UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1990

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
Geneva

TRADE AND DEVELOPMENT REPORT, 1990

Report by the secretariat
of the
United Nations Conference on Trade and Development

UNITED NATIONS
New York, 1990

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UNCTAD TDR 10

UNITED NATIONS PUBLICATION

Sales No.: E.90.II.D.6

ISBN 92-1-112291-0
ISSN 0255-4607

04000P

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Explanatory notes

Classification of countries and territories

Unless otherwise indicated, the following classification of countries and territories has been used in this Report. It has been adopted for the purposes of statistical convenience only and does not necessarily imply any judgement concerning the stage of development of a particular country or territory:

Developed market-economy countries (DMECs): Australia, Austria, Belgium, Canada, Denmark, Faeroe Islands, Finland, France, Germany, Federal Republic of, Greece, Iceland, Ireland, Israel, Italy, Japan, Liechtenstein, Luxembourg, Netherlands, New Zealand, Norway, Portugal, South Africa, Spain, Sweden, Switzerland, United Kingdom, United States.

Countries of Eastern Europe: Albania, Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania, USSR.

Socialist countries of Asia: China, Democratic People's Republic of Korea, Mongolia.

Developing countries and territories: All other countries, territories or areas not specified above.

Generally speaking, sub-groupings within geographical regions and analytical groupings (e.g. Major petroleum exporters, Major exporters of manufactures and Least developed countries (LDCs)) are those used in the UNCTAD *Handbook of International Trade and Development Statistics 1989.**

Latin America corresponds to the *Handbook* grouping "Developing America" and thus includes the Caribbean countries.

South Asia includes Afghanistan, Bangladesh, India, Myanmar (formerly Burma), Nepal, Pakistan, Sri Lanka and *East Asia* includes all other countries in *South and South-East Asia* as well as countries in *Oceania.* In general, data for the People's Republic of China exclude Taiwan Province.

Commodity classification

Unless otherwise stated, the classification by commodity group used in this Report follows generally that employed in the *Handbook of International Trade and Development Statistics 1989.*

* United Nations publication, Sales No. E/F.90.II.D.1.

Other notes

In the tables and in the text: references to "countries" are to countries, territories or areas as appropriate. References to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1989* refers to *Trade and Development Report, 1989* (United Nations publication, Sales No. E.89.II.D.14).

The term dollar ($) refers to United States dollars, unless otherwise stated.

The term 'billion' signifies 1,000 million.

The term 'tons' refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued f.o.b. and imports c.i.f., unless otherwise specified.

Use of a hyphen (-) between dates representing years, e.g. 1965-1966, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1980/81, signifies a fiscal or crop year.

One dot (.) indicates that the data are not applicable.

Two dots (..) indicate that the data are not available, or are not separately reported.

A dash (-) or a zero sign (0) indicates that the amount is nil or negligible.

A plus sign (+) before a figure indicates an increase; a minus sign (-) before a figure indicates a decrease.

Details and percentages do not necessarily add up to totals, owing to rounding.

Abbreviations

ACP	African, Caribbean and Pacific (Group of States)
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
CAP	common agricultural policy (of EEC)
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
c.i.f.	cost, insurance and freight
CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee (of OECD)
DMEC	developed market-economy country
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
ECU	European currency unit
EEC	European Economic Community
EES	European Economic Space
EFTA	European Free Trade Association
EMS	European Monetary System
ESAF	Enhanced Structural Adjustment Facility (IMF)
ESCAP	Economic and Social Commission for Asia and the Pacific
ESCWA	Economic and Social Commission for Western Asia
EXIM	Export-Import Bank (United States)
FAO	Food and Agriculture Organization of the United Nations
FDI	foreign direct investment
f.o.b.	free on board
FY	fiscal year
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	generalized system of preferences
ICCO	International Cocoa Organization
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
ILO	International Labour Organisation
IMF	International Monetary Fund

LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
MFA	Multi-Fibre Arrangement
MFN	most favoured nation
MTNs	multilateral trade negotiations
MYRA	multi-year rescheduling agreement
NMP	net material product
ODA	official development assistance
ODF	official development finance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PACRIM	Pacific Rim
SAF	Structural Adjustment Facility (IMF)
SAL	structural adjustment loan
SAP	Structural Adjustment Programme
SDR	special drawing right
SELA	Latin American Economic System (Sistema Económica Latino-Americana)
SIGMA	System for Interlinked Global Modelling and Analysis
SII	Structural Impediments Initiative
SITC	Standard International Trade Classification (revision 1)
SPA	Special Programme of Assistance (World Bank)
TNC	transnational corporation
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development
USTR	United States Trade Representative
VER	voluntary export restraint

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OVERVIEW
by the
Secretary-General of UNCTAD

At the turn of the decade the world economy appears poised for a number of changes of far-reaching importance. These include the transformation of the economies of Eastern Europe and their integration into the world trading and financial systems; the creation of a single market in Western Europe; major reduction of the United States budget deficit, with the prospect of the United States ceasing to be a large net capital importer; and changes in the international trading system, following the conclusion of the Uruguay Round. In some of these areas - for example the creation of a single market in Europe in 1992 - the shape of the eventual outcome is reasonably clear, but its consequences for the world economy none the less remain uncertain. In others - for example the transformation of Eastern Europe and the assault on the United States budget deficit - the shape of the outcome is at present quite unclear, and the consequences of the policy initiatives under way therefore all the more uncertain. The outcome of the Uruguay Round is also difficult to foresee. Should it fail, there is a very real danger that the international trading system could become fragmented into a few powerful trading blocs and that the forces for managed trade could gain the upper hand, with negative consequences for developing countries.

These major changes are occurring at a time when the ascendency of finance over industry together with the globalization of finance have become underlying sources of instability and unpredictability in the world economy. Financial markets have for some time had an independent capacity to destabilize developing countries; there are now increasing indications of the vulnerability of all countries to financial crisis. The evidence indicates that the costs of financial liberalization and deregulation can be quite high; despite this, further liberalization of banking has become a major goal of some participants in the Uruguay Round. Overall, there appears to be a need for more collective control and guidance over international finance.

A large part of the developing world remains mired in economic stagnation that is often accompanied by various forms of financial disorder. The international debt strategy has made important advances, but policy responses - both national and international - often appear to be too little and too late. The task of breaking the vicious circle of poor growth, over-indebtedness and economic disorder remains for the decade ahead.

The policy challenge of the 1990s is to restore development while managing the rapid changes that are occurring in the world economy in a way that ensures that they contribute to the prosperity of all. This will be no easy task, requiring further policy innovation and adequate command over resources. The latter would be facilitated by overall economic buoyancy, but the near-term prospects are not encouraging. The world economy seems to be slipping into recession, a tendency that only some economies in Asia and some members of the EEC appear likely to resist.

The pace of activity in the world economy has decelerated markedly. World output, which grew at 4.3 per cent in 1988, and by more than 3 per cent in 1989, is expected to advance at around 2.5 per cent in 1990, and in both North America and Eastern Europe the balance of uncertainty in this forecast suggsts that it may be optimistic. The outlook for 1991 is for a small improvement in growth performance; on the whole, however, activity appears to be settling down at rates distinctly below those achieved in 1987-1988. In 1989 stagnation or slowdown of growth occurred in all major groups of countries, except in Africa.

Developing countries are recording highly divergent growth experiences. Output in Latin America barely rose in 1988 and 1989, and appears set to decline in 1990, so that since the early 1980s output per head will have fallen by some 10 per cent, implying significant welfare losses. The improved performance in Africa simply brought to a halt the significant declines in output per head of the earlier period. Moreover, a number of countries in the region suffered economic set-backs. Growth in East and South Asia continued to be vigorous, though expansion in both areas slowed from previous high rates, and some signs of increased vulnerability were appearing in South Asia. The pace of activity in West Asia strengthened in 1989, but does not appear to be following the same course in 1990. For many countries, especially in Africa and Latin America, economic performance remained heavily influenced by the need to cope with external debt.

In China output growth has slowed markedly from the exceptionally high rates recorded in 1987-1988, following the initiation of adjustment policies to counter inflationary and balance-of-payments pressures.

As regards the developed market-economy countries, growth has weakened noticeably in North America. In Japan, on the other hand, activity remains relatively strong, as it does in Western Europe, with the notable exception of the Scandinavian countries and the United Kingdom. These developments mark a decided shift in the locus of growth dynamics, with continental Western Europe emerging as a major growth pole, and North America ceding this role which it had played throughout much of the 1980s. Policy in the United States is entering a particularly delicate phase, with further substantial adjustment of the budget balance likely to occur at a time of decided weakness in the economy.

Economic activity in the countries of Eastern Europe continues to be heavily influenced by the difficulties of engineering a transition to market-oriented economic structures. This process is in differing stages of evolution in the various countries, and at present a wide variety of approaches, time frames and desired final outcomes is in evidence. In many cases the old administrative system of economic governance is not functioning sufficiently, while the new mechanisms of economic regulation and market incentives have not yet become fully operational. The inevitable outcome is poor growth performance overall, a condition that appears likely to persist for some time into the future.

Adjustment and distribution

Patterns of growth and economic performance in 1989 and early 1990 in many respects marked the continuation of trends that emerged in the early 1980s, and which became more pronounced as the decade progressed. Some of these trends are a source of satisfaction - for example the high degree of success achieved by OECD member countries in sustaining expansion while containing price inflation. But others are far less favourable and some are a source of deep concern.

Foremost among the latter has been the tendency for the dichotomy between those doing well and those doing poorly to sharpen. Within many national economies, this has manifested itself as a worsening in the distribution of income. The costs of recessionary adjustment and macroeconomic disorder in Africa and Latin America have fallen disproportionately on the poor. In both continents the share of real wages in GNP declined during the 1980s. In a number of countries these shifts have pushed a larger proportion of the poor into absolute poverty in which even minimal nutritional needs cannot be met. The well-being of many in the middle social classes has also often deteriorated.

These same tendencies are mirrored at the international level. The 1980s have seen an enlargement - rather than a reduction - in the gap between income and wealth in the developed world and those of the developing world. During this period per capita output of OECD countries rose by about 2 per cent per annum. For developing countries as a group, however, output per head

declined. Moreover, within the group of developing countries there emerged a further distinction between countries - mainly in Africa and Latin America - that consistently turned in poor growth performances, and in which per capita output declined sharply, and those - mainly in East Asia - where per capita output expanded (albeit at a rate below that recorded in the 1970s).

Thus, within the developing world itself fundamental differences in economic dynamics have emerged. These differences now defy simple explanation in terms of the usual economic analysis of structures, markets and policies, and appear to be the product of cumulative forces that have become deeply entrenched. For countries caught in the vicious circle of low growth, excessive external indebtedness and internal economic and financial disorder, these cumulative forces are a matter of deep concern. A number of aspects of these negative dynamics are particularly worrying.

A first concern is the cumulative impact of the behaviour of investment. For a large number of debt-distressed developing countries investment remained throughout the 1980s at levels significantly below that reached in 1980. In some countries gross investment was so low that net investment must have been insignificant. The resulting deterioration in the stock of productive capital is now becoming increasingly evident in a number of countries, in particular as regards social and economic infrastructure. This in itself creates a severe handicap to future growth. An additional concern, however, is that stagnation in investment has necessarily entailed a slow-down in the pace of the technological up-dating of the productive base. This is contributing to a widening gap as between debt-distressed and other developing countries in their capacity to secure and utilize effectively the most modern forms of technology, and helps explain the differences in economic dynamics mentioned above.

A second concern is the deterioration in income distribution within debt-distressed countries, mentioned earlier. In addition to the serious fall in human welfare that this often entails, worsened income distribution increases the burden on economic policy: when such changes are not socially or politically sustainable, the need to reverse them heavily mortgages future gains in income, and the scope of future policy action.

The worsening of income distribution is in large part the product of the sheer size of the macroeconomic losses that were sustained by these economies, together with the particular social and political mechanisms in force in each country. The operation of the international system, however, also plays a role. Unskilled labour is not mobile internationally to any significant degree. Capital, on the other hand, is highly mobile - a mobility that is often facilitated by prevalent policy stances emphasizing liberalization of external payments. Highly educated nationals with internationally-marketable skills - individuals who are in the upper income brackets in their own countries - are also reasonably mobile. The upshot is that the overall macroeconomic burden of adjustment cannot be made to fall to any significant degree on capital or the highly skilled without provoking their migration - i.e. an acceleration of capital flight and the "brain drain". Specific policies to mitigate the impact of adjustment on the most vulnerable groups must be put in place and intensified. But as long as economies cannot be shielded from large macroeconomic losses, and upper income groups cannot be made to share to any great degree in those losses, a deterioration in income distribution is inevitable. It should be noted that an international debt strategy that is oriented toward improving the investment climate and encouraging the return of flight capital as instruments for overcoming the debt crisis (rather than incorporating them as factors that will follow the resolution of the crisis) works to intensify this phenomenon and thus to worsen the distribution of income in the short run, even though this is clearly not the intent.

A third concern is the resistance of inflation in some countries to policy action. An essential ingredient in mastering inflation is succeeding in changing the expectations of economic actors so that the sum of their individual decisions becomes consistent with a lowering of the rate of inflation. When Governments put forward anti-inflationary programmes that subsequently fail to meet their objectives, inflationary expectations can actually become more deeply ingrained, and inflation itself becomes more impervious to future policy action. This has undoubtedly already occurred in some countries.

A final, overriding concern is the extent to which the policy-making and policy-executing capacities of many countries have been - and continue to be - overloaded. There can be no doubt that improvements in both the formulation and execution of policy are often needed. But the exigencies of bringing about simultaneously reform, adjustment, stabilization and liberalization - and all of this within a relatively short time and in the context of reduced resources - while promoting growth, protecting the most vulnerable and dealing with the conflicting demands of various groups, would tax severely the most experienced and sophisticated governmental apparatus. When

such an array of tasks is thrust upon administrations that are themselves in the process of development, it should come as no surprise that objectives are frequently not met.

The external environment

A notable feature of the 1980s has been the changed relationship between economic performance in the North and the South. The deep recession experienced by OECD countries in 1980-1982 produced an external environment that was unfavourable to developing countries - because of its implications for interest rates, trade volumes and commodity prices. It was therefore widely expected that recovery in the OECD countries would foster recovery in developing countries. However, this did not turn out to be the prevalent pattern: most of the developing countries that performed poorly during recession in OECD countries performed equally poorly - or worse - during the OECD recovery, and most of the countries that performed well during the OECD recovery also performed reasonably well during the OECD recession.

For many countries that have done poorly, this outcome is explained in the first instance by the collapse of financial inflows, in particular bank lending. But it also reflects the fact that recovery in OECD countries in the 1980s has produced weaker growth impulses for developing countries than have previous periods of expansion. In particular, recovery failed to return interest rates and commodity prices to the ranges experienced during the 1960s and 1970s. Because of this, changes in the external parameters that had at first appeared to be mainly cyclical in character had to be viewed as longer-term changes requiring adjustments to the domestic economy that were - and continue to be - costly in terms of welfare and growth.

As regards interest rates, this outcome had much to do with policy stances in the major industrial countries, particularly the United States. The recovery of OECD economies in the early 1980s was characterized by considerable fiscal stimulus in the United States and high interest rates driven first by the policy of disinflation, and later by the need to protect the economy from a resurgence of inflation, given the fiscal stance. Throughout the 1980s the need to finance the fiscal deficit also exerted upward pressure on interest rates. Consequently, although monetary policy passed through a number of distinct phases and interest rates came down from their peak, they none the less remained high throughout the expansion: the average real long-term rate of interest was 5 to 6 times higher than in the previous two cyclical expansions.

The failure of commodity prices to respond to the economic recovery in the OECD reflected a variety of factors: the investment boom in raw materials resulting from the previous high level of prices often resulted in oversupply; attempts by producer countries to increase export earnings in response to their external debt problems added further to supply; the sharp reduction of inflationary expectations in the OECD areas and the return to positive real interest rates reduced the demand for raw materials for speculative purposes; the raw material content of output in the OECD area was on a downward trend. In general, commodity prices during the upswing appear to have been governed as much by supply considerations as by the relatively weak growth of demand.

In retrospect, it can be seen that the shift in policy priorities in OECD countries, and in the relative roles of monetary and fiscal policy, virtually precluded the emergence of strong linkages between expansion in OECD countries and the foreign exchange availabilities of developing countries. The high priority assigned to combating inflation, together with the reliance of the United States exclusively on monetary policy as the macroeconomic regulator, meant that relatively low interest rates and relatively high commodity prices were an improbable combination: low interest rates would emerge when inflation was deemed to be firmly under control; that meant low and/or declining commodity prices. Any tendency for commodity prices to rise would be read in industrial countries as a resurgence of inflation and would trigger a response by the monetary authorities (even in circumstances in which interest rates were already high). Given the policy

parameters of the 1980s, macro-management in OECD countries was virtually assured to contribute to either weak commodity prices or high interest rates; often it contributed to both.

The recent decision of the United States Administration to seek agreement with Congress on a package of fiscal measures designed to reduce the Federal budget deficit is of special significance. Should these efforts - which were still under way when this Report was being completed - be successful they could lead to a fundamental shift in policy parameters. A credible effort at budget deficit reduction would undoubtedly be accompanied by a relaxation of monetary policy and a lowering of interest rates, and any cyclical weakness in the pace of United States activity could be expected to reinforce this. The outcome that should be sought is a budget position that produces balance at high levels of activity in the United States economy, and real interest rates substantially below those recently experienced: monetary policy would retain its vigour and flexibility, but the range within which interest rates fluctuate would be moved permanently downward.

