OVERVIEW

Global trends

The world economy is continuing to grow slowly. Despite the success in reducing inflation almost everywhere, expectations of faster growth have not been fulfilled so far. Since the beginning of the decade, world output growth has averaged about 2 per cent, compared to the roughly 3 per cent attained during the turbulent years of the 1980s. Since the economic recovery that started in 1993, in no year has world output growth exceeded 3 per cent, 1996 included. The prospects are for a continuation of this slow growth.

The slowdown in developed countries from an average growth of 2.8 per cent in the 1980s to 1.8 per cent since the beginning of the 1990s has affected all the major countries, including the United States, where growth averaged 2.3 per cent in the 1990s, against 2.7 per cent in the previous decade. The contribution of individual industrial countries to global growth has varied over time as business cycles have become increasingly desynchronized. In 1993-1994 expansion was faster in the United States than in the European Union (EU) and Japan; in 1995 it was faster in EU than in the United States and Japan; and in 1996 it was fastest in Japan.

A certain pattern of growth can be observed in the developing world since 1990, where growth has averaged 4.8 per cent including China, and 3.9 per cent if China is excluded. Much of this growth has been due to East Asia, where expansion has been both fast and stable. In Latin America growth has been not only more unstable but also on average much lower - less than 3 per cent annually. In Africa the fall in real per capita income that began in the 1980s continued in the early 1990s, but there has been a marked improvement over the past two years, when output rose faster than population for the first time in many years.

A significant development in 1996 has been the slowdown in world trade. While world merchandise exports had grown at rates 3-4 times that of world output in the previous two years, in 1996 the difference was much smaller, a tendency which can be expected to continue in coming years, as the initial effects of widespread trade liberalization, particularly in developing countries, taper off. This recent slowdown in world trade has also been associated with a weakening of commodity prices. After two years of sustained increases, many non-oil commodity prices began to decline in 1996, particularly those of interest to developing countries.

Improved governance and strong commodity prices have been among the most important factors accounting for a broad-based recovery in sub-Saharan Africa, others being the substantial improvement in weather conditions as well as diminished civil strife. However, some of these factors are of a one-off character. Sustainability of recovery depends on the expansion of exports of non-traditional products so that higher export earnings can finance the imports needed for investment. It also depends on utilizing existing capacity more fully. But many countries of the region have a competing claim on export earnings, namely the payment of their mounting arrears on external debt. Thus, external debt relief and the transfer of new resources, as well as continued domestic policy efforts, are the key to sustained recovery in Africa.

In this respect the Highly Indebted Poor Countries (HIPCs) Debt Initiative of the World Bank and IMF is a major step forward and could play an important role. A speedy and flexible implementation of the Initiative is, however, crucial; and completion dates must be such that relief is available in good time. If, as is feared in some quarters, the eligibility and sustainability criteria prove too restrictive, some countries in need of immediate relief may not be eligible at all. Increased flexibility in the application of certain conditions determining country eligibility, as well as promptness in implementation, are essential for ensuring a lasting and rapid solution to the debt crises of the HIPCs not only in Africa but also in other regions.

In Latin America, growth averaged 3.3 per cent in 1996, with recovery in Mexico and Argentina and continued strong expansion in Chile. Exports continued to be the main demand impetus for most countries of the region, particularly on account of increasing intra-regional trade. However, at about 10 per cent in 1996, the rate of growth of the value of merchandise exports for the region as a whole was less than half that of the previous year. Most countries continue to face serious policy dilemmas in attaining both growth and price stability. Control over inflation depends largely on the stability of the nominal exchange rate, while even modest growth is often associated with a rise in deficits on current account. Reconciling external equilibrium and competitive exchange rates with growth and price stability remains the basic challenge for most Latin American countries.

Asian economies continued to perform well in 1996, but even there growth slowed with the weakening of exports. Policies in a number of East and South-East Asian countries have been reoriented towards curbing rising deficits on current account and holding back inflationary tendencies, and in some cases towards dealing with weaknesses in the financial sector. China succeeded in bringing down inflation to a single digit, while nevertheless growing at an impressive rate of almost 10 per cent. In some countries the slowdown reflects difficulties in sustaining export expansion now that the relatively easy stages of labour-intensive production for export have been completed. It also highlights the importance of technological upgrading and productivity growth in maintaining the export momentum.

