Review of the Global Economics Prospects 2005

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I

The Annual World Bank publication 'The Global Economic Prospects' of 2005 (GEP2005) deals with Trade, Regionalism and Development. The report is divided into two parts; the first part of the report is about the prospects of the global economy and the second part discusses the role of regional trade agreements in the current economic regime.

The global outlook section highlights that economic growth in developing countries has been strong in the year 2004. Real GDP growth rate of developing countries increased from 5.2 percent in 2003 to 6.1 percent in 2004. This is the highest growth rate achieved by developing countries in the past 30 years. However, decomposition of this growth rate shows that there is considerable variation in growth among developing countries. The regional break-up of growth rate of developing countries indicate that the increase in growth rate in 2004 happened mainly because of very high GDP growth rates in the Latin America and the Caribbean, Europe and Central Asia and to some extent in Sub Saharan Africa. On the other hand, East Asia and Pacific, Middle East and North Africa and South Asia have experienced lower real GDP growth rate than the previous year (Table 1). However, projections suggest the high growth experienced by developing countries may not be sustainable as they may face less favorable macro conditions because of the expected slow down of world economy in 2005.

Table 1. Real GDP Growth Rate of Developing Countries[1]

	2002	2003	2004	2005	2006
East Asia and Pacific	6.7	7.9	7.8	7.1	6.6
Europe and Central Asia	4.6	5.9	7.0	5.6	5.0
Latin America and the Caribbean	0.6	1.6	4.7	3.7	3.7
Middle East and North Africa	3.2	5.7	4.7	4.7	4.5
South Asia	4.6	7.5	6.0	6.3	6.0
Sub-Saharan Africa	3.1	3.0	3.2	3.6	3.7
All Developing Countries	**3.4**	**5.2**	**6.1**	**5.4**	**5.1**
-excluding transition countries	3.2	5.1	5.9	5.4	5.1
- excluding China & India	2.1	3.8	5.4	4.6	4.3

GEP 2005 points out that several factors can lead to a slowdown of the world economy in the next two years. Slowdown of investment growth in the US, the threat of increase in oil and other commodity prices, the possibility of hardening of the interest rates by the central banks and projected lower growth in China are said to be the main reasons behind the expected deceleration of the world economy in the next couple of years. The report also expects that there will be less rapid expansion of trade in the next two year period. However, in spite of these hurdles, the report says that the "far-reaching structural reforms carried out in many countries" and the efforts to reduce government deficits will enable developing countries to tide over the aforementioned obstacles and achieve a sustained per capita growth rate of 3.5 percent for the period 2006 to 20015. According to the GEP 2005, if developing countries manage to sustain this level of growth, then the Millennium

Development Goal (MDG) of reducing incidence of extreme poverty by 50 percent by 2015 is achievable in many developing countries. It is notable here that the rate of growth required to achieve this goal is double the growth rate experienced by developing countries during the decade of 1990s.

As far as developed countries are concerned, strong growth is also expected in USA, Japan and Europe for the year 2004. In USA, the growth is mainly driven by a boom in investment and household consumption whereas in Europe and Japan, exports were the main source of growth. Projections by GEP2005 suggest that in the next two years, tight monetary policy followed by central banks in USA and Japan is likely to dampen growth in these two countries. Also factors like oil price hike, maturation of the investment cycle and tightening of fiscal stimulus are expected to slow down growth rates of USA and Japan. Europe, on the other hand, is expected to grow at a fast rate for the next two years.

As far as international trade is concerned, GEP shows that high growth of developed and developing countries in 2004 has translated to high growth for world trade in the current year. The share of developing countries in world exports has increased from 19 percent in 2000 to 23 percent in 2004. However, most of this increase is due to the phenomenal increase of exports from China. Between 2000 and 2004, more than 20 percent of the growth in world merchandise trade volumes was accounted for by China and as a result, China managed to double its share in world exports from 2.9 percent to 5.8 percent during this period. The performance of developing countries in world trade becomes much more modest once the contribution of China is removed. The forecast made about world trade in GEP2005 indicates that there will be slowing down of merchandise trade in the year 2005. GEP2005 has identified slowing down of China's trade and the unsustainable nature of US current account deficit as the possible dampening factors. The GEP apprehends that a failure to address the twin deficits of USA can lead to protectionist tendencies in USA which can translate into lower import demand for manufactured and agricultural goods arising out of that country.

Overall, the picture painted by GEP shows that the world economy has managed to bounce back from the downturn suffered in 2001 and 2002 but the year 2004 is a peak in the current upward cycle and according to the report, GDP growth rates of countries will move towards the long term trend in the following few years. Table 2 shows the actual and projected long term per capita GDP growth rates.