Such a shift in the parameters of United States macroeconomic policy would have a positive impact on the external environment for development, provided that it were effected in the context of rapid growth in the United States economy - an outcome that is by no means assured. For such a "soft landing" to materialize a number of difficulties will have to be skirted. Budget correction, taken by itself, will have an immediate and direct contractionary impact on the economy, as taxes are raised (thereby reducing private expenditure) and governmental outlays reduced (thereby reducing public expenditure). This contractionary impact should be offset by increased outlays induced by lower interest rates, but here the magnitude and timing of changes in private expenditure are much less certain, and investment decisions will be influenced negatively by the reduction in expenditure resulting from budget correction, as well as positively by the reduction in interest rates. Lower United States interest rates would probably lead to at least some weakening of the dollar and a strengthening of net exports. This would also help sustain the pace of activity. However, excessive weakness of the dollar would risk rekindling inflation and would undoubtedly be resisted. Consequently, should a large drop in interest rates prove necessary in the United States, this might be feasible only if there were some lowering of interest rates in other major financial centres. Other major industrial countries may therefore need to examine their own fiscal stances to ensure that they provide the monetary authorities with sufficient flexibility.

Trade issues

While the growth of world trade slowed significantly in 1989, relative to the preceding year, it continued to be strong (about 7.5 per cent in volume) and to outstrip the growth in world output. The fastest growing import markets were those of the EEC and Japan, reinforcing a trend that has been in evidence since the mid-1980s. In Japan, this growth is likely to continue into the future, as the expansion of domestic demand and particularly of public investment could remain strong. In Europe, imports will remain buoyant, as a consequence of fast economic growth. New investments, both domestic and foreign, in anticipation of the EEC's 1992 deadline for completing the internal market and strong demand stemming from German reunification will most probably lead to rapid growth in output, incomes and imports. Import growth in the United States could well decelerate further, as a result of recent dollar depreciation and weak overall demand conditions.

All in all, the outlook for world trade is relatively optimistic: the growth of trade could continue to outstrip the growth of output, two of the three largest import markets are likely to continue expanding briskly, and trade imbalances could show signs of correction, encouraging further growth in output and trade.

There are, however, a number of disquieting factors. The overall dichotomy among developing countries in growth performance, discussed above, was mirrored in trade performance: export growth has been strong in developing countries of East Asia, while other developing countries have not performed nearly as well. Export growth in Latin America has been very erratic, and

exports have stagnated in sub-Saharan Africa. This uneven performance has been due partly to the commodity composition of exports of the different regions: primary commodities with slowly expanding demand and fluctuating prices predominate in the exports of Africa and several Latin American countries, while the Asian economies derive a large proportion of their export earnings from manufactures in high demand in the rapidly growing Japanese market. It also reflects long-standing differences in trade strategies. Finally, the debt crisis and the instability it has engendered have prevented some countries, particularly in Latin America, from building supply capabilities in manufactures.

The continuation of trade growth will depend to a large extent on the ability of the Uruguay Round to reverse the protectionist tendencies that have gained ground in the trade policies of most developed countries. Success in strengthening the multilateral trading system acquires particular importance because of the acceleration of economic integration in Europe and the emergence of a free trade area in North America.

Political and economic reform and progressive economic integration and co-operation in Europe have created a new dynamics that may lead eventually to the formation of a "Common European House". The new dynamics is bound to have implications for the export opportunities of developing countries. On the one hand, European economic growth will undoubtedly accelerate, and so may the demand for developing country exports. On the other hand, given the diversity of economic conditions and development levels in Europe, the pursuit of greater economic integration will give rise to the temptation to resort to protectionist policies towards third countries which could result in significant trade diversion. Political decisions at the highest levels may be needed to resist such temptation.

The rapidly evolving economic links between Eastern and Western Europe raise a number of issues in this regard. Several Eastern European countries are already seeking to enter into some form of association with EFTA and the EEC. While the situation is still quite fluid and difficult to predict, it is possible that these countries might obtain access to Western European markets on better terms than those granted to competing developing countries. In any case, sourcing in Eastern Europe and investment links which promote exports from East to West could be at the expense of developing country exports, especially if trade barriers against the latter are maintained or increased. Moreover, once economic reconstruction in Eastern Europe is underway, a hesitant approach by these countries toward opening their markets could be damaging to the export prospects of developing country exporters of manufactures. It could also deprive the Eastern European countries of cheaper sources of supply. These are possibilities which need to be forestalled, and the best way to do this is through the integration of the Eastern European countries into a strengthened multilateral trading system.

In the United States, the drift away from GATT disciplines on grounds of the unenforceability or lack of clarity of the relevant rules, and increasing resort to non-tariff measures, have been conspicuous. A particularly worrisome departure from multilateralism has been the increasing willingness to practice or threaten unilateral retaliation against trading partners perceived to be engaging in unfair trading practices, even in areas such as trade in services, intellectual property and foreign direct investment where no accepted international norms yet exist. In this environment, the move by the United States to enter into bilateral trade agreements with its neighbours has given rise to concern that, unless they are accompanied by adherence to multilateral disciplines and a rollback of existing non-tariff measures, such agreements could lead to significant trade losses for non-members.

The "Structural Impediments Initiative" (SII) talks with Japan are further evidence that the United States is attempting to broaden trade negotiations beyond what has traditionally been understood as their proper scope. In the SII talks, the United States' emphasis has been on Japan's domestic laws, regulations and business practices which are perceived as constituting barriers to United States exports to Japan and, therefore, as being partially responsible for its trade deficit with Japan. For its part, the United States has had to recognize that several of its own economic policies have had a bearing on the loss of competitiveness of its exports.

It may well be that in certain special circumstances the consequences for trading partners of domestic policies and institutions become appropriate objects of trade policy discussion. When this occurs, however, such discussions are best undertaken in a multilateral setting, where decisions can take into account the needs and interests of all trading partners. Moreover, any attempt to generalize the SII procedures would pose particular problems for developing countries. Development-oriented policies and institutional arrangements in developing countries have an in-

fluence on both the level and the composition of their imports and exports, and could be seen to have implications for the trade of other countries. But failure to recognize fully the need for such policies and institutional arrangements would jeopardize development itself. Moreover, a bilateral approach to the trade impact of domestic policies would open the door to unwarranted intrusions by powerful countries into the domestic economic policies of weaker ones.

Most of the changes in economic structures and domestic policies agreed to in the SII talks are unlikely to have a significant impact on the United States bilateral trade deficit with Japan. One of the results of the SII talks, however, was a promise by Japan to increase public investment, thereby strengthening recent reliance on domestic demand as the main source of growth. At the same time, the United States promised to continue its efforts to reduce its budget deficit. Such actions are squarely in the macroeconomic field and have little to do with the direct and indirect market access issues with which United States trade policy has been preoccupied. Policy changes in this direction, by assisting in the reduction of long-standing international imbalances, would make an important contribution to an easing in protectionist pressures and to the preservation and strengthening of the multilateral open trading system.

The Japanese economy has undergone major changes since 1985. One of the most striking has been the emergence of an import boom as the economy has shifted from growth led by exports to growth led by domestic demand. Imports from a number of Asian developing countries have grown particularly rapidly. The recent surge in Japanese imports is a most welcome development, and its continuation should make an important contribution to world economic growth and to the exports of developing countries. However, in some quarters it is feared that the bulk of Japan's trade growth will be confined to a select group of Asian developing economies which are recipients of Japanese foreign direct investment and that countries, both developed and developing, which are not part of this network could be relatively disadvantaged when competing in the Japanese market.

There is some quantitative evidence that in some dynamic manufacturing sectors (particularly capital equipment) intra-firm trade of Japanese corporations has played an important role in the expansion of exports from the Asian developing economies to Japan. However, the bulk of the increase in these economies' exports to Japan has not been the outcome of the investment activities of Japanese corporations. These economies have become competitive not only in the Japanese market but in other major markets as well. In addition, they have developed supply capabilities in those goods which have been in high demand in international markets. Generally, developing countries seeking rapid growth in exports to the Japanese market will have to emphasize policies which promote the efficient development of supply capabilities in goods which are, and will be, in strong demand in Japan. International assistance to overcome obstacles to productive investment would help to expand the number of developing countries in a position to take advantage of this growing market.

Capital markets and debt

1989 saw a continuation of the stark contrast between the overall buoyancy of international capital markets and the sluggishness of major categories of lending to developing countries. Net lending to developing countries by commercial banks remained negative. This stemmed largely from banks' efforts to reduce their exposure to countries in Africa and in Latin America and the Caribbean, because of their debt overhang. Overindebtedness was also an important force behind the continuing prevalence of the high costs and restrictive conditions of official insurance and guarantees for export credits, and low levels of demand for investment goods in developing countries. The upshot was stagnation in export credit flows.

The low perceived creditworthiness of most debtor developing countries has been strongly influenced by the failure of their external financial position to register sustained improvement. During 1989, such improvements as were forthcoming in ratios of debt to exports were to levels

still above those of 1982, and were not accompanied by improvements in ratios of interest payments to exports, partly because of the rise in interest rates during the year. Net outward financial transfers from developing countries remained high, and arrears continued to increase for many major borrowers among them.

Commercial banks and the Brady initiative

The strengthened debt strategy, adopted following the Brady initiative, began to be implemented last year. Although this new approach marks a significant step forward, it promises to yield only half the amount of debt and debt service reduction needed by highly indebted countries. Its viability therefore depends, like the Baker plan, on the willingness of creditor banks to supply new money.

However, as explained in last year's *Trade and Development Report*, the willingness of banks to extend their exposure is questionable. The level of concerted bank lending dwindled to a mere $2.3 billion in 1989 (one fifth of the 1984 level). Some of the impediments to lending intensified. For instance, many banks further raised their loan-loss provisions, thereby adding to the cost of new lending, and arrears to commercial banks rose very steeply.

The banks' lack of interest in providing new money is also obvious from the experience of the three "Brady" agreements concluded thus far. (The agreements in principle reached by Morocco and Venezuela include a new money option; but it is not yet known what the banks' response will be).

- The Mexican agreement succeeded in eliciting only half the target set for new money, with many creditors opting instead for debt or debt service reduction.
- Subscriptions to the "new money bonds" offered by the Philippines fell short of the target figure, while more tenders were received for buy-backs than could be accommodated.
- The Costa Rican agreement made no attempt to raise new money and concentrated instead on debt and debt service reduction.

Since the agreements were negotiated without authoritative estimates of the debt and debt service reduction required by individual countries, it is difficult to judge their adequacy. However, some of their features are worrisome. First, outcomes were in most cases below expectations. Secondly, the remaining debt is more difficult to restructure, since it is now mainly in the form of bonds; moreover, these may come to be held by investors less willing to provide new money but more willing to engage in litigation. Thirdly, the agreements are asymmetric regarding future contingencies: the creditors will gain if the country's position improves, but are not obliged to help if it deteriorates.

The absence of authoritative estimates of debt reduction needs, together with the failure to assign to any international financial agency the role of "honest broker", has left the level of debt reduction to be shaped by the balance of negotiating strength rather than by objective needs. In the Mexican deal, pressure on creditors by the United States Government helped to reduce this imbalance; but such pressure is not part of the architecture of the strengthened debt strategy. In the Costa Rican agreement, the creditors' willingness to conclude an agreement owed much to the decision of the Fund and Bank to provide financial support to the country's adjustment programme despite its arrears (reflecting the authorities' success in managing the consequences of these arrears for the domestic economy). Systematic resort to this approach where arrears are unavoidable, combined with firm internationally-set targets for the debtors' medium-term cash flow and debt profile, would give the negotiating process the anchor which it currently lacks.

Providing creditors with additional incentives to engage in debt and debt-service reduction on a larger scale and to accept steeper discounts in such operations could usefully complement increased pressures. A wide variety of proposals in this vein have been put forward in recent years (for instance, to establish an international debt facility), and have been discussed in previous issues of the *Trade and Development Report*.

National laws and regulations could also be directed more effectively towards achieving adequate levels of debt and debt-service reduction. One recent suggestion (made with European countries in mind) is that creditors should qualify for tax deductions on their loan-loss provisions only to the extent that they participate in debt reduction packages. Another (made with the

United States in mind) is that creditors that fail to participate in debt reduction packages sanctioned by the IMF and World Bank should be required to make special provisions on their loans, and should not be eligible for tax relief on losses.

The broad conclusion is that the scale of debt and debt service reduction by commercial banks needs to be enlarged very considerably. However, the combination of additional incentives and disincentives chosen in order to enlarge the scale of debt reductions should not be tilted in favour of increased financial support from the World Bank and the regional development banks. Unless additional funds are put at their disposal, such support could reduce lending for new investment, which is the key to successful adjustment.

Official debts

The relief resulting from the Toronto measures has proved to be very limited. As explained in last year's *Trade and Development Report* the eligibility criteria need to be reviewed, so as to increase considerably the number of beneficiary countries. As a first step, all least-developed countries and all IDA-eligible countries should benefit from the Toronto treatment. The recent agreement with Bolivia, which became the first country outside sub-Saharan Africa to benefit from the Toronto terms, is encouraging. The concessionality of the Paris Club measures should be enhanced considerably, especially for the most distressed countries, and the coverage of consolidation should be widened up to 100 per cent of Paris Club obligations. Multi-year rescheduling should be the rule, with the length of the consolidation period being related to financing needs rather than invariably being fixed to the length of IMF arrangements. Co-ordination between the Paris Club and donor groups should be strengthened, particularly to ensure that debt relief is not at the expense of aid. Finally, other bilateral creditors should consider the adoption of comparable measures.

Many middle-income developing countries whose debt is mostly owed to official creditors also have a debt overhang. Recent action within the Paris Club to extend longer repayment periods to some middle-income countries represents a step in the right direction but a timid one. Many debtor countries in this category will need reduction of their official bilateral debts. For them, debt reduction by commercial banks alone is not enough: official bilateral creditors also need to reduce their claims. Despite the difficulties involved - such as the impact on the finances of export credit agencies - this issue has been receiving closer attention by policy makers in creditor countries, as evidenced by the initiatives most recently announced by the Presidents of France and the United States. However, these initiatives were not followed by agreement for global action on this important matter at the Houston summit.

For many developing countries, and especially some of the poorer, debt owed to the multilateral financial institutions represents an important part of their overall debt burden. Additional resources need to be brought to bear on this problem, so as to reduce debt and/or debt service payments when needed, and in a manner that safeguards the financial viability of those institutions.

Attention must also be paid to those countries that do not at the moment have an overt debt problem but are struggling to avoid that eventuality. The vulnerability of some of these countries has recently increased considerably.

International financial uncertainty

Last year witnessed further bouts of instability in financial markets. Shifts in exchange rates, interest rates, asset prices and the volume and direction of capital movements are now too frequent to be viewed as episodic. They are a characteristic of the global economy that has been emerging over the past two to three decades.

The volatility involves a very wide variety of monetary and financial instruments and is international in scope. Its intensity is due to the globalization of finance interacting with the new thrust of government policies which favour liberalizing and deregulating private finance and aim fiscal and monetary policies at nominal (as opposed to real) objectives. This shift sought to unleash initiative and enterprise. But since asset markets are ruled by changing expectations and temperament, its end result may have been, rather, to unshackle speculation.

Admittedly, thus far a global crisis has been avoided; indeed, the growth of the world economy as a whole has proceeded apace. Nevertheless, disruptions have not been absent, most notably in indebted developing countries. Moreover, the need to avert crisis and contain the spread of damage has obliged Governments to take actions inconsistent with their own economic philosophy and objectives. Besides, production and trade continue to be subject to acute uncertainty and unpredictability because of financial turbulence. It is therefore none too early to consider how to diminish, if not remove, the instability of the international monetary and financial system.

By post-war standards, instability has been very high in the 1980s.

- Interest rates in the main financial centres have been much more variable, and the direction of movement has changed more frequently.
- The amplitude of fluctuations has risen even for countries with relatively low interest rates. Levels of nominal and real interest rates have reached extraordinary heights.
- The principal exchange rates have gyrated more in the past decade, and have deviated for substantial periods from levels warranted by differences in productivity and thrift.
- Swings in equity prices have registered an intensity unprecedented in the post-war period. The general level of equity prices has risen, but downward movements have at times been extraordinarily steep and abrupt.
- A number of developed countries have experienced sudden short-term inflows or outflows of funds on a massive scale.
- Many developing countries have experienced breakdowns in their external financing from capital markets, as well as large-scale capital flight.

One of the main sources of the increased instability is the liberalization and deregulation of financial activity. Since the late 1970s the removal of policy barriers to capital movements has become an objective of policy, and "hands-off" has pervaded official thinking generally. Moreover, attempts by countries to retain and attract financial activity to their shores has led to competitive deregulation and reduction of taxes, the principal result of which has been to make funds more mobile. Deregulation has also encompassed interest rates and the range of activities permitted to different types of financial institutions. This has reduced considerably the degree of segmentation of markets and widened the potential for funds to move across institutions, markets and borders.