Growth experience continued to vary among the transition economies of Europe. In the region as a whole output fell by 2.8 per cent, a repeat of the previous year. Output continued to decline on average in the CIS area, most markedly in the Russian Federation and Ukraine, but in some other member countries there was at last a resumption of growth. In Central and Eastern Europe only a few countries managed to sustain steady growth. However, their current-account balances generally deteriorated as a result of currency appreciations brought about by surges in capital inflows, tariff reductions and a slower growth of exports to Western Europe.

The economies of Central and Eastern Europe, East Asia, and Latin America all continue to depend, to an important extent, on private capital inflows to finance current-account deficits. During 1996 and early 1997 there was a substantial expansion in the major categories of external financing for many countries in these regions, whose integration into the global network of financial markets is now well established. For these countries the one-off capital inflows associated with the process of integration are becoming less important, and they are now experiencing the effects of more differentiated changes in international investors' perceptions, in both favourable and unfavourable directions. For example, some of them have recently had to confront large capital outflows and periods of strong downward pressure on their currencies as a result of investors' reactions to the current-account deficits or to increased fragility of domestic financial systems. These events suggest that sustainable current-account balances may be lower than recent levels. Policies concerning exchange rates and capital accounts, as well as monetary policy more generally, must now increasingly take into account their impact on market perceptions and of the need to manage financial inflows and outflows.

Among the major industrial countries the United States has enjoyed a more persistent expansion than most forecasters had predicted. After six years of continuous expansion, unemployment and inflation have both fallen to historically low levels, below 5 per cent and 3 per cent, respectively, belying the widespread belief that a drop of unemployment below 6 per cent would trigger accelerated inflation. Indeed, while monetary policy allowed unemployment to fall to as little as 4.8 per cent in early 1997, inflation continued to abate. In this connection it may be recalled that in *TDR 1995* the view was expressed that the unemployment problem in the North could not be solved unless central banks acted boldly and tested their theories about the level of unemployment compatible with stable inflation.

The United States recovery has been driven primarily by investment, which has brought about a significant increase in productivity, particularly in manufacturing. However, much of the resulting gain has been captured by profits. After six years of expansion, average gross weekly earnings in real terms in 1996 were below the level of 1991 (itself below that of 1987), while the share of profits in gross value added in the non-financial business sector rose by 3.5 percentage points from 1992 to 1996.

Japan finally reaped the benefits of its fiscal packages, growing at 3.5 per cent in 1996 after a prolonged recession. Recovery has also been greatly helped by the depreciation of the yen against the dollar. However, the growth stimulus of the emergency budget measures is now largely exhausted, and current plans are to reduce the budget deficit. Thus, the performance of the economy will increasingly depend on exports and hence on the exchange value of the yen.

The widely expected recovery has not materialized in continental Western Europe, where unemployment has reached record levels. As foreseen in *TDR 1996,* efforts to meet the Maastricht targets for fiscal deficits prevented automatic stabilizers from coming into play, thereby strengthening the deflationary forces and raising unemployment. Growth fell to under 1.5 per cent in both France and Germany, while in Italy the decline was even stronger, from 3 per cent to under 1 per cent. In contrast, thanks largely to a rise in private domestic spending, expansion continued in the United Kingdom.

However, political developments in the European Union suggest that governments are increasingly being confronted by a major challenge: how to reconcile growth and employment with the objective of meeting fiscal targets. The underlying rationale for setting fiscal targets was to attain conditions conducive to monetary and exchange rate stability. In the event, there has been a remarkable convergence of inflation and interest rates among the major EU countries, and exchange rates have also been stable, even though fiscal deficits generally remain above the targets. By contrast, the debate over the targets is creating conditions that can provoke greater volatility in financial and currency markets. Consequently, perhaps the best way for generating the right conditions for growth and employment without sacrificing stability would be, as suggested in *TDR 1994*, to cut the Gordian knot of fiscal convergence and proceed to monetary union as soon as possible.

Differing contributions by the major industrial countries to global demand, combined with the appreciation of the dollar, have started to produce global trade imbalances similar to those experienced in the 1980s, with a growing deficit in the United States and growing surpluses in Western Europe and Japan. While domestic demand has expanded rapidly in the United States, most other industrial countries have continued to rely on exports for growth.