Table 2. Actual and Projected Long Term Growth of Per Capita GDP (in percent)

	1980s	1990s	2000-06	2006-15
World Total	1.3	1.1	1.6	2.1
High Income Countries	2.5	1.8	1.7	2.4
Developing Countries	0.6	1.5	3.4	3.5
East Asia and the Pacific	5.8	6.3	6.0	5.3
Europe and Central Asia	1.0	-1.8	5.2	3.5
Latin America and the Caribbean	-0.9	1.5	0.8	2.4

The table shows that the level of performance GEP projects for developing countries for the period 2006-15 is much higher than what was experienced during the last two decades. Such

a high rate of growth will not be easy to achieve. As previously mentioned, the GEP 2005 itself points out a number of factors which can prevent rapid growth of developing countries in the longer run. The report recognizes these problems and to overcome these drawbacks, this report is banking on a few factors to push developing countries towards a higher growth trajectory. First and foremost is the role of anticipated structural changes in developing countries. The GEP expects that developing countries will go through a number of growth inducing structural changes between 2006 and 2015. According to this report, developing countries are expected to move away from their dependence on agriculture and diversify their economic activity during this period. Closer integration of developing countries with the world economy is also likely to happen. GEP 2005 suggests that these factors will usher in structural changes in demography, alter the rural-urban composition of workforce, lead to sectoral and employment shifts, increase openness and improve income distribution in developing countries. Together these changes will propel the growth in these countries. Along with these factors, improvement in macroeconomic conditions like inflation and indebtedness and changes in the international trading environment are likely to help developing countries attain high levels of growth during the period 2006-15.

However, this chain of logic is based on some very questionable assumptions. It seems that the report puts a lot of emphasis on increased global integration of developing countries and in structural changes in these countries to attain high level of growth in medium terms. The experience of the last two decades has shown that increased trade and financial integration of developing countries has an ambiguous effect on growth rates of these countries. While some countries have gained from increased trade liberalization, many other countries have not been able to benefit from international trade. For every successful country like China, there are many countries, like the ones in Sub-Saharan Africa, which have suffered from trade liberalization. Also, there is an emerging consensus among economists that the beneficial effects of financial liberalization and free movement of capital are quite ambiguous. Rodrik comments[2]:

> ***"…persuasive evidence on the benefits of opening up to capital flows--especially of the portfolio and short-term kind--has yet to be provided"***

Even some IMF economists, once the staunchest supporters of financial liberalization and foreign portfolio investment, are conceding that the so-called beneficial aspects of integration of financial markets have not been realized in practice. Michael Mussa, Economic Counselor and Director of Research, IMF, says[3] :

> ***" ... the experience in recent financial crises could cause reasonable people to question whether liberal policies toward international capital flows are wise for all countries in all circumstances."***

Given the problems faced by developing countries with trade and financial liberalization during the 1990s, it is difficult to understand why GEP 2005 has put so much faith on increased integration of developing countries to raise their growth rates. It also needs to be remembered here that increased integration of developing countries with the world has not led to unequivocally positive structural change in all developing countries. In fact, integration with the global economy had significant negative impact in many developing countries. Trade and financial liberalization have not only threatened industrialization in some of these countries, but have also led to increased inequality in most countries across the world (WIDER 2004)[4].

Therefore it will be unwise to assume that, in the medium term, increased integration of developing countries with world economy will necessarily lead to growth inducing structural

changes in these countries. It is also disturbing to note that unless developing countries manage to achieve record growth rates in the next decade, the MDGs will remain unfulfilled in most of these countries.

II

The second part of this report deals with Regional Trade Agreements in the current global multilateral trade regime. This is an important issue because there has been a proliferation of regional trade agreements since 1990 and currently nearly 40 percent of total global trade is done among regional trading partners. Along with the increase in share of RTAs in global trade, the complexity and the coverage of the new RTAs have also increased over the years. Most new RTAs have also gone beyond agreements between adjacent countries and these agreements tend to cover much more than liberalization of tariffs and quotas. As the report points out, many new RTAs have provisions on enforcement of labour laws, environmental laws, services and intellectual property rights issues addressed in their agreements. RTAs were initially encouraged in WTO as it was thought that they can complement the multilateral trading system. However, by their very nature, RTAs discriminate against countries outside the trade bloc and depart from the MFN principle. Moreover, trade within RTAs does not come under the jurisdiction of WTO. As an increasingly higher percentage of trade occurs outside the purview of WTO, this has raised a concern about whether regional trade blocs are posing a threat to the WTO based multilateral trading system.