The "hands-off" approach has also led to greater risk-taking. While some of the financial innovation characteristic of 1980s has been designed to spread risks, a good deal of it has been intended to exploit openings for capital gains on the basis of debt instruments. Because increased market freedom has not been adequately matched by prudential regulation, the lure of quick profits has put at risk not only imprudent creditors and debtors but the financial system as a whole.

Aided by advances in electronics, as well as by changes in government policy, the globalization of finance has proceeded rapidly. Its centrepiece has been the closer integration of national money markets as holders of liquid funds have increasingly regarded interest-bearing money-market instruments denominated in different currencies as potential substitutes for each other. Bond and equity markets too have become more closely integrated. These trends have been closely connected with the internationalization of industry, banking and various other services such as insurance. Fund managers have become increasingly alert to opportunities to improve their returns by continuously readjusting their portfolios, and borrowers have become more conscious of possibilities for raising funds from different markets abroad.

Financial integration, liberalization and deregulation have been the main factors causing international financial activity to expand rapidly. Growth in world output, trade and direct investment naturally causes international financial transactions of various kinds to grow as well. However, the latter's tempo has been very much faster.

International financial deepening does not appear to have improved the international allocation of savings. There has been no narrowing of differences in rates of return on capital invest-

ment in the major market economies, or in yields on financial assets with differing currency denominations but similar risk and maturity, or in real interest rates; nor has the link between the level of savings and investment in individual countries been weakened. The main reason is that most international financial transactions have been portfolio decisions, largely by rentiers, rather than business decisions by entrepreneurs.

Similarly most currency transactions have been generated by trade in the stock of financial assets rather than by flows of saving. Consequently, foreign exchange markets have been ruled by expectations (including as to how currency expectations will evolve). The speculative component of the market has therefore predominated, giving rise to speculative "bubbles", "bandwagon effects", over-reactions and under-reactions to news, and sudden shifts of view even as regards the relationship between economic variables. It is therefore not surprising that exchange rates have shown no systematic tendency to move towards "equilibrium" values, and that speculation on future currency movements frequently has acted not as a stabilizing mechanism but as a source of turbulence.

The approach to policy followed by Governments has also been a major factor behind the increased instability. In the 1980s monetary policy became far less concerned to stabilize interest rates and much more concerned to control monetary growth. Governments have also become extremely reluctant to use fiscal policy to manage the level of demand, and even more so to control prices and incomes in order to combat inflation. This has left monetary policy as the only tool for macroeconomic management - something not synonymous with controling the stock of money. Monetary policy has been further overloaded by the need to take account of the exchange rate. Moreover, Governments have failed to pay due regard to the impact of their own policy approaches and actions on the rest of the world. Consequently, major inconsistencies have emerged among the policy stances of countries, resulting in vast trade imbalances and sharp swings in exchange rates.

Exchange rate instability has inflicted damage on international trade and finance through two main routes.

- It has increased the cost of conducting trade, as well as the uncertanties faced by industries producing tradeable goods and services. Unpredictability has shortened the time-horizons for investment decisions, and made it necessary for firms to maintain higher mark-ups and financial reserves. Equally important, it has diminished the usefulness of the exchange rate as a signal for resource allocation, reducing the ability of depreciations and appreciations to alter exports and imports. Moreover, currency overvaluations have added to pressures for protection; and the protectionist measures taken have often been maintained long after the overvaluation has ended. Continuous uncertainty regarding exchange rates has also encouraged pressures for permanent protection to compensate for the exchange risk.
- It has also tended to disrupt finance. For one thing, uncertainty in exchange-rates, like that in interest rates, has increased the preference of wealth-holders for liquid over long-term assets, and thus put upward pressure on long-term interest rates. Moreover, sudden shifts in exchange-rate expectations have set off movements of funds out of certain markets, for instance bonds and equities,on a scale large enough to depress prices very sharply (as in Japan in late 1989/early 1990). They have also made it necessary to tighten monetary policy (or created the expectation that this will occur), with similar consequences; pressure on the dollar played an important role in bringing about the Wall Street crash of October 1987. Attempts to counteract with monetary policy undesirable movements in exchange rates (eg. ones that are perverse from the standpoint of trade or which represent over-reactions to changes in trade imbalances) have in practice led to a ratcheting up of interest rates. This has added to other upward pressures, including those produced by the instability of exchange rates and interest rates.

High interest rates have had numerous adverse consequences.

- They have increased the cost of external debt in developing countries. This, together with the resulting increase in the volume and burden of internal debt, has had a devastating impact on macroeconomic stability, domestic interest rates, income distribution, investment, growth, and development.
- In developed market economies, higher interest rates have redistributed income in favour of rentiers at the expense of investment, wages and raw material prices. Al-

though rates of profit have now regained their 1960s levels, the share of investment in income has not.

To remedy instability and reduce uncertainty to more tolerable levels requires action across a broad front, including the mobility of funds.

- Governments need to commit themselves to defend a publicly announced pattern of exchange rates which should be internationally agreed and compatible with high levels of activity and employment. Serious consideration should be given to establishing an EMS type arrangement (i.e. adjustible pegs with predefined obligations, intervention rules, and relatively narrow bands) between the dollar, the ECU and the yen.
- Multilateral surveillance of policies of major industrial countries should be much strengthened. In particular, targets need to be set for demand growth and current account balances. The burden of adjusting policy when outcomes deviate from those targets should be clearly specified. This burden should be shared between deficit and surplus countries in such a way as to avoid bias towards deflation and high interest rates; this is an especially important consideration for developing countries. Fiscal as well as monetary policies need to be included among the instruments of policy. Global targets and indicators should also be used to ensure that the world economy as a whole is neither deflated nor over-heated.
- The cost of speculation should be increased through policy intervention, using such devices as taxes on financial transactions. Considerable policy innovation in this area is called for.
- Prudential regulations need to be tightened to raise the cost of excessively risky operations in both credit and security markets. They also need to be harmonized, and applied in all major financial centres including those off-shore.

In order for the approach outlined above to command consensus, it would be necessary to recognize that financial markets need to be managed if they are to serve the needs of enterprise; that interdependence has already resulted in a loss of policy autonomy; and that in a multi-polar world co-operation is essential to prevent interdependence from accentuating conflict.

International banking and the Uruguay Round

The internationalization of finance has thus far affected the character of monetary and financial instruments more than the actors themselves. In most countries, the bulk of banking operations remains in the hands of domestically owned and controlled institutions. Moreover, most countries, including the majority of developing countries, maintain restrictions on cross-border capital movements and on foreigners' access to domestic financial markets.

Banking is an important subject at the multilateral negotiations on services taking place as part of the Uruguay Round. The impetus for an agreement on international trade in banking services as part of the Uruguay Round comes mainly from certain developed countries, their objectives concerning both each others' markets and those in developing countries. Banks from the developed countries clearly perceive widespread opportunities in developing country markets, particularly in the supply of certain retail banking services to the better-off and in the provision of services to corporations, the exploitation of which could be facilitated by an agreement at the current multilateral trade negotiations.

The costs and benefits of competition in banking and the relations between liberalizing the banking sector, on the one hand, and the conduct of monetary policy and the direction of credit allocation, on the other, need to considered in the context of efforts to establish an agreed regime for trade in banking services. Banking services generally play a pivotal role in the functioning of economies since a great many economic transactions are linked to their use. The banking sector is therefore a powerful instrument for controlling or influencing production and other major eco-

nomic aggregates. As a result of banking's potential in this regard and of the large number of different services of which the sector consists, the establishment of norms and regulations in the field at national and international levels is a complex process, and frequently also a contentious one.

Proponents of an agreed regime generally are supporters of substantial liberalization, and point to analogies between restrictions of international competition in the provision of banking services, and quotas and tariffs affecting trade in goods. For example, according to this view, restrictions on the establishment of foreign banks (and thus on "trade" in the form of financial services supplied locally by such institutions) lead via lower levels of competition to reduced innovativeness and microeconomic efficiency or to excess profits (or both) among banks already in the market. Restrictions on such banks' operations are thought to lead via increased costs to higher interest rates and other charges and to lower levels of lending. Thus liberalization of restrictions on the establishment and operations of foreign banks, it is believed, will improve the performance of financial sectors both with respect to the opportunities made available to depositors and investors for the placement of their funds and with respect to the amount and allocation of financing for borrowers.

For developing countries, liberalization of international trade in banking services also brings with it substantial dangers, which help to explain their widespread apprehensions.

- Commitments to liberalize cross-border transactions in banking services would entail dismantling significant parts of national regimes of exchange control. Some developing countries are already integrated with the financial world outside, either by deliberate choice or because of inability to exercise control over foreign exchange operations (due, for instance, to the extent of earnings from emigrants' remittances, tourism, illicit products, etc. or to the weaknesses in the national administration). But in many others this is not the case, and exchange controls have proved effective in stemming capital flight, thereby making an essential contribution to macroeconomic management.
- Unless subject to appropriate controls, the presence of foreign banks also would complicate the conduct of autonomous national monetary policies owing to the character of the banking operations which this presence facilitates, and to the lower degree of 'moral suasion' to which such banks tend to be susceptible.
- Economic development often requires direction of the allocation of credit. The liberal, market-driven banking systems of the type currently prevailing in many OECD countries may therefore not be appropriate models to follow.
- Much of the protection accorded to domestically owned and controlled banks in developing countries is of an infant-industry nature. The avoidance of financial dependence and the establishment of indigenous banking systems are an integral part of economic development. These objectives can generally be achieved only through the provision of appropriate protection and support to national institutions which would otherwise risk being swamped by the superior competitive strength of banks from the OECD area.

These dangers will need to be borne in mind and the issues they raise given proper weight in the Uruguay Round negotiations.

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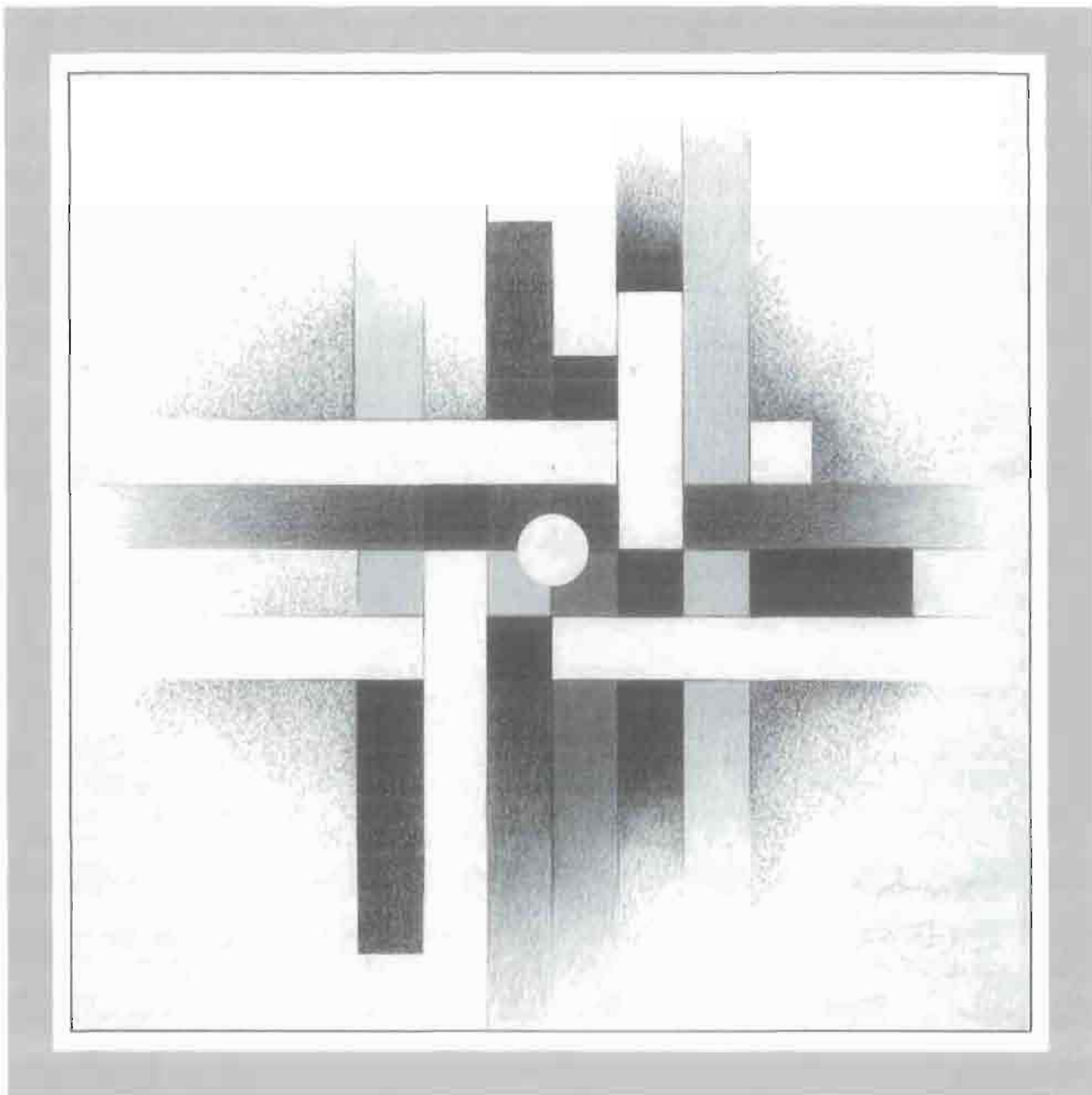

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Chapter I

INTERNATIONAL MARKETS AND DEVELOPING COUNTRIES

A. Introduction

International markets are the main vehicle through which changes in the overall economic environment affect developing countries. Inflation, deflation, growth, recession and structural change in the world economy at large are transmitted to developing countries in the first instance through international trade and financial transactions. Developing countries are naturally influenced by the overall ebb and flow of the markets, in some of which they are important actors. But they are also influenced by changes in their own capacity to participate in current market dynamics.

Both factors were at work in 1989. The growth of world trade slackened and this was reflected in a considerable decline in the pace of growth of the trade of developing countries. Likewise, the overall index of commodity prices weakened throughout 1989, and this was reflected in a somewhat more pronounced weakening in the price of commodities exported by developing countries.

In capital markets, however, the sharp contrast - already visible in preceding years - between the general buoyancy of markets and the increasing marginalization of developing countries in these markets persisted and was accentuated. The increasingly marginal role of developing countries in capital markets reflects mostly the continued perception of the lack of creditworthiness of most of them, despite their own adjustment efforts and improvements in the international debt strategy. Indeed, the changes introduced in the strategy appear to have led directly to a reduction in new lending, without, however, having provided sufficient cash flow through the reduction of existing debt.

These and related issues are explored in the paragraphs that follow.

B. The growth of international trade

Uneven volume growth as between different countries and regions and price instability have characterized developing countries' trade during the 1980s. These features were well in evidence in 1989. In a few countries of South-East Asia, export performance based on

Table 1

GROWTH OF IMPORT VOLUMES IN SELECTED GROUPS OF COUNTRIES, 1980-1989

(Percentage)

Imports into	1980-1985	1985-1989	1987	1988	1989 [a]
	(Annual average)				
World	3 2	7.1	6.4	9.4	7.5
Developed market-economy countries	3.2	7.5	7.0	8.4	7 9
EEC	2.5	7.8	8.2	8.3	8.5
Japan	1.9	10.0	9.2	16.5	7.5
United States	7.7	5.5	3.5	6.0	5.0
Developing countries	0.4	6.2	8 0	14.7	5.9

Source: UNCTAD secretariat, based on official international sources.
a Estimates.

increasingly sophisticated manufactures has continued to be strong; in some other South and West Asian countries, export growth has accelerated relative to the first half of the decade. However, in many countries, particularly in Africa and Latin America, export earnings continue to be at the mercy of the vagaries of primary commodity prices; in others, which have developed some capability for exporting manufactures, domestic instability and the burden of debt do not allow for a self-sustained expansion of exports and output.

1. *The evolution of trade volumes*

The estimated 7.5 per cent rise in world import volumes in 1989 was well below the record 9.5 per cent achieved in 1988. This decline in the growth of world trade reflected mainly the slower output expansion in developed market economies, but also the important decline in the growth of output in the relatively more industrialized South-East Asian economies, leading to a lower demand for internationally traded goods. None the less, the rise in the volume of world trade was still appreciable, having regard to the average 4 per cent per annum increase recorded between 1980 and 1988.

Although there was a sharp fall in the growth of imports into Japan in 1989, the trend toward faster import growth in Japan and EEC in comparison to the United States, which had begun in 1987, continued in 1989 (see table 1 and also chapter III below, section C). However, imports into the United States continued to grow strongly relative to output and, as already mentioned, Japanese import volumes decelerated markedly. Part of this evolution was caused by exchange rate movements, as the yen depreciated and the dollar appreciated in international markets. The recent reversal of these currency movements, together with the likehood of a more expansionary fiscal policy in Japan and greater fiscal restraint in the United States, could well lead to a resumption of fast import growth in Japan and to a further deceleration of import volumes in the United States. Import expansion into Western Europe continued to be very strong in 1989. This dynamism is likely to persist into the next few years, as firms invest in readiness for the completion of the single European market in 1992 and as a result of the expected opening up of trade opportunities in Eastern Europe.

