group as well as from the so-called periphery. The grouping of Brazil, Russia, India and China (BRICs) is a case in point.

In this globalized, tripartite world, import substitution no longer seems the answer to development challenges, Klein continued, pointing instead to other ways to harness globalization for development. In his view, developing countries should aim at higher valued added output while simultaneously increasing productivity across all sectors, including primary production. In the tradition of Paul Krugman and Lawrence Lau, Klein suggested that higher values of total factor productivity (TFP) are the key to success and that the Asian Miracle before 1997 was really a mirage owing to the fact that high growth rates were not correlated with corresponding increases in TFP. A second problem at that time was that some of the Asian countries had unwisely pegged their currencies to a rising US dollar throughout the 1990s, thereby effectively pricing themselves out of the market.

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[2] See, for example, Raúl Prebisch, "International Trade and Payments in an Era of Coexistence: Commercial Policy in the Underdeveloped Countries", *American Economic Review*, 49, May 1959, 251-73.

According to Lawrence Klein, the recent growth performances of China and India represent a new Asian Miracle, one which holds many potential lessons for other developing countries and the world as a whole.

The Chinese experience, as summarized by the speaker, was one of step-by-step gradualism, beginning with a concept of market-socialism with a Chinese flavour under Deng Xiao Peng. Early reform steps after 1978 were a comprehensive land reform, the establishment of special economic zones, and improvements in the education system. In addition, the basic food supply problem was solved and the significant demographic policy of one child per family was implemented. Later reform steps included the freeing-up of small enterprises in manufacturing, retailing, and controlled trade, and subsequent steps included an increase in infrastructure investments, the unification of differential exchange rates, the enhancement of foreign direct investment (FDI) inflows, and the beginning of a financial system reform. In addition, China accessed the World Trade Organisation (WTO) in 2001. More recently, economic policy support for growth was diversified towards the previously neglected western and interior parts of the country, and new steps are being taken towards some degree of flexibility in the exchange rate policy.

As a result of these policies, China was able to sustain high GDP growth rates between eight and ten per cent for more than 25 years and its economy is still going strong. While other Asian countries complained about China's competition in export markets, especially during the 1997-98 financial crisis, China's import demand has, over time, provided new export opportunities for these countries, a development which has already started to spread to Latin American exporters as well. Lawrence Klein cautioned, however, that China will remain a strong competitor in world markets, as was to be seen after the abolishment of the textile quota regime (Agreement on Textiles and Clothing, ATC) at the beginning of 2005, when Chinese exports flooded the markets in the advanced economies, displacing exports from less competitive developing countries. Independent of potential future exchange rate adjustments, labour costs in China – while rising - are still low enough to guarantee that Chinese exports will stay highly competitive in the world market.

In his analysis of India, Lawrence Klein noted the marked growth acceleration after the introduction of economic reforms in the 1990s. Especially the take-off of the service sector has become a stabilizing force in an economy that used to be dependent on agricultural output and therefore on the vagaries of the monsoon rains. India's success as an offshoring centre, especially of business and software services, lies in its comparative advantage of a work force fluent in the English language and with strong scientific and engineering skills, combined with relatively low labour costs. In addition, he pointed to the potentially high productivity gains from harnessing India's IT strength also for the domestic economy – emulating the productivity increase in the US since the 1980s.

Unlike China, India has not implemented a strict demographic policy in the past, which will probably lead to India's population outnumbering that of China soon, making India the largest country in the world. More importantly, Lawrence Klein noted that this implies a growing Indian labour force over the next decades, while China's labour force is expected to decline in relation to its overall population. While it is unclear whether China will be able to avoid the Japanese pitfall of a rapidly greying population, India is not likely to suffer from too few workers having to support an expanding group of aged citizens. A bigger threat for Indian development stems from the increased incidence of the HIV-AIDS epidemic, especially in the most economically advanced regions.

In his concluding remarks, Lawrence Klein stressed that other economies of Southeast Asia and Northeast Asia were also performing strongly after the 1997-98 crisis, and Latin America as well might eventually realise the gains that Raúl Prebisch envisioned for the periphery. While West Asia and North Africa could see strong economic growth if they managed their resource endowments well, the route to better living conditions was likely to be more tortuous for most of Africa.

