Executive Summary

At the beginning of 2005, the cyclical recovery in the world economy was reaching its zenith; growth of gross world product (GWP) increased by 4 per cent in 2004, compared to 2.8 per cent in 2003 and a forecast of 3¼ per cent for 2005. Growth in the developing countries was the fastest for more than two decades, while output in the remaining economies in transition continued to increase more rapidly than in the other major country groups.

The world economy has considerable momentum entering 2005 and most determinants of the short-term prospects remain positive, with only a modest deceleration anticipated for 2005. The higher oil price has already slowed global growth somewhat and policy measures intended to avert overheating will reduce it further, including in the United States and China, the principle engines for the global economy at present. The growth of international trade will slow accordingly and the upward movement in the prices of oil and several other commodities is unlikely to continue, reducing that stimulus to many developing countries. The expected upward drift in interest rates will also cause growth to ease in many countries.

The high aggregate rate of growth in 2004 in part reflected the fact that the improvement was almost universal: every region except South Asia and the Commonwealth of Independent States (CIS) grew more rapidly in 2004 than in 2003. In these two exceptional cases, growth slipped from its previous high levels but remained above 6 per cent and 7 per cent, respectively. All the groups of countries with special development challenges—the least developed and landlocked countries and the small island developing States (SIDS)—grew by more than 5 per cent in 2004. On a per capita basis, output increased by more than 3 per cent in almost half the developing countries, but these countries accounted for over 80 per cent of the developing world's population. The widespread nature of growth in developing countries in 2004 was attributable to the fact that most countries benefited from one or more of three unusually coincidental developments: rapid growth of trade in manufactures, increased prices for oil and most non-oil commodities and calmer conditions in international financial markets.

Among the developed countries, performance was more varied. Growth was strong in North America, moderate in Japan but weak in Europe. With the exception of its new members and a few other countries, the European Union has replaced Japan as the lagging economy. A modest cyclical acceleration is expected in these slow-growing countries in 2005 but growth will still languish around 2 per cent.

One of the universal weaknesses in the world economy continues to be the slow growth of employment and the persistence of high rates of unemployment and underemployment in most developing countries. Unless improved economic growth is reflected in increased employment, it will prove difficult to reduce poverty. Even in the most rapidly growing region, East Asia, unemployment and underemployment remain problems in several economies. The need to absorb the millions of surplus workers in the agriculture sector and in State-owned enterprises in China is a special case, but lack of employment is also a problem in other countries in the region. In 2004, there were signs of an improving employment situation in Latin America; this increased employment should translate into increased domestic demand and thereby be sustained. More generally, domestic demand gained strength in many developing countries in 2004, pointing to the possibility of more

general gains in employment if growth can be sustained. In the developed countries, employment is recovering slowly in the United States but continues to be weak in Europe and Japan so that the term "jobless growth" remains largely applicable.

The United States is increasingly being complemented in its role as the main engine of growth for the world economy by China. The combined strong demand from these two countries has provided a wide-ranging boost to global growth because China has acted as a catalyst in several areas of economic activity where the United States provides less stimulus. For example, with manufacturing playing a less important role in its economy, growth in the United States has a limited impact on the demand for raw materials but larger implications for trade in manufactured goods. Increasing Chinese demand for raw materials to fuel its industrial expansion, on the other hand, has been an important factor in reversing, at least temporarily, the long-term downward trend in the prices of non-oil commodities, thereby improving the formerly weak prospects of countries exporting such products. The index of non-oil commodity prices in dollars rose by a further 10 per cent in 2004, following gains of over 11 per cent in 2003 and almost 12 per cent in 2002. These improvements in part reflected the concurrent depreciation of the dollar. Moreover, they followed a lengthy period of declining prices: the average dollar prices of non-oil commodities were about 25 per cent lower at the end of 2004 than in 1980.

Oil prices rose by over 50 per cent in the first part of 2004, mainly because of the persistent increase in demand. This contrasted with the oil crises of the 1970s, when record prices were the result of reduced supplies from the major producers. Following the latest surge, prices fell back towards the end of 2004 and are expected to ease further with the moderation in the growth of the world economy. However, since the supply of oil is unlikely to be able to respond to the underlying growth of demand in the medium term, oil prices are not expected to retreat to their 2003 levels for any extended period in the near future.