Developing countries again lost momentum as importers in 1989, after what now appears as a recovery in 1987-1988 from previously very depressed levels. Imports in most of these countries continue to be affected by the debt overhang and other sources of foreign exchange shortage. The total imports of developing countries rose by almost 6 per cent in volume terms in 1989, considerably less than the 14.7 per cent growth observed in 1988. The decline in 1989 affected all developing regions, and import volumes stagnated or even declined

Table 2

DEVELOPING COUNTRIES: GROWTH IN THE VOLUME OF IMPORTS, 1980-1989

(Percentage)

Imports into	1980-1985 (Annual average)	1985-1989 (Annual average)	1987	1988	1989 [a]
All developing countries	0.4	6.2	8.0	14.7	5.9
Africa	1.5	1.2	2.0	8.0	0.7
North Africa	3.5	2.4	1.7	10.5	1.4
Sub-Saharan Africa	-1.7	-1.2	2.3	2.2	-
Asia	3.2	9.1	11.0	18.0	7.5
West Asia	0.6	-5.1	-4.8	1.3	3.4
South and South-East Asia	4.9	12.3	16.0	25.2	8.3
Latin America	-5.6	1.6	-	5.4	2.6

Source: UNCTAD secretariat, based on official international sources.
a Estimates.

in most developing country groups except South and South-East Asia, where they rose by 8.3 per cent. However, this latter region provided considerably less support to world economic growth in 1989 than it did in preceding years. Latin American imports rose very little in volume terms in 1989, reflecting major problems in some countries (e.g. Argentina, Brazil, Peru and Venezuela). In these countries, slow growth or even declining output and investment decreased the demand for imports. Modest increases in export earnings in most countries and the unavailability of external capital resources restricted the foreign exchange available for imports. In sub-Saharan Africa, imports stagnated in 1989, partly because of the fall in export earnings for tropical beverage exporters, and partly owing to import compression within the context of generalized adjustment efforts (see table 2).

2. *Exports from developing countries*

In 1989, there was a significant deceleration in the growth of export volumes in developing countries, from 13.5 per cent in the previous year to about 6 per cent (see table 3). The exports of both manufactures and raw materials were affected by the slowdown in industrial production in the developed market economies. Several supply-side factors also contributed to the export slowdown. These included, especially in Latin America and Africa, disruption of investment in previous years brought about by strong domestic disequilibrium or stabilization and adjustment efforts. In Africa, much of the small increase in exports was accounted for by oil, with the largest increases in export volumes taking place in oil-exporting countries such as Algeria and Nigeria.

As regards manufactures, apart from certain countries, there has been a generalized deceleration of export growth. The growth of manufactured exports from South and South-East Asia slowed down markedly in 1989. Currency appreciation, domestic inflation and rising wages in the major exporters of manufactures (Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China) reduced the competitiveness of their manufactured exports, the value of which fell sharply (see table 4). In contrast, the new exporters of manufactures from that region (Indonesia, Malaysia, Thailand and Philippines) continued to expand the value of their exports strongly. There was also strong growth in the value of manufactured exports from other Asian developing countries (e.g. Bangladesh and India) and from China.

The exports of manufactures of the Latin American countries are heavily concentrated in

Table 3

DEVELOPING COUNTRIES: GROWTH IN THE VOLUME OF EXPORTS, 1980-1989

(Percentage)

Exports from	1980-1985	1985-1989	1987	1988	1989 [a]
	(Annual average)				
All developing countries	-1.2	9.5	5.9	13.5	6.0
Africa	-4.1	2.5	1.2	8.5	2.8
North Africa	-4.9	5.0	-3.4	18.8	4.0
Sub-Saharan Africa	-3.7	0.8	7.8	1.2	2.0
Asia	5.5	8.9	7.8	15.7	7.3
West Asia	-12.3	11.4	-12.1	15.0	2.0
South and South-East Asia	7.4	15.0	18.9	16.0	9.5
Latin America	3.7	2.8	1.7	8.4	4.1

Source: UNCTAD secretariat, based on official international sources.
a Estimates.

the United States (see chart 1). The growth of such exports to the United States decelerated considerably in 1989. On the supply side, internal problems in several Latin American countries strongly affected the manufacturing sector. Manufactured exports to the United States declined by 8.7 per cent in Brazil and by 14 per cent in Argentina. In contrast, Mexico increased such exports by approximately 15 per cent, to reach nearly $18 billion. Sizeable advances were also observed in Chile, Colombia and Costa Rica.

West Asian countries resumed their export growth of manufactured products in 1989, mainly in the petrochemical and aluminium sectors. Production capacities in the aluminium sector have increased in Bahrain and Qatar, leading to increased shares of the world aluminium market. In the petrochemical sector, increased oil revenues have allowed West Asian countries to pursue their diversification process. Consequently, exports of petrochemical products have increased.

African countries increased the value of their manufactured exports markedly in 1989. Estimates of such imports into OECD countries for the first three quarters of 1989 show a growth of well over 15 per cent. However, this trade still represents a very small percentage of manufactured imports by OECD countries and involves only a few countries.

3. *The behaviour of commodity prices*

The combined index of commodity prices (excluding petroleum), expressed in current dollars, rose marginally in 1989. The index for the principal export commodities of the developing countries, however, was the same for 1989 as 1988, but this concealed a reversal of the underlying trend. The quarterly index, which had been on a steady upward trend for ten quarters until the first quarter of 1989, then began declining. As may be seen from table 5, by the first quarter of 1990, it was 11 percentage points below its level a year earlier. The index of real prices, expressed as the combined index deflated by the unit value index of manufactured goods exported by developed market-economy countries, also declined by more than 10 percentage points over the same period.[1]

[1] During certain periods (as happened in 1985-1986) exchange rate fluctuations for the dollar may cause radical divergences between the index expressed in dollars and in other currencies or in SDRs, making difficult the intrepretation of price movements. However, over the last two years the indices expressed in dollars and in SDRs have moved fairly consistently.

Table 4

GROWTH OF THE VALUE OF IMPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES INTO THE UNITED STATES, EEC AND JAPAN, 1980-1989

(Percentage)

Imports from	*1980-1985* (Annual average)	*1985-1989* (Annual average)	*1988*	*1989* [a]
		United States		
World	15.1	10.3	10.5	5.4
Developing countries	17.3	14.7	14.4	4.3
Latin America	18.4	16.3	25.2	8.3
East Asia four [b]	17.6	12.3	8.8	-1.3
ASEAN four [c]	13.9	23.1	27.8	25.1
Africa	6.0	32.8	16.0	19.8
China	29.5	42.9	36.0	45.5
		EEC		
World [d]	-1.6	21.1	16.0	7.7
Developing countries	-0.1	28.1	25.8	7.8
Latin America	0.6	23.0	35.4	17.4
East Asia four [b]	-2.2	30.1	24.0	2.2
ASEAN four [c]	6.7	31.7	33.5	18.8
Africa	-2.6	25.0	19.6	14.1
China	3.2	43.3	39.2	24.2
		Japan		
World	4.9	29.2	39.2	18.3
Developing countries	6.1	38.8	48.9	19.6
Latin America	9.2	19.2	53.9	5.7
East Asia four [b]	5.3	39.7	46.4	16.4
ASEAN four [c]	4.2	55.9	52.2	63.3
China	10.2	38.8	62.2	29.8
Memo item:				
Change in index of unit value of manufactured exports of DMECs	-1.7	7.1	6.1	-0.3

Source: UNCTAD secretariat, based on data from the United Nations Statistical Office

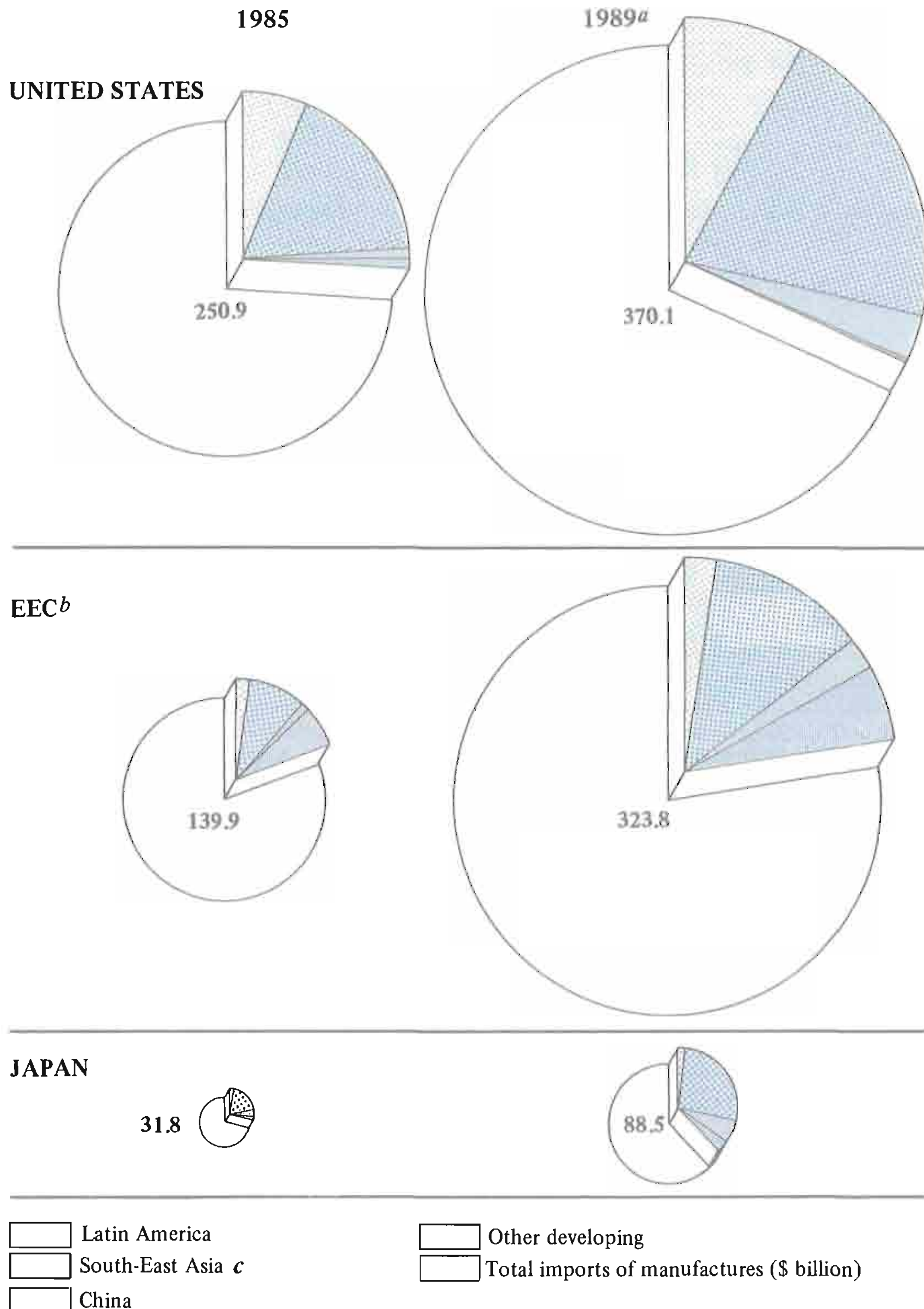
a Estimates based on partial data.
b Hong Kong, Republic of Korea, Singapore, Taiwan Province of China.
c Indonesia, Malaysia, Philippines, Thailand.
d Excluding intra-EEC trade.

From the point of view of developing countries, the overriding elements of the commodity market situation were the collapse of cocoa and coffee prices, high prices for basic foods and the short duration of the copper and aluminium price boom. Prices for vegetable oilseeds and oils declined, but those for agricultural raw materials remained firm. For many developing countries in Africa, in particular those which rely on exports of coffee and cocoa and depend on imports for much of their basic food requirements, foreign exchange difficulties were exacerbated.

Chart 1

DEVELOPING COUNTRIES AND CHINA: SHARE IN THE MANUFACTURED IMPORTS OF THE UNITED STATES, EEC AND JAPAN, 1985 AND 1989

(Percentage)



Source: UNCTAD secretariat, based on data from the United Nations Statistical Office.

a Preliminary, based on partial data.

b Excluding intra-EEC trade.

c Hong Kong, Republic of Korea, Singapore, Taiwan Province of China, India, Malaysia, Thailand and Philippines.

Table 5

QUARTERLY INDICES OF FREE MARKET PRICES IN CURRENT DOLLARS FOR GROUPS OF PRINCIPAL COMMODITIES EXPORTED BY DEVELOPING COUNTRIES, 1987-1990

(1985 = 100)

Commodity group	Year	Annual average	Quarter I	Quarter II	Quarter III	Quarter IV
Food, tropical beverages and vegetable oilseeds and oils	1987	101	98	99	98	110
	1988	126	118	125	132	128
	1989	127	128	132	124	123
	1990	124 [a]	124			
of which:						
Food	1987	117	111	114	114	129
	1988	152	139	150	163	156
	1989	161	154	163	164	164
	1990	165 [a]	165			
Tropical beverages	1987	81	85	78	76	84
	1988	82	85	82	77	82
	1989	70	87	81	58	54
	1990	59 [a]	59			
Vegetable oilseeds and oils	1987	93	68	73	71	79
	1988	96	88	95	105	95
	1989	85	91	92	80	77
	1990	74 [a]	74			
Agricultural raw materials	1987	119	112	117	123	126
	1988	129	128	133	129	127
	1989	129	131	129	128	128
	1990	132 [a]	132			
Minerals, ores and metals	1987	113	96	104	115	135
	1988	164	149	173	158	177
	1989	164	183	168	156	149
	1990	140 [a]	140			
Combined index	1987	107	100	103	106	118
	1988	135	126	137	137	139
	1989	135	140	139	132	130
	1990	129 [a]	129			
Combined index of real prices [b]	1987	84	77	78	87	92
	1988	95	88	95	99	96
	1989	94	88	99	91	89
	1990	87 [a]	87			

Source: UNCTAD, *Monthly Commodity Price Bulletin.*

a First quarter.

b Prices deflated by the unit value index of manufactured goods exported by developed market-economy countries

The prices of tropical beverages continued to fall throughout 1989, reflecting surplus production. The surplus in the cocoa market persisted despite a relatively rapid growth in demand. The recent upsurge in the price index of the tropical beverages group reflects the improvements in the price of arabica coffee and of cocoa (see boxes 1 and 2).

Prices for cereals, by far the most important commodity import of developing countries, surged in 1988 and 1989 owing to the drought in North America. Recently there has been a slight weakening in cereal prices because the current wheat harvest is likely to meet world consumption needs for the first time since 1986. Prices for rice, which is the most important cereal export of developing countries, also followed this trend. Among the main non-cereal basic food exports of developing countries prices for bananas and, in particular, sugar have been relatively high. In both cases lower output, partly as a result of weather conditions in some of the principal producing countries, and strong demand have been the main causes. It should be noted that rice and sugar are also important import commodities for many developing countries.

Prices for vegetable oilseeds and oils have been on a declining trend, reflecting supply side developments, notably the recovery of United States production after the 1988 drought and increasing output in other parts of the world. In the case of palm oil, high production levels increased the price differential between it and soyabean oil to unprecedented levels. Overall stock levels, however, are not very high and make for a volatile market situation.

Prices for both copper and aluminium (which, together, account for over 50 per cent of developing countries' exports of minerals, ores and metals) reached peak levels in the second half of 1988 but declined markedly during 1989. The volatility of mineral and metal prices in this period reflected a supply situation characterized by disruptions to production and by relatively low stock levels. Base metal consumption responded fully to the strong rise in OECD industrial production which occurred during 1987 and 1988. During 1989 metal consumption seems to have reacted less strongly to the continued, albeit smaller, rise in industrial activity. These developments suggest that while minerals and metals consumption is affected by the level of general economic activity, the positive impact of economic growth on metal prices continues to be moderated, over the longer term, by a declining trend in the raw material intensity of production and increasing recycling of scrap.

Throughout 1989, despite the slowing down of economic growth, the price index of the agricultural raw materials group remained around its level of 1988. In the first quarter of 1990, it even registered a small increase, principally because of restricted supplies of certain commodities, such as tropical timber (the most important agricultural raw material export of developing countries) and jute.

The close link between metals and minerals prices and economic growth in 1987-1989 can be attributed in particular to the rapid and sustained growth in gross fixed investment in industrialized countries. The investment component of GDP involves a more intensive use of industrial raw materials than the consumption of goods and services. In contrast, in the recovery in 1984-1985, when metals and minerals prices did not increase, growth in public expenditures was a major element of the expansion but fixed investment grew for only a short period.

Macroeconomic conditions in the developing countries which are suppliers of commodities also influence commodity markets. In several countries, general economic policies, such as those relating to exchange rates and protectionism, have had a larger impact on the agricultural sector than sector-specific measures such as price policies.[2] In this respect, devaluations which lead to higher domestic prices of tradeables, including commodities, relative to non-tradeables tend to encourage an expansion of output and exports, in spite of lower world market prices. However, the diversity of experience of developing countries with regard to the relationship between currency depreciation, the strength of trade liberalization policies and the resulting commodity export growth suggests that many factors other than macroeconomic policies are responsible for commodity export growth.