Given the growing importance of RTAs in the global trading system, this report seeks to address two broad questions regarding these agreements. First, it tries to identify what are the characteristics of regional trade agreements that strongly promote or hinder development for member countries. Secondly, it tries to find out whether the proliferation of regional trade agreements poses risks to the multilateral trading system and examines how these risks can be managed.

This section of the report attempts to answer these questions by looking at the factors which motivate the formation of regional trade agreements. The report suggests that both politics and economics play important roles in the formation of RTAs. From the standpoint of developing countries, the most important economic reason to have a regional trade agreement with a developed country is to gain access to a large market, such as that of the EU or the United States. The report further points out that in spite of the fact that some developing countries and most least-developed countries already enjoyed preferential access to developed country markets, most of these countries have subsequently entered into bilateral treaties with developed countries to “preempt” being left out of future protectionist policies. According to the report, another reason for developing countries to join regional agreements with developed countries is to reinforce regulatory reform through external treaty obligations. But this argument is debatable: as discussions at WTO over the trade facilitation issues have shown, most developing countries do not see internal regulatory reforms as a high priority issue on their agenda.

As far as the motivations behind South-South trading blocs are concerned, GEP2005 says that non-economic motives often play a more important role in formation of such RTAs. This report suggests that in many cases these South-South agreements reflect a political desire to form or join a broad based regional initiative and sometimes these agreements are formed on military or strategic reasons. Apart from these factors, pooling resources for multilateral trade negotiations and dealing with region-specific issues are other reasons behind formation of South-South RTAs.

These arguments about the South-South RTAs give an impression that such RTAs make sense only when non-economic factors induce developing countries to go into such regional groupings. However, economic success stories of a number of South-South RTAs like the Mercosur and the ASEAN have clearly shown that South-South RTAs can significantly contribute to economic development. It is also to be noted here that the entire discussion on the negative effects of regional trade agreement through trade diversion assumes full employment. If the assumption of full employment is relaxed, the welfare effects of trade diversion are ambiguous and may be even positive. As developing countries almost never fulfill the full-employment criterion, even theoretically, the impact of trade diversion is likely to be less severe in developing countries.

As far as the benefits of RTAs are concerned, the GEP 2005 finds no strong evidence to support the claim that a preferential trade agreement will be net trade creating or that all members will benefit from such agreements. However, the report says that RTAs can indirectly benefit trade by lowering the cost of trading, by raising the level of policy salience, spreading information about members and about international markets, improving the institutional efficiency of countries, providing "institutional homes" for joint initiatives, and by facilitating dispute resolution. But, on the other hand, the report recognizes that the growing number of RTAs may lead to a complex system of regulatory structures and preferences where market access for products in one particular country will vary widely depending on their alleged origin. This phenomenon, known also as the "spaghetti-bowl" problem, may lead to complexity and lack of transparency in the global trading system.

The report also suggests that many RTAs promote trade liberalization by going beyond merchandise trade. It highlights a number of RTAs, mostly North-South RTAs, include provisions for services, investment, intellectual property, and temporary movement of workers. Though GEP argues that wider coverage of these RTAs are helping trade liberalization, a number of economists are of the argument that by aggressively pushing wide ranging trade treaties on a bilateral basis, developed countries are weakening the power of developing countries in multilateral trade negotiations[5]. They argue that in an RTA between a developed and a developing country, the developed country often manages to include aggressive trade liberalization clauses, investment protection clauses and extraneous issues in the treaty. Having abandoned objections about these issues on a bilateral level, the developing country cannot resist these issues on a multilateral platform. This not only helps developed countries push these issues in WTO, but it also breaks the alliance of developing countries in the multilateral negotiations.

Overall the report comes to the conclusion that benefits of RTAs will depend upon the structure and design of RTAs. RTAs which involve countries with low levels of external trade barriers, both at preferential level as well as at applied MFN levels, are likely to succeed. It also says that trade agreements which cover all sectors and have non-restrictive Rules of Origin are more likely to increase national incomes of member countries over time.