The experience of the 1980s illustrates the difficulties that can be posed by mounting trade imbalances and misalignments in exchange rates for both the international trading system and international monetary stability. These imbalances cannot be blamed on the United States fiscal deficits - as they could in the 1980s - since expansion in that country has been associated with falling rather than rising deficits. The burden of adjustment consequently has to be borne by surplus countries. A return to a more sustainable pattern of global demand and trade balances therefore requires an expansion of demand in Europe and Japan rather than monetary tightening in the United States.

Furthermore, if monetary policy is tightened in the United States, its effects may not be limited to widening the global deflationary gap. If accompanied by upward pressure on the dollar, the effect might well be to increase, rather than to reduce, trade imbalances. History shows that a combination of slow growth, rising unemployment and increased trade imbalances can make it difficult to resist protectionist pressures and avoid trade frictions. Moreover, the consequences of a combination of such frictions, dollar appreciation, and a hike in international interest rates would today be more serious and widespread for developing countries than in the 1980s, in view of the increased integration of many of them into the global trading and financial system and of their greater dependence on highly liquid capital inflows.

Globalization, growth and distribution

Inequality: the record

The big story of the world economy since the early 1980s has been the unleashing of market forces. The deregulation of domestic markets and their opening up to international competition have become universal features. The "invisible hand" now operates globally and with fewer countervailing pressures from governments than for decades. Many commentators are optimistic about the prospects for faster growth and for convergence of incomes and living standards which greater global competition should bring.

However, there is also another big story. Since the early 1980s the world economy has been characterized by rising inequality and slow growth. Income gaps between North and South have continued to widen. In 1965, the average per capita income of the G7 countries was 20 times that of the world's poorest seven countries. By 1995 it was 39 times as much.

Certainly, a number of developing countries have been growing faster than industrial countries, but nevertheless not fast enough to narrow the absolute per capita income gap. In Africa, where the gap has been widening over the last three decades, average per capita income is now only 7 per cent of that of the industrial countries. In Latin America, the change has been more abrupt: average per capita incomes have fallen from over one third of the northern level in the late 1970s to one quarter today. Only a handful of East Asian economies have managed to sustain growth rapid enough to narrow the gap, or even in some cases to catch up, with the North. However, as these economies have graduated into the high-income club, few developing countries have been able to step into their place; the middle strata of developing countries, with incomes between 40 per cent and 80 per cent of the average in advanced countries, are thinner today than in the 1970s.

Polarization among countries has been accompanied by increasing income inequality within countries. The income share of the richest 20 per cent has risen almost everywhere since the early 1980s, in many cases reversing a postwar trend. In more than half of the developing countries the richest 20 per cent today receive over 50 per cent of the national income. Those at the bottom have failed to see real gains in living standards, and in some cases have had to endure real losses. In many countries, the per capita income of the poorest 20 per cent now averages less than one tenth that of the richest 20 per cent. But the increase in the shares of the latter has invariably also been associated with a fall in the share of the middle class. Indeed, this hollowing out of the middle class has become a prominent feature of income distribution in many countries.

The trend towards a widening of gaps between income groups is apparent in both more and less successful developing countries, and is associated with export-oriented as much as with inward-oriented strategies. In East Asia, inequality has increased, albeit to different degrees, in both the first- and second-tier NIEs during the past two decades. With the exception of the Republic of Korea and Taiwan Province of China, inequality in East Asian economies today is as high as or even higher than in other developing countries. In Latin America, while the debt crisis of the early 1980s and the economic slowdown led to a worsening of income distribution, the subsequent recovery has failed to turn this around. In Africa, rising rural inequality is widespread.

These trends are rooted in a common set of forces unleashed by rapid liberalization that make for greater inequality by favouring certain income groups over others:

- Growing wage inequality between skilled and unskilled workers is not just a problem for the North. It is becoming a global one. In almost all developing countries that have undertaken rapid trade liberalization, wage inequality has increased, most often in the context of declining industrial employment of unskilled workers and large absolute falls in their real wages, of the order of 20-30 per cent in some Latin American countries;

- Capital has gained in comparison with labour, and profit shares have risen everywhere. In four developing countries out of five, the share of wages in manufacturing value added today is considerably below what it was in the 1970s and early 1980s. In the North there has been a remarkable upward convergence of profits among the major industrial countries. The rate of return on capital in the business sector of the G7 countries taken together rose from 12.5 per cent in the early 1980s to over 16 per cent in mid-1990s. This is again the counterpart to declining wage shares;