In most of the highly indebted developing countries there has been a shift of resources into the production of exportable commodities (as measured by the ratio of non-fuel commodity exports to GNP) and a general tendency for commodity export volumes to expand. Macroeconomic adjustment policies, however, do not seem to have been a prerequisite for increasing exports. For example, between 1985 and 1988, an increase in the volume of non-fuel commodity exports was observed both in

2 Krueger, Anne O., Maurice Schiff and Alberto Valdes, "Agricultural Incentives in Developing Countries: Measuring the Effect of Sectoral and Economy-wide Policies", *The World Bank Economic Review*, vol. 2, No. 3, 1988.

Box 1

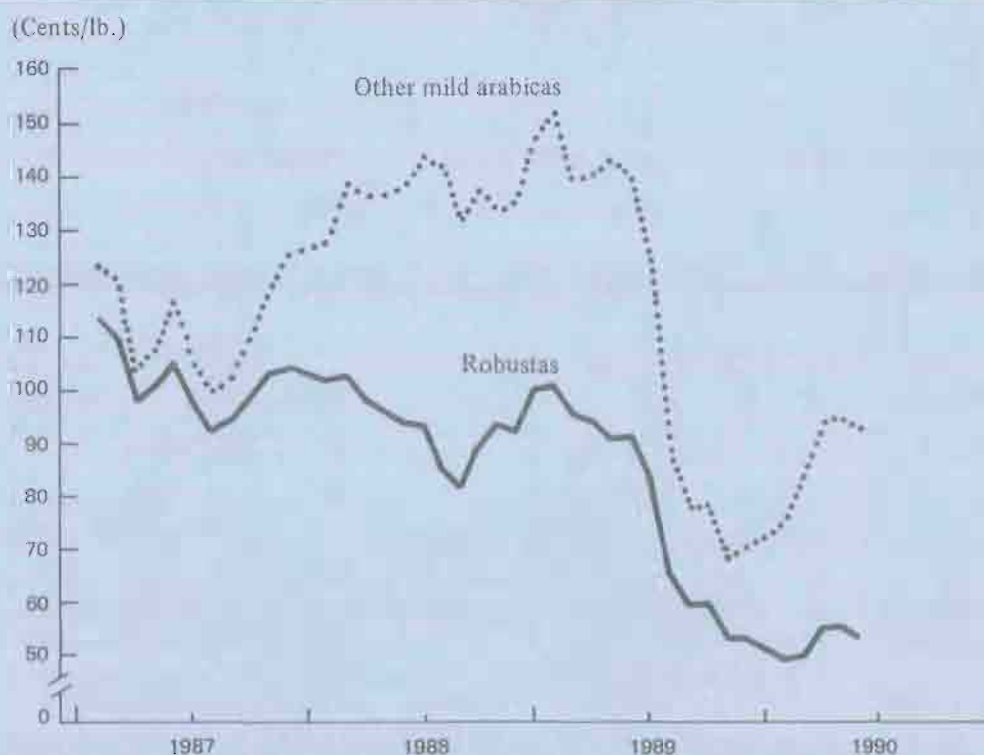
DEVELOPMENTS IN THE WORLD COFFEE MARKET

The International Coffee Agreement, 1983 was due to expire on 30 September 1989. On 3 July 1989, the International Coffee Council decided to extend the Agreement for a period of two years and to suspend quotas as from the following day. The Council also resolved to prepare the way for a resumption of negotiations for a new Agreement.

While quotas were in force from October 1987 to 3 July 1989, the world coffee market was characterized by a situation of oversupply, with accumulation of stocks in the producing countries. The suspension of quotas immediately triggered a dramatic fall of prices. The composite indicator price of the International Coffee Organization fell in one month by more than 26 per cent. A sharp rise in coffee exports took place from virtually all sources. Exports increased by as much as 24 per cent in the second half of 1989 compared with the first half of that year. During 1989 as a whole, prices collapsed by more than 50 per cent - from 126.69 cents/lb. in January to 61.90 cents/lb. in December and recovered only modestly to 74.6 cents/lb. by the end of May 1990 (see chart below).

Of the two major varieties of coffee (arabica and robusta), consumer preferences have in recent years tended to favour arabica. Until the suspension of export quotas the price margin between the two varieties widened on account of the stronger demand for arabica. However, following the suspension of quotas the bulk of increase in exports was in arabica coffees and the margin narrowed temporarily. At the end of March 1990 the price differential between "other mild" arabicas and robustas amounted to over 40 per cent of the indicator price of "other milds".

World coffee prices, 1987-1990 [a]



Source: UNCTAD, *Monthly Commodity Price Bulletin.*
[a] Monthly average of daily prices (ex-dock New York).

Box 2

DEVELOPMENTS IN THE WORLD COCOA MARKET

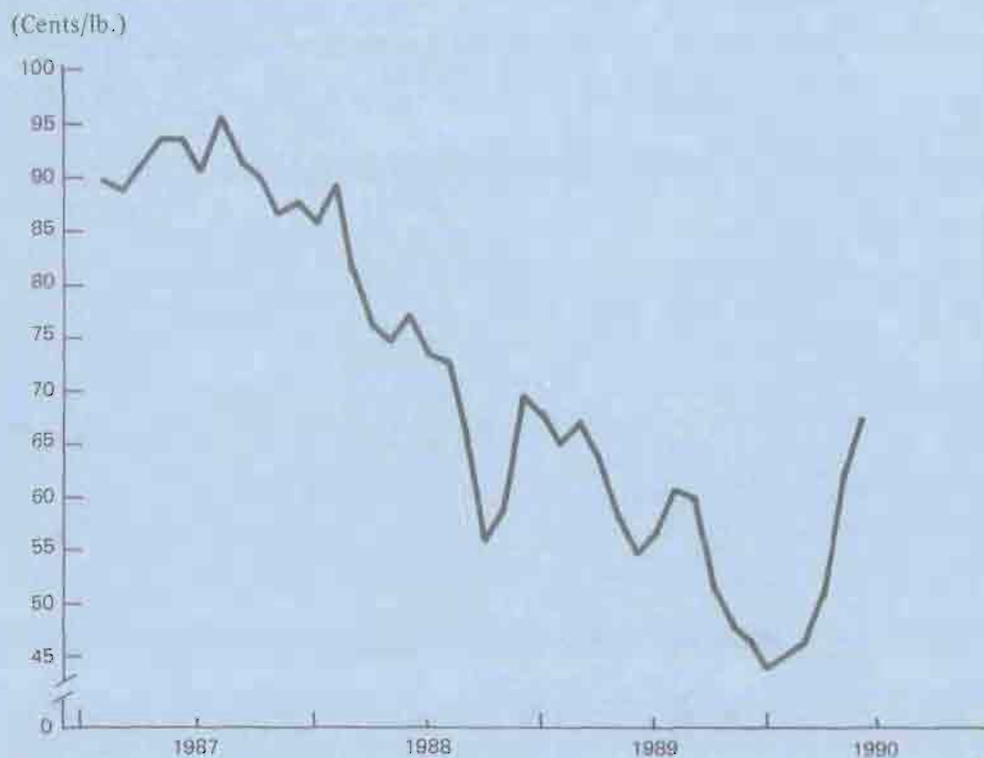
The International Cocoa Agreement, 1986 was due to expire on 30 September 1990. The economic mechanism of the Agreement has, in effect, been inoperative since February 1988, when the levy-financed buffer stock held under the Agreement reached its maximum capacity of 250,000 tons. The withholding scheme, the second line of price defence, under which a total of 120,000 tons of cocoa could be withheld, was not put into effect.

On 30 March 1990, the International Cocoa Council adopted, without dissent, a decision to extend the Agreement "in part" for a period of two years from 1 October 1990 and to maintain the buffer stock during the period of extension. The economic provisions of the Agreement were not extended, except for certain provisions relating to the maintenance of the buffer stock. In adopting this decision the members of the Agreement were "convinced of the necessity of continuing international co-operation in all sectors of the world cocoa economy" and appreciated "the need to continue the search for adequate solutions to the problems of the world cocoa economy in the framework of a new international cocoa agreement".

The international cocoa economy is in its sixth consecutive year of overproduction despite steady growth in demand. Statistically derived world stocks of cocoa, including those held under the Agreement, were expected to reach an unprecedented level of 1,385,000 tons by October 1990 which would correspond to as much as 63 per cent or 7.6 months of world consumption. As a result, prices have been extremely low and stood at their lowest level for 14 years at the beginning of 1990.

Following the decision to maintain rather than liquidate the buffer stock of 250,000 tons and certain difficulties in major producers to meet supply commitments, prices improved rapidly. In early April 1990, i.e. immediately after the Council's session, prices in London were nearly £250 per ton higher than at the beginning of February, an increase of almost 40 per cent (see chart below).

World cocoa prices, 1987-1990 [a]



Source: UNCTAD, *Monthly Commodity Price Bulletin.*
[a] Monthly average of daily prices (New York-London).

countries which introduced significant liberalization programmes (Malaysia, Chile, Mexico) and those with restrictive import policies (Venezuela). Similarly, an increase in commodity exports took place both in countries implementing large real devaluations of their currencies (Ghana, Nigeria, Ecuador) and in those with high real appreciations (Peru, Côte d'Ivoire).

Higher productivity is a major factor behind expanding output, which is the main cause of lower prices for several export commodities of developing countries. Palm oil and cocoa are good examples in this respect in the agricultural field, where productivity has increased because of cloning and hybrids.

In the case of metals lower production costs have likewise exerted a downward pressure on market prices. For example, substantial cost reductions have been achieved for copper and tin in recent years, basically through a reduction in employment, profit-related wage rates, new technologies, closure of high cost mines and the coming on stream of more efficient installations. Most recent indications, however, are that, generally, costs have already reached their trough and have started to rise.

4. *The outlook for 1990-1991*

(a) Trade volumes

Short-term trade prospects are relatively good, despite a probable further slowdown in world economic activity in 1990. The forces which nurtured the prolonged trade expansion since 1983 continue to prevail. World trade is expected to grow by 6-7 per cent in both 1990 and 1991, with a tendency for current trends towards regionalization of trade becoming more pronounced, especially in Western Europe and in South-East Asia. The product composition of East Asian exports should continue to shift towards higher quality goods as exporters in those countries become more competitive. Trade among Eastern European countries is likely to continue to decline in the short term, as these countries seek western markets and technology. With the exception of oil, trade in primary products is likely to be sluggish.

(b) Prices and the terms of trade

After two years of improving terms of trade for non-oil primary commodities relative to manufactures, the short-term outlook is for a probable decline. While a number of commodity-specific factors have been at play in determining the overall terms of trade of primary commodities, their particular strength in 1988 and 1989 can be seen as a result of unusually rapid growth in the more industrialized parts of the world economy, together with relatively modest rates of increase in world prices of manufactures. By the same token, their forecast weakness in 1990-1991 is based on an expected slowdown in industrial activity, together with a resumption of trend rates of increase in prices of manufactures (see chart 2). After an average annual rise of about 3.4 per cent in 1988-1989, prices of manufactures are expected to increase by somewhat more than 5 per cent in 1990-1991. In contrast, non-oil primary commodity prices, after increasing by more than 14 per cent in 1988-1989, are forecast to remain virtually unchanged in 1990-1991.

C. Money, finance and debt

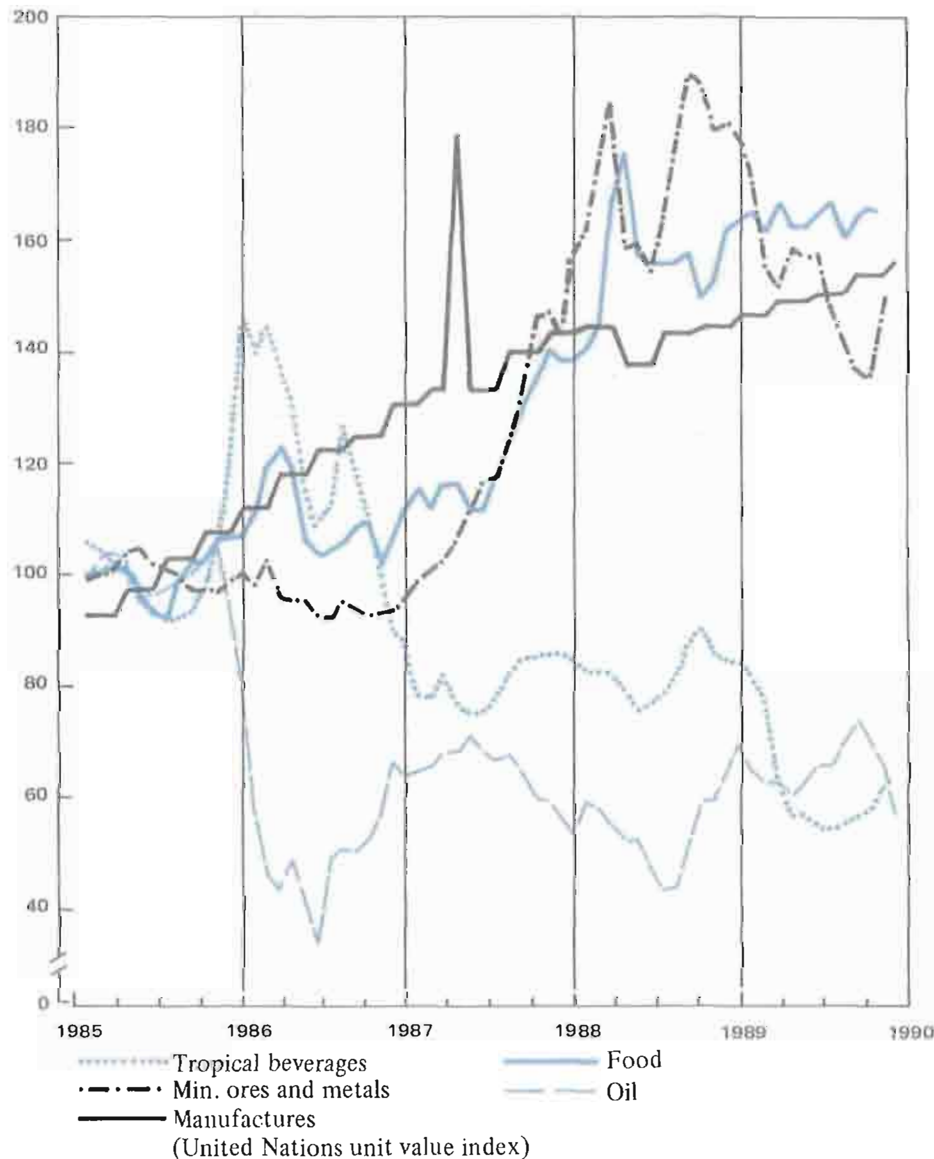
1. *Overall trends*

During 1989 there was a continuation of the stark contrast between general conditions in the international capital markets and the performance of major categories of lending to developing countries such as that of commercial banks and private export credits. Overall activity in the international capital markets has been notable for its buoyancy, although there have been substantial fluctuations in particular types of lending. By contrast, new external fi-

Chart 2

PRICE INDICES FOR MANUFACTURES AND PRIMARY COMMODITIES, 1985-1990

(1985 = 100)



Source: UNCTAD, *Monthly Commodity Price Bulletin*; United Nations, *Monthly Bulletin of Statistics*.

nancing for developing countries from private sources has remained at a low level, the result being negative net flows for many borrowers. Moreover, data concerning developing countries' creditworthiness in the international capital markets (such as that discussed below in sub-section 2) indicate the continuing prevalence of unfavourable perceptions in this regard.

The contrast between the overall scale of international financial activity and lending to developing countries is exemplified for major categories of gross borrowing in table 6. The rapid expansion in 1989 of the largest of the categories of international financing shown, external bonds, was accompanied by declines in syndicated credits and committed borrowing facilities. These movements reflected supply and demand conditions for external financing for borrowers in developed market-economy countries, while lending to developing countries was of clearly marginal importance. Indeed, developing countries' borrowing in the form of

Table 6

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING COUNTRIES THEREIN, 1983-1989

Category	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
External bond offerings							
Total ($ billion)	77.1	109 5	167.8	227.1	180.8	227 1	253.9
Share of developing countries (per cent)	3.4	3.2	3.7	1.3	0.9	1.5	0.9
Syndicated credits							
Total ($ billion)	67.2	57.0	43.0	52.4	91.7	125.5	96.8
Share of developing countries (per cent) [a]	47.8 (26.5)	39 6 (20.2)	37.4 (20.9)	19.1 (19.1)	18.3 (7.9)	10.2 (6.1)	11.6 (9.2)
Committed borrowing facilities [b]							
Total ($ billion)	9.5	28.8	42.9	29.3	31.2	16.6	6.8
Share of developing countries (per cent)	7.4	21.5	4.7	8.5	4.2	7.8	11.8

Source: OECD, *Financial Market Trends* (Paris: OECD), various issues, and UNCTAD secretariat estimates.

a Figures in parentheses exclude managed loans - i.e. new money facilities extended by banks in the context of debt restructuring agreements.

b Multiple-component facilities, note issuance facilities and other international facilities underwritten by banks, excluding merger-related stand-bys.

external bonds continued on its post-1985 downward trend, their share of such financing in 1989 being only about 1 per cent. Their share of syndicated credits was higher, but still well below the level of 1983, the year following the outbreak of the debt crisis, and still further below the typical figures recorded in the late 1970s and the early 1980s. Developing countries' share of committed borrowing facilities was also greater than of external bonds, but total funds raised for all borrowers by this means are small in relation to the other categories of financing shown in the table.