In the general discussion, questions were raised about the sustainability of China's high growth rates in the future, its performance as a WTO member, as well as its rising income inequality, and the reliability of Chinese data on poverty and inequality. In his answers, Lawrence Klein made it clear that he expected Chinese economic growth to remain strong until 2010 at least, given the economic impetus of the upcoming Olympic Games in 2008 and the world exposition in Shanghai in 2010. He cautioned, however, that the wage differential was a variable to watch. While China had not violated the WTO principles, it had indeed snatched up large market shares, especially in the textiles sector, causing protectionist rhetorics in the US and other advanced economies. Concerning inequality, this had indeed risen in China, and Lawrence Klein professed that he was unsure about whether/when this might lead to animosities between the rich and the political class, as it is currently the case in Russia. He was, however, optimistic about improvements in the quality of data from China's National Bureau of Statistics, as statistical surveys were getting better and international standards were increasingly observed.

ANNEXES

Annex 1

Agenda

Monday 31 October

10:00-10:15	**Opening** **Chair : Peter Pauly** *Supachai Panitchpakdi* *Director-General, UNCTAD, Geneva (TBC)*
10:15-12:00	**Global Outlook** **Chair : Peter Pauly** United Nations Project LINK *Rob Vos, United Nations, New York* International Monetary Fund *Thomas Helbling, IMF, Washington* World Bank *Hans Timmer, The World Bank, Washington*
12:00-13:00	**Invited Presentation** **Chair : Peter Pauly** Recovery in Europe: Will It Eventually Materialize? *Norbert Walter, Deutsche Bank, Frankfurt*
13:00-14:30	Lunch
14:30-16:30	**Global Outlook (cont.)** **Chair : Bert Hickman** OECD *Pete Richardson, OECD, Paris* National Institute of Economic and Social Research *Ray Barrell, NIESR, London* Agricultural Markets *Willy Meyers, University of Missouri* The World Oil Market *Robert Kaufmann , Boston University* General Discussion

16:30-17:30	**Invited Presentation** **Chair : Thomas Wilson** Unwinding Global Economic Imbalances *Heiner Flassbeck, UNCTAD, Geneva* General Discussion

<u>Tuesday 1 November</u>

9:30-11:30	**Regional Economic Outlook** **Chair : Delia Nilles** Western Europe : Summary *Ray Barrell, NIESR, London* Eastern Europe and the CIS : Summary *Rumen Dobrinsky, UN - ECE , Geneva* Sustainability of Economic Growth in Russia *Andrei Roudoi, Global Insight, Boston* General Discussion
11:30-13:00	**Regional Economic Outlook (cont.)** **Chair : Byron Gangnes** United States *Lawrence R. Klein, University of Pennsylvania, Philadelphia* Japan *Kanemi Ban, Osaka University* General Discussion
13:00-14:30	Lunch
14:30-16:30	**Invited Presentations** **Chair : Stephen Hall** Quality of Life : Comparing India and China *S.R. Basu, L.R. Klein, and A.L. Nagar, UNCTAD, University of Pennsylvania, and NIPFP, Delhi* Official Reserves and Currency Management in Asia *Avinash Persaud, Intelligence Capital Ltd., London* General Discussion
16:30-17:30	**Regional Economic Outlook (cont.)** **Chair : Adolfo Castilla** Asia : Summary *Hiren Sarkar, ESCAP, Bangkok* General Discussion