- Financial liberalization has given rise to a rapid expansion of public and private debt. A new rentier class has emerged worldwide with the substantial expansion of international capital flows and the hike in real interest rates. In some developing countries interest payments on private and public debt have reached 15 per cent of GDP. Where asset holding is concentrated and the tax system regressive, as is often the case in developing countries, government debt is serving to redistribute income from the poor to the rich, in a manner that is proving even more regressive than “taxation” through inflation. Much of the rise in business revenues in both the North and the South has been absorbed by increased interest payments;

- Agricultural price liberalization has not always removed the urban bias or boosted incomes of farmers, as is particularly evident in Africa. In many countries that have implemented reforms, expected improvements in the domestic terms of trade for agriculture have not materialized and farm-gate prices for export crops have remained well below border prices. The benefits of liberalization have been reaped mainly by traders rather than by farmers.

Does inequality matter?

It is possible that these international and national divisions reflect merely temporary adjustments to a rapidly changing world economy. Helping the rich to get richer may indeed be a prelude to rapid growth and the trickling down of income gains to all other socio-economic groups. But evidence is mounting that slow growth and rising inequalities are becoming more permanent features.

Over the past decade, the world economy has settled down to an average rate of growth of around 3 per cent per year - some 2 percentage points lower than that achieved during the “Golden Age” of 1950-1973. Such a relatively modest rate can solve neither the North’s labour market problems nor the

South's poverty problem; nor will it allow for a narrowing of the North-South divide. Past issues of the *Trade and Development Report* have examined some of the underlying causes of this slowdown. What is especially disturbing is that the increased concentration of national income in the hands of a few has not been accompanied by higher investment and faster growth. In the North, profits are at levels not seen since the 1960s, but in the main they now generate much less investment and employment than previously. In the South, the rich often receive more than half of the national income, but private productive investment is rarely sufficient to generate a significant increase in per capita income.

It is this association of increased profits with stagnant investment, rising unemployment and reduced pay that is the real cause for concern. What matters is not inequality *per se*, but the manner in which incomes of the rich are used. Profits accrue to a small minority of the population whose spending behaviour has wider economic and social implications. For owners of capital, investment acts as a social tax on profits which justifies concentration of income in the hands of a few. Affluent groups that invest a large share of their incomes and generate a general improvement in the standard of living will acquire greater legitimacy than those that do not. In some successful late industrializers in East Asia, where the rich receive less than 50 per cent of national income, private savings and investment reach one third of GDP. By contrast, in many developing countries where the share of the rich in national income exceeds 50 per cent the share of private savings and investment in GDP barely exceeds 15 per cent.

Some of the factors making for greater inequality in a globalizing world at the same time deter investment and slow down growth. The fast pace of financial liberalization has delinked finance from international trade and investment. Higher interest rates brought about by restrictive monetary policies have raised the cost of capital formation and encouraged large segments of the industrial and commercial classes to concentrate their energies on buying and selling second-hand assets. The premium that global finance places on liquidity and the speedy entry into and exit from financial markets in search of quick gains have undermined the "animal spirits" needed to make longer-term commitments to investment in newly created productive assets. The greater exit options enjoyed by capital, combined with slow demand growth and excess supply of labour, have been instrumental in raising global profits, often without encouraging investment. Corporate restructuring, labour shedding and wage repression in this world of sluggish growth have thus become the order of the day, generating increased job and income insecurity.

If this situation continues, there is a real threat of a political backlash that may wipe out several of the benefits of recent economic reforms in developed and developing countries alike, and perhaps even roll back some of the achievements of economic integration. The 1920s and 1930s provide a stark and disturbing reminder of just how quickly faith in markets and openness can be overwhelmed by political events. Nor should there be any doubt that the burden of such international economic disintegration would once again be borne by those who can least afford it.

What is to be done?

Concern about income inequalities has in the past led some countries to establish institutional arrangements that severely restrict the role of markets and private property. Such arrangements have often successfully limited income disparities for quite long periods. But the result has in many cases been a loss of dynamism and eventual stagnation. Most countries now agree that this is too high a price to pay and that a certain degree of income inequality is necessary to provide the resources and incentives for activities that bring more general prosperity.