The low or negative net lending to developing countries in the form of commercial bank loans and export credits is shown in tables 7, 8 and 9. The exposure to developing countries of banks in the BIS reporting area declined in 1989 for the second consecutive year but at a pace somewhat less than in 1988. As indicated by table 7, a large part of the contraction was due to negative net lending to Africa and to Latin America. Negative net lending to these two regions and to certain other borrowers reflected the effects on banks' policies of the unfavourable perceptions as to creditworthiness mentioned above as well as the impact of debt reduction and conversion (as discussed further in sub-section 4).[3]

The long-awaited revival of export credits to developing countries does not appear to be materializing. As shown in table 8, the proportion of developing countries experiencing negative net flows of export credits (after adjustment for the effects of fluctuations in exchange rates) has tended to fall since 1987 but still exceeded 30 per cent in the first half of 1989. Similar trends are observable for the various regions specified in table 8. These figures have been accompanied by continuation of the series of low or negative net flows of export credits to developing countries since 1985 (shown for medium- and long-term export credits in table 9), although there are indications that a more favourable trend may be emerging for Latin America. For such credits the main influences on the supply side are of official origin. Some are in the form of direct

[3] Declining gross flows of bank lending to developing countries are exemplified by figures for syndicated credits, which fell from $16.8 billion in 1987 to $12.8 billion in 1988 and $11.2 billion in 1989 (see table 6).

Table 7

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA [a] VIS-À-VIS DEVELOPING COUNTRIES, 1983-1989

	Average 1980-1981	1983	1984	1985	1986	1987	1988	1989	Stock at end-1989
	Percentage rate of increase [b]								*$ billion*
All developing countries [c]	17.8	5.2	0.7	4.9	4.2	6.4	-4.0	-2.6	499 [d]
By region:									
Latin America	22.2	3.1	0.1	3.0	0.8	1.5	-5.3	-6.7	229
Africa [e]	10.9	1.6	-4.4	14.8	10.3	8.8	-8.0	-4.9	52
West Asia [e]	3.9	20.0	3.2	0.0	4.6	16.7	3.7	8.6	91
South and South-East Asia [f]	18.5	7.9	3.3	8.3	6.4	11.0	-4.2	0.1	116
Europe [g]	18.0	-2.0	-1.3	7.6	-2.1	-0.4	-9.5	14.1	8
Memo items:									
All borrowers: Total [h]	18.0	4.0	3.2	19.1	27.0	28.5	7.4	11.7	5031
Countries of Eastern Europe	-12.2	-8.2	-1.4	25.9	18.7	17.3	2.9	12.2	98

Source: Bank for International Settlements, *International Banking Statistics, 1973-1983* (Basle, April 1984) and *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.
b Based on data for end-December.
c Excluding offshore banking centres, i.e. in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Lebanon; in South and South-East Asia: Hong Kong and Singapore.
d Including a small amount not shown under the regions.
e Libyan Arab Jamahiriya is included in West Asia up to 1982 (since it could not be separated from this area in the BIS series). Since 1983, it is included in Africa.
f Including Oceania.
g Malta and Yugoslavia.
h Including multilateral financial institutions.

lending by OECD Governments. But much the largest part consists of private lending by banks and suppliers carrying official insurance or guarantees whose availability and terms reflect government policies in this area.

On the demand side the main influences on levels of borrowing are the pace of investment and macroeconomic conditions more generally in developing countries, export credits being a major source of finance for imports of capital goods. Both sets of factors have recently been depressing levels of export credits. The high costs and restrictive conditions recently associated with official insurance cover for private export credits and the closely related topic of continuing widespread losses amongst export credit agencies (ECAs) are discussed further in the next sub-section.

The low perceived creditworthiness of most debtor developing countries has been strongly influenced by the continuing lack of evidence of sustained improvement in their external financial positions. Selected indicators of recent trends in these positions are presented in table 10. Favourable changes can be observed in some cases for 1989 but not for all the indicators or regions shown. Thus, for net debtor countries as a whole and for the group of 15 highly indebted countries the ratios of external debt to exports continued to decline in 1989 but were still above the level of 1982, while for sub-Saharan Africa the ratio increased. The ratios of interest payments to ex-

Table 8

DEVELOPING COUNTRY RECIPIENTS OF NEGATIVE NET FLOWS OF TOTAL EXPORT CREDITS [a]

(Percentage of developing countries - in each region or grouping - for which figures are available)

	1986	1987		1988		1989
	(2nd half)	(1st half)	(2nd half)	(1st half)	(2nd half)	(1st half)
All developing countries	49	50	47	43	42	31
Africa	56	56	54	38	40	24
Latin America	42	39	35	38	38	32
West Asia	53	60	67	60	53	47
South and South-East Asia [b]	48	52	38	45	45	34
Memo item:						
Highly indebted countries [c]	33	53	67	60	60	33

Source: BIS and OECD, *Statistics on External Indebtedness. Bank and trade-related non-bank external claims on individual borrowing countries and territories*, new series, various issues.

a After adjustment for the effect of movements of exchange rates.

b Including Oceania.

c Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

ports rose slightly for the highly indebted countries, but changed little or not at all for net debtor countries as a whole and sub-Saharan Africa.[4] The failure of these ratios, an important indicator of pressures on current external cash flows, to improve in line with debt-to-export ratios reflects primarily the impact of higher interest rates, discussed in the following paragraph. Provisional estimates suggest that net outward financial transfers remained high for both net debtor countries as a whole and for highly indebted countries. Other signs of difficulties in debtor-creditor relations tend to reinforce the picture of no significant improvement given by table 10. For example, arrears continued to increase for major borrowers among the developing countries, and the number of reschedulings of their official debts reached 22 in 1989, a figure above the previous peak of 1985.

As indicated by table 11, average short-term international dollar interest rates were more than one percentage point higher in 1989 than in the previous year, (although there was a reduction in the first quarter of 1990). The incidence of such an increase on indicators of developing countries' external financial positions is difficult to estimate owing to the effects of arrears and of the varying proportions of variable rate debt for different countries. Nevertheless, it should be emphasized that the rise of $5-6 billion in developing countries' debt service obligations on an annual basis that results from such an increase in short-term international interest rates is a large sum in relation to the relief to developing countries' external cash outflows under operations for reducing their bank debt already negotiated or envisaged in the near future.

The analysis in this chapter does not point to an imminent revival of financial flows to developing countries from the international capital markets. Prospects in this regard should not be greatly affected by borrowing on the

[4] Ratios of debt and interest payments to exports valued at 1981 prices are also included in table 10 to illustrate the impact on external financial indicators of declines in average export prices since 1981.

Table 9

NET FLOW OF MEDIUM-TERM AND LONG-TERM EXPORT CREDITS TO DEVELOPING COUNTRIES, 1981 AND 1983-1989

(Millions of dollars)

Net flows to:	*1981*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
All developing countries								
Total	11278	7429	5055	243	-3041	-6750	-3145	.. a
Private	9211	4802	3728	428	-1932	-4264	-2132	..
Africa								
Total	3640	3009	1070	635	-875	-2801	-2306	..
Private	2934	2499	717	541	-281	-2244	-1866	..
Latin America								
Total	3442	2243	855	-146	-716	-859	278	..
Private	2695	1284	461	-240	-965	-1037	251	.
West Asia								
Total	589	456	1201	260	-309	248	950	..
Private	385	523	1377	477	-226	219	1025	..
South and South-East Asia b								
Total	3178	1687	1869	198	-651	-2884	-1691	..
Private	2797	585	1196	333	-94	-821	-1254	..

Source: Estimates of the UNCTAD secretariat based on OECD figures.
a Preliminary estimate.
b Including Oceania.

part of Eastern European countries in the context of their programmes of economic reform. These programmes will indeed require financing from the international capital markets over and above the expected flows of new direct investment to Eastern Europe. Even a substantial increase in lending to them by commercial banks would be small in relation to total borrowing in this form (as shown in table 7), so that, in the aggregate, apprehensions concerning competition with developing countries for available funds from this source seem unjustified. Part of the borrowing by Eastern European countries from private sources will be in the form of export credits. A re-evaluation of policies as to the availability of official insurance cover to these countries is to be expected as part of OECD countries' response to recent developments in the region but its outcome is not yet clear.

2. *The costs and other terms of private export credits*

The costs and other terms of export credits to developing countries are of special interest not only because of their influence on the level of lending in this form but also owing to the indications they give concerning trends in creditworthiness. These costs and terms comprise not only interest rates, determined either in the capital markets or by the OECD Consensus,[5] but also the premiums and other conditions[6] as to availability for credit insurance and guarantees provided by ECAs in de-

5 Rates of interest under the OECD Arrangement on Guidelines for Officially Supported Interest Rates (the so-called OECD Consensus) are shown in table 11.

6 These conditions comprise the proportion and size of credit for which insurance cover is available, the size of the limit on the amount of financing below which the exporter can exercise discretion in granting insured credits, the length of the period after the occurrence of non-payment before claims are met (the claims-waiting period), and the types of security required.

Table 10

SELECTED INDICATORS OF EXTERNAL FINANCIAL POSITIONS OF NET DEBTOR DEVELOPING COUNTRIES, [a] 1981-1989

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
	Ratio of debt [b] to exports of goods and services (per cent)								
All net debtor countries [a]									
Actual	152.1	192.8	215.1	207.3	227.2	263.6	252.0	227.9	206.0
In 1981 export prices	152.1	180.7	185.1	177.9	190.7	198.0	207.1	182.1	169.7
Highly indebted countries [c]									
Actual	211.3	283.3	320.9	299.7	304.5	369.2	365.1	310.5	286.7
In 1981 export prices	211.3	260.3	267.0	253.3	248.4	272.5	288.9	253.1	244.5
Sub-Saharan Africa									
Actual	130.5	188.3	232.2	228.9	252.8	340.4	392.1	380.3	384.5
In 1981 export prices	130.5	165.6	191.1	183.6	207.2	268.4	313.0	306.6	306.0
	Ratio of interest payments [d] to exports of goods and services (per cent)								
All net debtor countries [a]									
Actual	16.0	17.2	16.8	16.6	16.7	16.5	13.7	14.5	14.3
In 1981 export prices	16.0	16.2	14.5	14.3	14.0	12.4	11.3	11.6	11.8
Highly indebted countries [c]									
Actual	26.8	30.6	29.4	28.0	26.9	26.6	22.8	23.9	24.4
In 1981 export prices	26.8	28.1	24.5	23.7	21.9	19.7	18.1	19.5	20.8
Sub-Saharan Africa									
Actual	9.4	10.8	11.7	12.9	12.3	12.0	10.1	12.0	12.0
In 1981 export prices	9.4	9.5	9.6	10.7	10.1	9.6	8.1	9.7	9.5
	Net financial transfers [e] ($ billion)								
All net debtor countries [a]	27.7	23.3	-31.2	-28.8	-46.6	-49.1	-30.8	-45.1	-50.9 [f]
Highly indebted countries [c]	19.6	3.3	-43.9	-35.3	-50.3	-47.0	-20.0	-31.5	-31.3 [f]
Sub-Saharan Africa	4.7	4.5	5.9	2.0	-1.2	1.3	3.1	1.1	1.1 [f]

Source: Figures for total external debt and interest payments for 1981-1988 were taken from The World Bank, *World Debt Tables 1989-90* (Washington, D.C., 1989); figures for 1989 were estimated on the basis of data in IMF, *World Economic Outlook* (Washington, D.C., April 1990). Figures for exports of goods and services at current prices are data of the UNCTAD secretariat; exports of goods and services at 1981 prices are extrapolations of 1981 figures at current prices on the basis of data of the UNCTAD secretariat for export volumes; figures for exports at current and 1981 prices in 1989 were estimated on the basis of data in IMF, *op. cit.* The figures for net financial transfers for 1981-1988 were estimated from data in The World Bank, *op. cit.*, and those for 1989 were estimated on the basis of data in *ibid.*, and IMF, *op. cit.*

a Excluding Islamic Republic of Iran, Kuwait, Libyan Arab Jamahiriya, Qatar, Saudi Arabia, Taiwan Province of China, and United Arab Emirates.
b Total short-term and long-term debt.
c See note *c* to table 8.
d Interest on total short-term and long-term debt.
e Disbursements of, minus repayments of principal and interest on, total short-term and long-term debt.
f Preliminary estimates.

veloped market-economy countries or by the private market. In general, levels of insurance premiums and the restrictiveness of the other conditions tend to increase with perceived risks of non-payment, and eventually credit insurance may cease to be available altogether. The cost and availability of financing and payments arrangements other than official insurance tend to be affected in the same direction by risks of non-payment. These arrangements include private credit insurance and payments mechanisms such as letters of credit.

Table 11

SELECTED INTERNATIONAL INTEREST RATES

LONDON INTER-BANK OFFERED RATE (LIBOR) ON DOLLAR DEPOSITS

(Period averages in per cent per annum)

Year/period	Maturity 3-month	Maturity 6-month	Year/period	Maturity 3-month	Maturity 6-month
1975-1978	6.86	7.36	1985	8.40	8.64
1979	12.09	12.15	1986	6.86	6.85
1980	14.19	14.03	1987	7.18	7.30
1981	16.87	16.72	1988	7.98	8.13
1982	13.29	13.60	1989	9.28	9.27
1983	9 72	9 93	1990 (1st quarter)	8.40	8.48
1984	10.94	11.29			

MATRIX MINIMUM INTEREST RATES UNDER THE OECD ARRANGEMENT ON GUIDELINES FOR OFFICIALLY SUPPORTED EXPORT CREDITS

(Per cent)

Rate as from:	Maturity: 2 to 5 years			Maturity: over 5 years		
	Group I	Group II	Group III	Group I	Group II	Group III
July 1976	7.75	7.25	7.25	8.00	7.75	7.50
July 1980	8.50	8.00	7.50	8.75	8.50	7.75
November 1981	11.00	10.50	10.00	11.25	11.00	10.00
July 1982	12.15	10.85	10.00	12.40	11.35	10.00
October 1983	12.15	10.35	9.50	12 40	10.70	9.50
July 1984	13.35	11.55	10.70	13 60	11.90	10.70
January 1985	12.00	10.70	9.85	12.25	11.20	9.85
January 1986	10.95	9.65	8 80	11.20	10.15	8.80
July 1986	9.55	8.25	7.40	9.80	8.75	7.40
January 1988	10 15	8.85	8.00	10.40	9 35	8.00
July 1988 [a]	..	9.15	8.30	..	9.66	8.30

Source: IMF, *International Financial Statistics*; OECD press releases and publications.

Note: Under the OECD Arrangement Group I consists of relatively rich borrower countries, Group II of intermediate borrower countries, and Group III of relatively poor borrower countries.

a As from 15 July 1988 matrix minimum interest rates for Group I countries were abandoned.

Recent years have been characterized by the widespread imposition of increased premiums and other restrictive conditions in the case of official credit insurance for developing country borrowers. The prevalence of such terms is exemplified in tables 12 and 13 by data for two major ECAs, the Export-Import Bank (EXIM) of the United States and the Export Credits Guarantee Department (ECGD) of the United Kingdom. The tables also indicate the absence of any marked improvement between late 1988/early 1989 and late 1989/early 1990. No change between these two periods is recorded in table 12 for the number of instances[7]

[7] As explained in note *b* of table 12, an instance corresponds to the terms on official insurance cover either for short-term or for medium-term and long-term credits available from one of the two ECAs.

Table 12

TERMS [a] OF INSURANCE COVER AVAILABLE TO SELECTED DEVELOPING COUNTRIES FROM THE EXPORT-IMPORT BANK (EXIM) OF THE UNITED STATES AND THE EXPORT CREDITS GUARANTEE DEPARTMENT (ECGD) OF THE UNITED KINGDOM

(Number of instances [b] in which EXIM or ECGD applied specified terms)

	Normal terms [a]		*No cover [a]*		*Restrictive conditions [a]*	
Region/period	*Short-term [c]*	*Medium- and long-term [d]*	*Short-term [c]*	*Medium- and long-term [d]*	*Short-term [c]*	*Medium- and long-term [d]*
Africa						
Late 1986/early 1987	6	4	14	18	50	48
Late 1988/early 1989	9	8	18	21	43	41
Late 1989/early 1990	9	8	18	18	43	44
Latin America						
Early 1987	7	7	5	8	40	37
Late 1988	7	7	6	9	39	36
Late 1989	7	7	6	8	39	37
South and South-East Asia [e]						
Early 1987	16	14	5	5	27	29
Early 1989	16	16	3	3	29	29
Early 1990	16	16	3	3	29	29
Memo item:						
Highly indebted countries [f]						
Late 1986/early 1987	2	1	3	4	25	25
Late 1988/early 1989	3	3	4	5	23	22
Late 1989/early 1990	3	3	4	4	23	23

Source: Exporter's regional guides in *Euromoney Trade Finance Report, Trade Finance* and *Trade Finance and Banker International*, various issues.

a Normal terms apply when cover is available to a borrower subject to no restrictive conditions. Such conditions include surcharges and restrictions on the availability of insurance cover and reflect the perceived riskiness of the provision of financing to the borrower in question (or in certain cases other considerations). The number and stringency of the conditions vary. For some borrowers cover is not available on any terms.

b Each country for which information is available corresponds to two instances for the terms available on its insurance cover for short-term credits, one for EXIM and one for ECGD, and likewise to two instances for the terms available on its cover for medium- and long-term credits.

c Insurance cover for credits with maturities up to 180 days except in the case of credits from EXIM for certain equipment goods and bulk agricultural commodities, for which maturities up to 360 days are also classified as short-term.

d Insurance cover for credits other than short-term.

e Including Oceania.

f See note **c** to table 8.

in which cover for short-term export credits was unavailable. While for Africa there was a decrease of 3 in the number of instances for which medium-term and long-term cover was unavailable, elsewhere there was scarcely any change under this heading. Similarly, there were no increases in the number of instances for which short-term or medium-term and long-term cover was available without any special restrictions (i.e. under normal conditions). For all regions restrictive conditions were applied in more than 60 per cent of the instances

shown for late 1989/early 1990, the proportion being greater than 70 per cent for Latin America. Table 13 provides a further demonstration of the small amount of change in the terms on which credit insurance was available from the two ECAs. A similar situation has characterized the market for private credit insurance. The terms on which such insurance is available improved for three African countries but remained unchanged for the other countries covered in tables 12 and 13.