Chapter six of this report discusses how regionalism can be made complementary to multilateralism. Among the vast literature available on this topic, this report has surveyed some more recent work. However, the theoretical and empirical studies reviewed in this chapter have not provided any definite verdict about whether RTAs act as 'building blocks' or 'stumbling blocks' to the multilateral trade regime. Among the studies cited in this chapter, Limao (2003) suggests that developing countries may resist the multilateral system in fear of erosion of their preferential treatments in regional agreements with developed countries. Similarly, industrial countries can have a strategic incentive in keeping their multilateral tariff level at a higher level than they otherwise would, so that they can have

more bargaining power when negotiating market access at the bilateral/regional level. Mansfield and Reinhardt (2003) argue that multilateral trade negotiations, in fact, motivate countries to conclude RTAs. This is so because as WTO membership expands, individual countries' ability to influence the content and pace of MFN liberalization reduces and the large membership makes it difficult for countries to have a coordinated strategy. As formation of regional blocks lead to increased negotiating power at the multilateral level, countries want to become a part of a regional grouping to increase their leverage in the multilateral negotiations. Schott (2004) says that USA has pursued bilateral trade agreements over the last two decades to complement and cajole progress at the multilateral level. Winham (1986) and Lawrence (1991) argue that creation and expansion of EEC had indirectly motivated earlier GATT rounds where other GATT members tried to reduce EC's external protection through MFN tariff reduction.

The diversity of the opinion about the role of RTAs in the multilateral trade regime underscores the inconclusive nature of the debate in literature. However, the GEP 2005 tends to suggest that Regional Trading Agreements cannot be a substitute for the multilateral trading system. According to this report, as RTAs alter the incentives for countries to participate in multilateral trading system, they therefore act more as stumbling blocks for multilateralism than as building blocks. However, the report appears to be putting the most of the blame on developing countries for the current problems with the multilateral trading system. The perception that developing countries do not want progress in the multilateral forum to protect their preferential margins has been given a lot of emphasis on the report. On the other hand, in spite of acknowledging that USA and EU are continuously pursuing bilateral and regional FTAs, this report is quick to add "we see little evidence that the high-income countries have reduced their effort to bring the current multilateral negotiations to fruition".

Overall, the GEP2005 gives the impression that it is discussing the issue of regionalism and multilateralism essentially from the perspective of developed countries. It misses the fact that the growth in regionalism took place among developing countries essentially because of the dissatisfaction with the current multilateral trading system. It also does not highlight the fact that some developed countries like USA have perused regionalism aggressively during the 1990s, and according to many economists, this has led to the snowballing of regionalism in the 1990s (See Bhagwati 1993[6], Panagariya 1996[7] and Bergsten 1996[8]).

To conclude the discussion, one must agree that theoretically speaking, trade liberalization through regionalism does not offer the best solution. But in the current state of distorted multilateralism, the formation of regional trade agreements has turned out to be one of the more viable alternatives for developing countries to expand their market access. In this context, South-South RTAs have been particularly useful as they have allowed developing countries to expand their markets without having to bow before hegemonic powers. However, there are some obvious pitfalls with regionalism. Apart from the problems of trade diversion, the complex web of regional agreements can also introduce uncertainties and opacity in the global trade system. Secondly, the problems associated with unequal power structure and exploitation of smaller members by a bigger economic power is more acute in a regional trade block. Also, it is always possible that if the world is divided in a few mega trade blocs, then the weakest countries will be marginalized.

[1] Unless otherwise mentioned, source for all tables and figures is the *Global Economic Prospect 2005*

[2] "Exchange Rate Regimes and Institutional Arrangements in the Shadow of Capital

Flows" Dani Rodrik Harvard University, September 2000, conference on Central Banking and Sustainable Development, held in KualaLumpur, Malaysia, August, 28-30, 2000.

[3] "Factors Driving Global Economic Integration" by Michael Mussa, Economic Counselor and Director of Research, IMF, Presented in Jackson Hole, Wyoming, at a symposium sponsored by the Federal Reserve Bank of Kansas City on "Global Opportunities and Challenges," August 25, 2000.

[4] *Inequality, Growth and Poverty in an Era of Liberalization and Globalization*, edited by Giovanini Andera Cornia, UNU-WIDER studies in Development Economics, UNU-WIDER and UNDP. Oxford University Press, New York

[5] See Ghosh, Jayati (2004): "Regionalism, Foreign Investment and Control: The New Rules of the Game outside the WTO" paper presented at a seminar on The Economics of New Imperialism, Jawaharlal Nehru University, January, 2004 And Bilateral Trade Treaties Are a Sham- By Jagdish Bhagwati and Arvind Panagariya, Financial Times, July 13, 2003

[6] Bhagwati, J. (1993): "Regionalism and Multilateralism: An Overview," in Melo and Panagariya eds. New Dimensions in Regional Integration, Cambridge University Press, Cambridge.

[7] Panagariya, A. (1996): "The Free Trade Area of the Americas: Good for Latin America?" World Economy 19, no. 5, September, 485-515.

[8] Bergsten, C. Fred (1996): "Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century." Asia Pacific Working Paper Series No. 96-15. Washington: Institute for International Economics