<u>Wednesday 2 November</u>

9:30-12:30	**Regional Economic Outlook (cont.)** **Chair : Mette Rolland** Latin America *André Hofman, ECLAC, Santiago* General Discussion Africa : Summary *Janvier Nkurunziza, ECA, Addis Ababa* Foreign Direct Investment in Africa *Hilary Nwokeabia, UNCTAD, Geneva* General Discussion Middle East : Summary *Fadhil Mahdi, ESCWA, Beirut* General Discussion
12:30-13:00	**Special Session** **Chair: Peter Pauly** Economic Aspects of a Global Pandemic *Clark Abt, Abt Associates, Boston*
13:00-14:30	Lunch
15:00-17:00	**UNCTAD Special Session** **Palais des Nations, Room XIX** **Chair : TBA** Presentation of UNCTAD Report "Developing Countries in International Trade 2005 – Trade and Development Index" *Khalilur Rahman, UNCTAD, Geneva* 2005 Raủl Prebisch Memorial Lecture *Lawrence R. Klein , University of Pennsylvania, Philadelphia*
17:00	**Close of Meeting**

__Annex 2__

LINK Spring Meeting
31 October-2 November 2005
GENEVA

LIST OF COUNTRY REPORTS

NO.	NAME OF THE COUNTRY	AUTHOR
1	Costa Rica	Juan-Rafael Vargas
2	Italy	Carlo D'Adda
3	Colombia	Carolina Mantilla & Carlos Patino
4	Nepal	D.R. Khanal
5	Angola	Suzana Camacho
6	Venezuela	Cristina Rodriguez
7	Turkey	Suleyman Ozmucur
8	Togo	Kodjo Elvo
9	Slovak Republic	J. Haluska & M. Olexa
10	Bulgaria	Garabed Minassian
11	Malaysia	Muthi Samudram
12	Hong Kong	Chou Win Lin
13	Slovenia	F. Stiblar & Joe Mencinger
14	Croatia	Andrea Mervar
15	Japan	Kanemi Ban
16	Mexico	Alfredo Coutino
17	Korea	Dongchul Cho
18	Ukraine	V. Heyets & M. Skrypnychenko
19	Hungary	Andras Simon
20	Norway	T. Eika & M. Rolland
21	**Australia**	Peter Brain
22	Austria	Ulrich Schuh
23	Ghana	C. K. Dordunoo & E. Richard
24	Taiwan	Chung-Shu Wu
25	China	Zhang Yaxiong
26	Philippines	Dennis Arroyo
27	Mexico	Eduardo Loria
28	Czech Republic	Jan Hosek & Milan Klima
29	Germany	R. Dohrn & G. Barabas
30	Argentina	Arturo O'Connell
31	Switzerland	Delia Nilles

Annex 3

LINK Fall Meeting
31 October-2 November 2005
GENEVA

LIST OF COUNTRY FORECASTS

NO.	NAME OF THE COUNTRY	NAME OF AUTHOR
1	Belgium	Simon Erlich
2	Norway	Andreas Benedictow
3	Japan	Ban Kanemi
4	Mexico	Alfredo Coutino
5	China	Tao Liping
6	Turkey	Suleyman Ozmucur
7	Switzerland	Delia Niles
8	Togo	Kodjo Evlo
9	Spain	Julian Perez
10	Costa Rica	Juan-Rafael Vargas
11	Sudan	Faiza Mohamed
12	Slovak Republic	Jan Haluska
13	Austria	AndreasUlrich Schuh
14	Philippines	Dennis Arroyo
15	Croatia	Mervar Andrea
16	Korea	Sukha Shin
17	Italy	Monica Ferrari
18	Malaysia	Muthi Samudram
19	Bulgaria	Garabed Minassian
20	Australia	Duncan Ironmonger
21	Denmark	Tony M. Kristensen
22	Colombia	Carolina Mejia
23	Slovenia	Joe Mencinger
24	Ghana	Cletus Dordunoo
25	Singapore	Toh Mun-Heng
26	Hong Kong	Chou Win Lin
27	Czech Republic	Milan Klima
28	Ukraine	M. Skrypnychenko
29	Israel	Rachel Sheinin
30	India	Sundaram
31	Taiwan	Chung Shu
32	Brazil	E.J. Reis
33	Hungary	Simon Andras
34	Romania	C. Ciupagea
35	Bangladesh	Salahuddin Ahmad
36	South Africa	Renee Eyden
37	Nigeria	Sam Olofin

Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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Project LINK Meeting, United Nations Office in Geneva, 31 Octobe-2 November, 2005

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