The financial positions of ECAs in developed market-economy countries also reflect the continuing disruption of payments and financing for developing countries' imports. Throughout most of the 1980s premium income has been adversely affected by downward pressures on developing countries' imports, while claims have been increased by their difficulties in servicing their external debts. As can be seen from table 14, in consequence the proporation of cases in which claims under ECAs' insurance activities were greater than premium income and recoveries has remained above 70 per cent in all the years shown except one since 1983, the proportion being three-quarters in 1988. Since ECAs are generally required to be self-supporting on their commercial operations over the medium term, the positions evident from table 14 have themselves been a source of pressure for restricting both the availability and the terms of official export credit insurance.

3. *Rescheduling of developing countries' official debts*

The rescheduling of developing countries' official debts continued in 1989 and early 1990 at a higher pace, 22 meetings taking place in 1989 at the Paris Club (where bilateral official debts are rescheduled) in comparison with an average of 16 during 1983-1988. A large part of such debts consists of export credits, and the frequent reschedulings reflect the same disturbances of North-South financing and payments as the prevalence of restrictive conditions associated with credit insurance described in sub-section 2 above. The recent acceleration of rescheduling activity is also a symptom of the short-term approach of the Paris Club whereby the consolidation period (the period in which debt service payments to be rescheduled fall due) is typically only 12 to 18 months. Thus, in 1989 and the first six months of 1990, of the 29 rescheduling countries, 23 had rescheduled at least once before. Of these, ten had already done so three times or more and three others at least six times. Moreover, debt service due on previously rescheduled debt has become an increasingly important portion of the consolidated amount, reflecting the inadequacy of the terms of the original agreement.

A number of improvements have, however, been recently introduced in Paris Club practices. The most significant development was the Toronto agreement on concessional debt relief for poorer debtors. Others include longer maturities and the reintroduction of multi-year rescheduling agreements (MYRAs).

The Toronto summit in June 1988 marked a major advance in the treatment of non-concessional debt owed by poorer countries. In accepting the principle that in specified cases the servicing of such debt might not be met in full, official creditors agreed to the need for debt and debt service reduction. This led to the adoption of a menu of options to be chosen by Paris Club creditor countries for selected low-income countries: (a) partial forgiveness of debt service; (b) longer repayment periods; and (c) concessional interest rates. While no formal eligibility criteria have been established, creditors initially offered the Toronto terms to sub-Saharan African countries included in the World Bank's Special Programme of Assistance (SPA), most of them least developed countries. So far, 16 of these African countries have benefited from this initiative.[8] Earlier this year, however, Bolivia became the first country outside sub-Saharan Africa to obtain Toronto terms.

Implementation of the options has revealed a number of shortcomings.[9] The scale of relief they give rise to is extremely limited. As compared with previous practices, options (a) and (c) - but not option (b) - will generate cash-flow benefits over the next few years for the 15 countries benefiting during 1989 in the form of savings on interest payments roughly equivalent to 30 per cent of those under previous Paris Club terms. However, these savings in that year were less than 2 per cent of the debt service payments of these countries; and several of them will still have to make payments at least three times higher than those they have been able to make in recent years. The small impact of the Toronto scheme reflects its low concessionality: for the 15 beneficiaries, the overall grant element was, on average, about

[8] Benin, Central African Republic, Chad, Equatorial Guinea, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mozambique, Niger, Senegal, Togo, Uganda, United Republic of Tanzania and Zaire.

[9] For a more detailed discussion of the Toronto options see *TDR 1989*, box 7.

Table 13

CHANGES IN TERMS [a] ON INSURANCE COVER AVAILABLE TO SELECTED DEVELOPING COUNTRIES FROM THE EXPORT-IMPORT BANK (EXIM) OF THE UNITED STATES AND THE EXPORT CREDITS GUARANTEE DEPARTMENT (ECGD) OF THE UNITED KINGDOM

(Number of instances)

Region	*More favourable terms* [a]		*Less favourable terms* [a]	
	Late 1986/ early 1987- Late 1988/ early 1989	*Late 1988/ early 1989- Late 1989/ early 1990*	*Late 1986/ early 1987- Late 1988/ early 1989*	*Late 1988/ early 1989- Late 1989/ early 1990*
Africa	14 [b]	3	15 [b]	-
Latin America	3	1	6	-
South and South-East Asia [c]	4	-	-	-
Memo item:				
Highly indebted countries [d]	4 [b]	1	3 [b]	-

Source: Exporter's regional guides in Euromoney *Trade Finance Report, Trade Finance* and *Trade Finance and Banker International*, various issues.

a All instances in which there has been a change in the terms of export credit insurance cover available to a borrower from EXIM or ECGD between the categories "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see table 12.) Such changes are recorded separately for short-term and for medium- and long-term credits.

b Including the case of one borrower for which a favourable change in the terms of insurance cover available from one agency for long-term credits was accompanied by an unfavourable change in the terms for short-term credits.

c Including Oceania

d See note *c* to table 8.

20 per cent, less than half of the average on current official loan commitments to low-income African countries.

Another reason for the limited scope of the measures is that only debts meeting certain criteria can be rescheduled. Moreover, until very recently, only debt service payments falling due during a relatively short period benefited from the new terms, so that recourse was still necessary to time-consuming and costly repeated reschedulings. It should also be noted that the additionality resulting from the Toronto measures has been reduced by some creditors who finance the cost of debt relief by the transfer of funds from their aid budgets.

After the unsatisfactory experience with MYRAs in 1985-1986, there was a return to them in 1989-1990 for the Philippines, Mexico, Mali, Bolivia and Mozambique. In each case the length of the consolidation period was covered by an IMF programme: extended arrangements for the Philippines and Mexico, a Structural Adjustment Facility (SAF) in the case of Mali and an Enhanced Structural Adjustment Facility (ESAF) for Bolivia and Mozambique. The provision of medium-term support for a debtor country's efforts to overcome its problems through MYRAs linked to IMF programmes is a welcome development. But wider use of this practice would imply much more extensive recourse to these longer-term IMF facilities than is currently expected.

The past year has also witnessed the application of so-called "Venice terms", that is longer maturities than the standard 10-year period.[10] Under this new policy, Guyana received a 21-year maturity, and a 15-year maturity was

[10] At the Venice Summit of 1987 the Group of Seven agreed to extend longer repayment and grace periods to low-income countries. This was a prelude to the concessional terms adopted at the Toronto Summit in 1988.

Table 14

PROPORTION OF EXPORT CREDIT AGENCIES IN SELECTED DEVELOPED MARKET-ECONOMY COUNTRIES THAT INCURRED LOSSES [a] ON INSURANCE ACTIVITIES, 1981-1988

(Percentage)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
Proportion:	50	60	85	70	65	70	70	75

Source: 1981: D. Bown, D. Mills and M. Knight, *The Euromoney Guide to Export Finance* (London: Euromoney Publications, 1986), Part I; 1982-1988: ed. M. Knight, J Ball and A. Inglis-Taylor, *The Guide to Export Finance 1988* (London: Euromoney Publications, 1988), Part I; ed. J. Ball and M. Knight with the assistance of R. Saxena, *The Guide to Export Finance 1989* (London: Euromoney Publications, 1989), Part III; and E. Ford, "Agency review. The curate's egg of export credits - mixed results all round", *Trade Finance and Banker International*, January 1990.

a Losses occur when claims exceed the sum of premium income and recoveries (adjusted in some cases for the inclusion of other factors). The number of loss-making agencies is expressed as a proportion of the total number of agencies for which data were available (18 in 1981, 20 in 1982-1987 and 16 in 1988).

agreed for Côte d'Ivoire. This improvement implies the creation of an intermediate category between the standard rescheduling terms and Toronto terms. However, it should be recalled that, as with option (b) under the Toronto menu, longer repayment periods entail neither additional cash-flow relief in the short and medium term nor concessionality. Thus, the Venice terms cannot be seen as a proxy for the Toronto terms as they do not provide the debt or debt service reduction required by many countries which are not yet beneficiaries of concessional debt relief.

The issue of official bilateral debt reduction for middle-income countries whose debt is mostly owed to official creditors has received increasing attention by policy makers in creditor countries. In June 1990, President Mitterrand announced measures to lower interest rates on non-concessional loans by France to four middle-income countries of sub-Sahara (Cameroon, Congo, Côte d'Ivoire, and Gabon). At the same time, President Bush launched a programme aimed at reducing the official debt obligations of Latin American countries to the United States, within the framework of the "Enterprise for the Americas" initiative dealing with the region's trade, investment and debt.[11] The debt reduction programme of the United States envisages a substantial cancellation of concessional loans and the payment of interest in local currency which may be used to support environmental projects. Furthermore, a portion of non-concessional official loans (such as export credits) would be sold in the market in order to facilitate the conversion of debt into equity and debt-for-nature swaps. The financial problems of lower middle-income countries with high levels of official debt were also considered by the Houston Summit of the Group of Seven in July 1990. Although no new global initiative was agreed upon, the Group encouraged the Paris Club to lengthen the repayment period for these countries and to continue reviewing additional options to address debt burdens.

Despite recent improvements, the essential features of the Paris Club remain intact.[12] With few exceptions, official creditors continue to require that a rescheduling country conclude

[11] The precise modalities and overall impact of these proposals will become more clear as they are implemented. At this stage it would appear that debt reduction under President Bush's programme is to be conditional on the adoption of economic reforms, in particular measures designed to encourage inflows of foreign investment.

[12] The rescheduling of Polish debt earlier this year marked a significant departure from standard Paris Club practices in many respects. Poland's official creditors exceptionally agreed to reschedule virtually all payments on outstanding debt falling due during the 15 months to March 1991. The amount involved ($9.4 billion), was the second largest in the Club's history. Moreover, it is payable over a period of 15 years, an unusually long maturity. Finally, creditor countries agreed to set up a working group with the Polish Government to examine matters relating to Poland's financial obligations to Paris Club Governments. Within this group, Poland is seeking a long-term solution to its problem through debt reduction.

a prior arrangement with IMF. This often implies delays and a further deterioration in the country's financial position. In a few agreements negotiated recently, the link with Fund conditionality has become even stronger, as creditors made the implementation of the agreement contingent upon the meeting by the debtor country of performance criteria under a Fund arrangement.

4. Commercial bank lending and debt

The level of concerted bank lending to developing countries with debt servicing difficulties fell in 1989 to $2.3 billion, or half the level of 1988 and less than one-fifth that of 1984. This small figure was associated with a small number of new debt restructuring agreements[13] and the breakdown of a number of agreements concluded previously.[14] It was also accompanied by a significant rise in arrears on debt service to commercial banks, which reached $18 billion in March 1990 compared to $6.5 billion at the end of 1988. Indeed, only 5 of the 20 countries with debt servicing difficulties in the Latin American and Caribbean region managed to avoid significant arrears in 1989, and at the beginning of 1990 three of the five countries from the region with the largest debts remained in arrears.[15]

The most notable event last year was the start made in implementing the strengthened debt strategy adopted by IMF and the World Bank in response to the initiative proposed by United States Treasury Secretary Nicholas Brady. As explained in *TDR 1989*, by making debt and debt service reduction a central element of the debt strategy this initiative marked a major step forward. However, the amount of debt and debt service reduction that is in prospect comes, at most, to only about half the estimate by the UNCTAD secretariat of the minimum needed if the highly indebted countries are to be able to grow out of their debt problem over time.[16]

Other sources of financing are unlikely to revive sufficiently to make good the shortfall. Over the past eight years almost all types of capital flows to debt-distressed countries have declined together. This is largely because the debt overhang has acted as a powerful deterrent across the board. The experience of the 15 highly indebted countries is illustrative (see table 15). Net flows of export credits have fallen sharply since 1982, registering negative figures during several years since 1985. As indicated in table 12, most countries have recently faced restrictions on terms regarding the availability of official insurance and guarantees for such credits, and the very limited improvement in these terms during the last three years does not presage an imminent upturn of lending in this form. Foreign direct investment also declined after 1982, and, despite widespread efforts by Governments to encourage it by liberalizing their laws and policies and by granting new incentives and guarantees, in 1988 inflows were at only about one-half their 1982 level in real terms.

Capital flight, which has assumed dramatic proportions in a number of debtor countries, is encouraged by the macroeconomic disorder and sluggish growth associated with the continuing debt overhang - the same factors that discourage foreign investment. Renewed dynamism in flows of export credits and direct investment, and large-scale capital repatriation are capable of providing ways to avoid recourse to commercial bank lending in the future, once external financial viability and growth have been restored. They cannot, however, be expected to occur while external payments are in structural disequilibrium.

The rationale of the present approach depends critically on how far new lending by banks can be increased.[17] It is often argued

13 There were few restructuring agreements of developing country debt in 1989 other than those of Mexico, the Philippines, Costa Rica, Morocco and Venezuela (all under the auspices of the Brady initiative). Zaire reached agreement with its creditor banks to defer payments of its arrears and principal due in 1989 and early 1990; Jordan agreed in principle with its creditor banks on a restructuring package, including some new money; and Honduras (whose 1987 agreement in principle proved stillborn) managed to reach an agreement with two of its main creditor banks to reschedule part of its outstanding obligations. Colombia was able to obtain the refinancing of most of its bank debt due in 1989-1990.

14 For instance, the agreement reached in 1988 between Côte d'Ivoire and its creditor banks could not be implemented because interest payments had not yet resumed. The agreement between Brazil and its creditor banks in November 1988 was already encountering difficulty by early 1989, and in September Brazil suspended interest payments to creditor banks. Negotiations on a new agreement are expected to start in the second half of 1990.

15 One of these countries, Venezuela, began to reduce its arrears in early 1990 to facilitate an agreement on bank debt.

16 See *TDR 1989*, Part One, chap. II, sect. B.

17 For estimates by the World Bank of the amounts of new commercial lending required for severely indebted middle-income countries see The World Bank, *World Debt Tables 1989-1990. External Debt of Developing Countries* (Washington D.C.: The World Bank, 1989), vol. I, p. 25.

Table 15

NET RESOURCE FLOWS TO 15 HIGHLY INDEBTED DEVELOPING COUNTRIES, [a] 1982-1988

(Billions of dollars at current prices)

Type of flow	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*
Official flows [b]	7.2	6.4	8.9	8.4	9.7	11.4	9.0
ODA	2.1	1.9	1.9	2.5	3.0	3.1	3.4
Other	5.0	4.4	7.0	5.9	6.7	8.3	5.5
Private flows	18.9	12.5	22.8	-5.0	6.6	-3.3	-7.3
of which:							
Direct investment [c]	3.0	0.2	2.0	-0.4	2.1	2.8	2.5
Private borrowing [d]	14.3	9.8	19.7	-4.7	5.7	-4.7	-8.7
Total net flows	26.0	18.8	31.7	3.4	16.4	8.1	1.7
Memo items:							
Export credits [e]	2.5	3.9	1.8	0.3	-1.1	-0.9	0.8
IMF credits	2.2	6.3	3.3	1.6	-0.2	-1.3	-1.4
GDP growth (per cent)	1.1	-2.6	2.0	3.1	3.7	2.0	0.9

Source: OECD, *Geographical Distribution of Financial Flows to Developing Countries*, various issues; IMF for data on borrowing from IMF; and UNCTAD secretariat estimates.

a Medium- and long-term. For the 15 highly indebted countries see note **c** to table 8.

b Excluding IMF credits.

c The figures for direct investment in this table are based on data reported by the investing (DAC) countries. They differ significantly from those obtained from balance of payments statistics (such as those in IMF, *International Financial Statistics*), which are based on data provided by the recipient countries

d Bank lending and other private borrowing from capital markets.

e Medium- and long-term.

that adequate solutions can be found by giving creditors the options either to reduce debt and debt service or to provide new money. The extent and strength of creditor banks' interest in providing new money is, however, questionable.