The basic policy challenge in the South is how to translate rising profits into investment at a pace sufficient to underpin a social contract whereby initial inequalities can be justified - and eventually reduced - by the resulting rise in incomes and living standards of the mass of population. To meet this challenge, some awkward truths must be faced. In the first place, no economic law exists that will make developing economies converge automatically towards the income levels of developed countries. Second, growth and development do not automatically bring about a reduction in inequality. Even the fast-growing economies of East Asia have been confronted with distributional challenges.

The good news, however, is that where convergence has occurred, there are by now clear explanations for it in terms of the development strategy pursued. Moreover, various episodes in the East Asian development experience suggest that governments have an important role to play in reconciling rapid growth with distributional objectives.

If speculative talk about converging incomes and living standards is to cede place to a realistic policy agenda, it is necessary to have a firm grasp of what drives economic growth in a market economy. That role belongs to profits. What distinguishes the successful late industrializers from other developing countries is the high animal spirits of their business class, reflected in exceptionally high rates of saving and investment from profits. This experience shows that policies designed to manage profits so as to accelerate growth can also serve to manage distribution:

- **Managing profits:** A strong profit-investment nexus does not emerge spontaneously from greater global competition. Certain basic conditions such as political stability and secure property rights must indeed be fulfilled. But this is not enough. Policies must be actively pursued that are designed to provide incentives to private firms to retain profits and invest them in the enhancement of productivity, capacity and employment. Fiscal instruments, both taxes and subsidies, can be important tools in this respect. But there is also an array of trade, financial and competition policies that can help raise profitability and investment in key industries above what might be attained under free market conditions. Closing unproductive channels of wealth accumulation and discouraging luxury consumption are essential ingredients of such a strategy.

- **Managing integration:** The quality and quantity of investment can be improved by means of closer linkages with the world economy through trade and capital flows, including FDI. But these external linkages must be complementary to, and not a substitute for, the domestic forces of growth through capital accumulation and technological capacity building. This can be achieved only through a carefully managed and phased integration into the world economy, tailoring the process to the level of economic development in a country and capacity of existing institutions and industries. Such a strategy contrasts sharply with the "big bang" liberalization adopted by some countries in recent years.

- **Managing distribution:** A necessary condition for strengthening the forces making for greater equality in the South is the rapid absorption of surplus labour. Where it is in the rural sector, land reform, agricultural policies and public investment can check the rising inequality typical of the growth process in economies with surplus labour. The challenge, however, is more daunting if the surplus labour simply shifts to urban areas. As countries move along the development path, industrial policies to support upgrading become vital for sustaining rises in real wages. It is at this stage that an adequate supply of educated labour is particularly important to prevent skill shortages leading to wider wage differentials. Throughout the process, taxes designed to discourage distribution of profits as personal incomes, as well as to restrain luxury consumption, serve not only to accelerate investment and job creation, but also to reduce inequalities in personal incomes. Profit-related pay, which has been widely used in East Asia, can also help strengthen the social fabric surrounding the profit-investment nexus.

The policy efforts of developing countries should be accompanied by an accommodating global environment. However, among the asymmetries of globalization is the fact that liberalization of the world economy has proceeded so far in a lopsided way that tends to prejudice the growth prospects of developing countries by discriminating against areas in which they can achieve comparative advantage. Liberalization of trade in goods has proceeded more slowly in those sectors where developing countries are more competitive. Thus, free trade in textiles will be achieved only in the first years of the next century and the major trading blocs continue to protect their agricultural sectors. New forms of protection against exports of manufactures from the South are being sought as a remedy for labour market problems in the North. While many restrictions have been lifted on the freedom of capital and skilled labour to move to where it is best remunerated, no attention has been paid to abolishing the many restrictions on the freedom of movement of unskilled labour. Progressive redressing of these biases remains an important challenge facing the international community if an enabling global environment is to be created.

Global efforts to help developing countries could still come to naught if the slowdown in economic growth in the North is not reversed. Thus, a return to faster growth and policies of full employment is not only a prerequisite for resolving the twin evils of high unemployment and increasing wage inequality in the North, but is also essential for defusing the threat of a popular backlash against globalization, which might put the gains of global economic integration at risk.

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