The world economy accommodated this rapid shift to a new oil price regime in 2004 without major disruption. In the developed countries, core inflation did not increase untowardly. Among the developing countries vulnerable to an oil price shock, the effects were muted for those producing minerals and metals by the increased prices they received for their exports. The impact of the higher oil prices is expected to continue to be limited in 2005, although there remains the possibility that non-economic factors could severely disrupt the international oil market, to the detriment of global economic growth. Even without a major shock, oil markets are such that prices are likely to remain volatile.

In contrast with commodity markets, international capital markets remained calm in 2004, having to address only the remnants of former financial crises rather than new ones. Flows of foreign direct investment (FDI) to developing countries reversed their three-year downward trend and there were instances of successful bond issuances by developing countries as yield spreads narrowed over the course of the year. Flows of official development assistance (ODA) began to reflect earlier increases in commitments, although part of the increase was for international security and emergency relief rather than for development spending. Total net financial flows to developing countries declined from 2003 levels, primarily because of scheduled repayments under multilateral financial institution lending programmes. In addition to scheduled debt payments by the majority, a few developing countries were able to restructure or reduce their private sector external debt while others increased their foreign exchange reserves, sometimes substantially.

The overall outcome of the various financial flows was a seventh consecutive year of a net transfer of resources out of developing countries, at a record level of $300 billion in 2004. Except for sub-Saharan Africa, all developing regions, as well as the economies in transition, experienced a negative net transfer. However, some of this net transfer reflected positive rather than negative developments: as a result of strong growth in export revenues, some countries had trade surpluses which they chose to use as a means to improve their self-insurance against possible balance-of-payments difficulties, either by increasing their foreign exchange reserves or by reducing their foreign debt. The perceived need for such self-insurance must be seen as a major deficiency of the international financial system.

These increases in foreign exchange reserves were a partial reflection of the global external imbalances which not only persisted but increased in 2004. The largest of these imbalances was the United States trade deficit which rose to more than $650 billion, or above 5 per cent of GDP. This was countered by surpluses in a number of Asian developing countries, Japan and the European Union (EU). These imbalances were one of the forces causing the exchange rate of the dollar to continue its three-year decline and to reach a new low against the euro in 2004.

Apart from the depreciation of the dollar, the global imbalances failed to have significant repercussions in 2004, but the possibility of an abrupt and globally damaging correction persists since a depreciation of the dollar alone seems unlikely to be sufficient to reduce the global imbalances to sustainable levels in an orderly fashion. At the same time, efforts to correct the imbalances should not focus only on the deficit countries or regions because such an approach is likely to be excessively contractionary. In the present case, some correction of the United States fiscal deficit and an improvement in its private savings rate seems indispensable, but the contractionary effect of such action should be counterbalanced by expansionary measures elsewhere. It is necessary to ensure that global growth and stability are sustained.

Countries with external surpluses will therefore need to stimulate domestic demand, preferably investment in physical and social infrastructure. If such additional investment is deemed unnecessary, resources could be channelled to developing countries with unmet investment needs. As an immediate requirement, the extensive reconstruction required following the tsunami of December 2004 calls for an increase in investment within the Asian region.

These domestic actions should be complemented by various forms of enhanced international cooperation. In order to make sure that global growth is not derailed, cooperation is necessary to ensure coherence among national policy actions to address the imbalances. Improved cooperation in exchange-rate policy among the major developed countries and with the leading developing economies in Asia should be used to devise a phased and non-disruptive approach to any necessary changes in exchange-rate regimes.

All these actions should be such that they also contribute to the longer-term global development agenda, most notably the attainment of the Millennium Development Goals by 2015. Progress is being made in increasing ODA, but the total is only around one third of the target of 0.7 per cent of the gross national income (GNI) of the developed countries and falls far short of the amount deemed necessary to achieve the Millennium Development Goals. Further progress in raising ODA needs to be accompanied by enhanced debt relief for all developing countries that are confronted with unsustainable

external debt burdens and by further progress on measures to prevent and resolve financial crises. Finally, for the benefit of all countries, but with the primary objective of improving the development prospects of developing countries, it is also necessary to ensure the equitable completion of the programme of multilateral trade negotiations agreed at Doha.

The overall agenda is challenging but universally recognized. All members of the international community should rededicate themselves to the task at the summit meeting of the General Assembly in September 2005.