As was pointed out in *TDR 1989*, "By and large, [banks] see reduction of their level of exposure as offering a more certain outcome than trying to improve the quality of their exposure by adding to it ('defensive lending'). This is clearly the case for those banks which have managed to reduce their exposure and to set aside sizeable loan-loss provisions, and which are able to absorb the book-keeping losses from selling (or swapping) loans at a discount. But, those creditors whose exposure still remains high, or which have not yet been able to make substantial loan-loss provisions (or both), and which therefore show less interest in debt reduction, are also extremely reluctant to keep adding to their exposure. Such banks can be expected to participate (albeit reluctantly) in concerted lending only for big debtors, and only when, and to the extent that, the alternative is a discontinuation of debt servicing. They are not likely to finance growth, unless the debtor refuses to continue servicing its debt otherwise, or to provide new money to debtors too small to pose a serious threat to their own positions. This situation also implies that potential lenders will resist providing fresh funds if these are to be used for debt reduction".[18] It was also pointed out that regulatory pressures to raise capital ratios, the higher level of provisioning against losses and the low equity prices of highly exposed banks also militate against new lending.

These various impediments to new lending still exist, and some of them have intensified over the past year. Between mid-1989 and early 1990 a number of banks in the United States, the United Kingdom and Canada undertook a new round of reserve increases, thus further in-

[18] *TDR 1989*, pp. 43 and 46.

creasing the cost of new lending. In the United Kingdom, three of the four large clearing banks now have provisions amounting to 70 per cent of their claims on developing countries. Even the big United States banks, which previously maintained small provisions, have raised their ratios to levels ranging from 40 per cent to 80 per cent (in one case, 100 per cent).

By contrast,there has been official action to reduce the cost of debt and debt service reduction. For example, to facilitate the Mexican agreement (see below), United States regulators agreed not to require banks to mark down immediately from par to market value the discount bonds exchanged for their loans. Similarly, in France it was decided that the par bonds would not entail accounting losses and that, as regards the discount bonds, any tax liabilities incurred as a result of having loan-loss provisions in excess of the loss of face value could be spread over the life-span of the bond. In the United Kingdom, regulators decided not to require discount bonds to carry any additional provisions, in this way intending to ensure that the two types of bonds received equal treatment. In the case of Japan, banks participating in the Mexican package were allowed to realize some of their capital gains on equity holdings.

The paucity of banks' interest in providing new lending has become more evident from the experience of the "Brady" agreements concluded thus far. The Mexican agreement provided creditor banks with three options: (a) to exchange their loans for 30-year bonds carrying a market interest rate at a 35 per cent discount; (b) to exchange them at par for 30-year bonds carrying a fixed below-market interest rate; and (c) to provide new money over three years amounting to 25 per cent of their exposure. It had been expected that banks accounting for 20 per cent of the debt would take up the new money option. In practice, however, only half that figure was attained, while the debt reduction option was chosen by many more banks than anticipated. Although Mexico will receive a larger amount of debt reduction and less new money than expected, the net change in its debt stock resulting from the agreement is likely to be negligible.[19] The Philippines agreement included a cash buy-back option whereby banks could tender their loans for sale. It was expected that banks not participating in the buy-back would provide new money; "new money bonds" with a 15-year maturity and a floating rate of interest were thus offered. However, the $700 million pledged in this form fell far short of the Government's target of $1.2 billion. By contrast, more tenders for buy-backs were received than could be accommodated, the debt retired by this means amounting to about $1.3 billion and the discount being 50 per cent. As a result of the agreement the medium-term and long-term debt of the Philippines to banks will undergo a net reduction of about $600 million (about 5.5 per cent), while it borrowed about $500 million from multilateral financial institutions and banks to finance the buy-backs. The Costa Rican agreement recognized at the outset that no new money would be available, and was therefore geared towards large reductions in debt and debt service obligations and clearing arrears. Buy-backs were a key feature. This option was taken up by banks representing about 65 per cent of the country's total debt, and the sale took place at a very steep discount - 84 per cent of face value. The remaining claims were to be converted into bonds carrying a low and fixed interest rate. In order to stimulate interest in buy-backs, creditors willing to reduce their claims 60 per cent or more by this means received a partial guarantee on the interest due on the bonds, while those offering a reduction of less than 60 per cent received no such guarantee. The first group also received bonds of longer maturity. The buy-back will reduce Costa Rica's medium-term and long-term debt to banks by $980 million (or by about 55 per cent), while its borrowings from IMF, the World Bank and bilateral sources will increase by about $250 million.

Two other agreements in principle have been reached. The Moroccan agreement contains options for new money, debt exchange and buy-back, while the Venezuelan agreement also includes an additional option to reduce interest charges for a limited period. However, since the agreements have not yet been signed, the response of banks is not known.

The absence of authoritative estimates of debt reduction needs (mentioned below) makes it difficult to draw definite conclusions regarding the adequacy of these agreements. However, several of their features have given rise to concern. In the first place, as noted, the final outcomes were well below expectations (which were themselves shaped as much by debtors' views on what they could expect from the negotiating process as by their own long-term needs). Secondly, the agreements have rendered the remaining debt more difficult to re-

[19] The option of discount bonds (at a 35 per cent discount) will result in a reduction of bank debt of $7 billion, while the option of new bonds with low interest rates represents a $1.2 billion increase. The resulting net reduction of $5.8 billion in bank debt is roughly equivalent to the new loans Mexico has to secure from IMF, the World Bank and the Japanese Government to finance the bond guarantees.

structure. The debt is now in bond form, and may come to be held by investors even more reluctant than banks to provide new money, and more willing to take legal action in the event of arrears. The bonds are perceived as exit instruments, and often carry explicit undertakings by the borrower to exclude them from future restructuring and calls for new money. In the Philippines package, not only the new loans but also part of the previous claims of the lenders of new money were converted into bonds. Thirdly, the agreements are asymmetric with regard to future contingencies. The Mexican and Venezuelan agreements allow creditors to benefit in the event of a significant rise in the price of petroleum. The Costa Rican package contains a similar clause related to GDP growth. However, no comparable provisions are made in the event of a significant deterioration of the country's situation. Contingency clauses are also absent in the other agreements discussed above. Consequently, it would appear that by incurring additional multilateral debt and converting bank loans into bonds of various kinds, debt and debt service have been reduced, by a relatively small margin, at the price of increased vulnerability to external shocks and decreased manoeuvrability overall.

Moreover, two aspects of the debt strategy following the Brady initiative are especially problematic. In the first place, the negotiations have lacked firm targets based on authoritative estimates for what would constitute an adequate level of debt or debt service reduction for debtor countries (although the creditor community has displayed little inhibition about setting domestic financial targets or assessing the adequacy of adjustment efforts for such countries). Secondly, neither the Fund nor the Bank have been assigned the task of acting as an "honest broker" in negotiations with creditors.

These two lacunae, especially where combined with reluctance by debtors to suspend interest payments as a negotiating device, have naturally resulted in a tendency for the extent of debt and debt service reduction to be determined by the negotiating process rather than for the negotiating process to be shaped by authoritative estimates of needs. This was most evident in the Philippines agreement, which was based on a co-operative approach: not only was a large financing gap left, but a number of creditors were able to obtain a "free ride"; they neither provided new funds nor quit at a discount. Mexico managed to avoid "free riding" among its creditors (almost no banks refusing to participate) because the imbalance in negotiating strengths was partly offset by pressure exerted by the United States Government. However, pressure from this source is not part of the architecture of the debt strategy, and cannot be expected to fill the void systematically.

The Costa Rican agreement provides a more promising model. Here the willingness of the Fund and Bank to provide financial support to the country's adjustment programme despite its arrears, and the relatively successful management by the authorities of the consequences of these arrears for the domestic economy, provided a powerful incentive for the creditors to conclude an agreement. These factors also help explain why Costa Rica was able to ensure that almost all its creditors took up one of the options offered. Systematic resort by the Fund and Bank to this tactic, combined with firm targets for the debtors' medium-term cash flow and debt profile, would give the negotiating process the anchor which it currently lacks.

Providing creditors with additional incentives could usefully complement increased pressures on them to engage in debt and debt service reduction on a larger scale and to accept steeper discounts in such operations. A wide variety of proposals in this vein have been put forward in recent years, and have been discussed in previous issues of the *TDR*.

National laws and regulations could also be directed more effectively towards achieving adequate levels of debt and debt service reduction. One recent suggestion[20] is that creditors should qualify for tax deductions on their loan-loss provisions only to the extent that they participate in debt reduction packages. This proposal is designed for European countries, where tax treatment of provisions tends to be generous. The recent decision of the United Kingdom tax authorities to provide more liberal relief for loan sales to, or exchanges with, debtors is in accord with the rationale of this suggestion.[21]

Another recent suggestion[22] is that creditors that fail to participate in debt reduction

20 S. Griffith Jones "European banking regulations and third world debt: the technical, political and institutional issues", *UNCTAD Review*, vol. 1, No. 3 (forthcoming).

21 The tax relief will apply when the discount associated with the sale or exchange of the loan is greater than that required by the Bank of England's matrix (which is designed as a guide to appropriate rates of provisioning for banks' loans).

22 By Walter Fauntroy, Chairman of the United States House Sub-Committee on International Development, Finance, Trade and Monetary Policy (as reported in *Financial Times*, 29 June 1989).

packages sanctioned by IMF and the World Bank should be required to make special provisions on their loans, and should not be eligible for tax relief on losses. This proposal is designed for the United States, where banks have generally not been required to mark down the value of their loans, and have been allowed tax relief only after incurring losses. In conclusion, three points warrant emphasis:

(a) the scale of debt and debt service reduction needs to be enlarged very considerably;

(b) this should be done by providing additional incentives and disincentives to creditors; and

(c) the combination should not be tilted too heavily in favour of increased financial support from the World Bank and the regional development banks. Unless additional funds are put at their disposal, such support could result in diverting funds away from lending for new investment, which is the key to successful adjustment.■

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Chapter II

CURRENT TRENDS AND PROSPECTS FOR THE WORLD ECONOMY

A. Introduction

The pace of activity in the world economy has decelerated markedly. World output, which grew at 4.3 per cent in 1988, and by more than 3 per cent in 1989, is expected to advance at around 2-1/2 per cent in 1990 (see table 16), and in both North America and Eastern Europe the balance of uncertainty in this forecast suggsts that it may be optimistic. The outlook for 1991 is for a small improvement in growth performance; on the whole, however, activity appears to be settling down at rates distinctly below those achieved in 1987-1988. In 1989 stagnation or slowdown of growth occurred in all major groups of countries, except in Africa, where some improvement was recorded.

As has been the case for a number of years, developing countries recorded highly divergent growth experiences.[23] Output in Latin America barely rose in 1988 and 1989, and appears set to decline in 1990, so that since the early 1980s output per head will have fallen by some 10 per cent, implying significant welfare losses. The improved performance in Africa simply slowed the significant declines in output per head of the earlier period. Moreover, a number of countries in the region suffered economic setbacks. Growth in East and South Asia continued to be vigorous, though expansion in both areas lost some momentum, and some signs of vulnerability were appearing in South Asia. The pace of activity in West Asia strengthened in 1989, but does not appear to be following the same course in 1990.

In China output growth has slowed markedly from the exceptionally high rates recorded in 1987-1988, following the initiation of adjustment policies to counter inflationary and balance of payments pressures.

As regards the developed market-economy countries, growth has weakened noticeably in North America. In Japan, on the other hand, activity remains relatively strong, as it does in Western Europe, with the notable exception of the Scandinavian countries and the United Kingdom. These developments mark a decided shift in the locus of growth dynamics, with continental Western Europe emerging as a major growth pole, and North America ceding this role which it had played throughout much of the 1980s. Policy in the United States is entering a particularly delicate phase, with the need for further substantial adjustment of the budget balance at a time of decided weakness in the economy.

Economic activity in the countries of Eastern Europe continues to be heavily influenced by the difficulties of engineering a transition to more market-oriented economic structures. This process is in differing stages of evolution in the various countries, and at present a wide variety of approaches, time frames and desired final outcomes is in evi-

[23] These divergences, and some of their underlying causes, including their relation to the business cycle in developed market-economy countries, is explored in detail in the annex to this chapter.

Table 16

WORLD OUTPUT, 1987-1989, AND FORECASTS FOR 1990 AND 1991

(Percentage change)

Country group	*1987*	*1988*	*1989*	*1990*	*1991*
	Actual		*Estimated*	*Forecasts*	
World	3.5	4.3	3.3	2.5	2.9
Developed market-economy countries	3.4	4.2	3.5	2.8	2.9
of which:					
North America	3.8	4.5	3.0	2.0	2.5
Western Europe	2 8	3 6	3.5	2.9	2.9
Pacific	4.1	5.3	4.6	4.1	3.7
Countries of Eastern Europe	2.1	4.0	1.9	-1.2 [a]	0.2 [a]
Socialist countries of Asia	9 9	11.0	3.9	5.3	6.0
Developing countries	3.2	3.5	3 3	2.8	4.0
of which:					
Latin America	2.5	0.6	1.1	-0.4	2.7
Africa	1.1	1.7	2 8	2.9	2.4
Asia	4.6	6.5	5.1	5 2	5.3
Memo item:					
Least developed countries	2.6	3.0	2.7	3.4	2.9

Source: UNCTAD secretariat calculations, based on national and international sources for 1987-1989, and SIGMA for forecasts.

a Based on forecasts of Project Link.

dence. In many cases the old administrative system of economic governance is not functioning sufficiently, while the new mechanisms of economic regulation and market incentives have not yet become fully operational. The inevitable outcome is poor growth performance overall, a condition that appears likely to persist for some time into the future.

These and related matters are explored in the present chapter.

B. Developing countries

The economic performance of developing countries continues to be governed by their capacity to secure command over foreign exchange and to foster investment through mobilizing external purchasing power and domestic resources. For many heavily indebted countries, the outward transfer of resources has remained an important claim on both external purchasing power and domestic saving. The size of this claim, and its significance for domestic investment, are illustrated in the narrative on Latin America, in sub-section 1 below. In addition, for countries highly dependent on commodity exports, changes in the prices of those exports largely accounted for changes in economic performance, and this is highlighted in the narrative on Africa (sub-section 2).[24] For a small group of countries, the expansion of export earnings has been of such vigour that command over external purchasing power is no

[24] See also the annex to this chapter, especially table A-7.

Table 17

WORLD CURRENT ACCOUNT BALANCES, 1987-1989, AND FORECASTS FOR 1990 AND 1991

(Billions of dollars)

Country group	1987	1988	1989	1990	1991
	Actual		Estimated	Forecasts	
Developed market-economy countries	-3.0	-15.4	-43.2	-41.1	-34.7
of which:					
North America	-137.6	-121.8	-107.2	-102.2	-102.1
Western Europe	52.3	34 0	-2.7	-0.7	4.9
Pacific	82.4	72.4	66.7	61.7	62.5
Countries of Eastern Europe	4.5	3 1	-6 0	-6.2	-5.8
Socialist countries of Asia	0.2	-4.1	-4.5	4.2	4.8
Developing countries	-13.0	-28.9	-29.0	-37.0	-29.1
of which:					
Latin America	-16.8	-17.0	-14.7	-8.0	-0.0
Africa	-14.6	-20.7	-24.4	-24.7	-22.4
Asia	16.9	6.6	7.7	-7.3	-10.0
Statistical discrepancy	-11.3	-45.3	-82.7	-80.1	-64.8
Memo item:					
Least developed countries	-8.8	-9.8	-10.4	-11.1	-11.2

Source: UNCTAD secretariat calculations, based on national and international sources for 1987-1989, and SIGMA for forecasts.

longer a constraint on the expansion of activity. For such countries, it has now proved possible to rely more on domestic demand as an engine of growth, and imports have risen sharply, as described in the narrative on East Asia (subsection 3 (a)).

1. *Latin America*

(a) Background: trends in the 1980s

GDP per capita in Latin America declined by approximately 1 per cent in 1989 after a fall of 1.5 per cent in 1988, and an even sharper drop appears to be occurring this year. Thus the 1980s have registered a cumulative fall of more than 10 per cent, implying a very serious drop in the standard of living. By 1989 real private and government consumption per capita in the major countries of the region were estimated to have fallen by 10 per cent and 13 per cent, respectively, from their 1980 levels.

A major cause of this poor performance has been the inability of the major countries in the region, to varying degrees throughout the decade, to translate their domestic savings into domestic investment and the growth of their export volumes into increased imports. Initially, balance of payments adjustment policies concentrated on import reductions in order to secure the trade surplus required for financing debt service payments. Consequently, the early 1980s were characterized by deliberate recessionary adjustment policies. The ratio of imports and domestic investment to GDP for seven major Latin American countries[25] dropped from 14.8 per cent and 22.3 per cent in 1981 to 9.2 and 16 per cent in 1983, respectively (in terms of 1980 dollars). In the

[25] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. Those countries account for about 90 per cent of the region's GDP and 87 per cent of its external debt.

Table 18

CURRENT ACCOUNT DEFICIT OF DEVELOPING COUNTRIES: [a]
SOURCES OF FINANCING IN 1987-1989 AND FORECASTS FOR 1990 AND 1991

(Billions of dollars)

Item	1987 Actual	1988 Actual	1989 Estimated	1990 Forecasts	1991 Forecasts
Current account balance	-14.3	-25 9	-31.9	-37.4	-27.8
Source of financing:					
Increase in official reserves	45.5	7.0	15.0	15 0	15 8
Total net capital flows	59.8	32.9	46.9	52.4	43.6
Official flows	32 2	28 6	38 3	37 4	35 8
Grants [b]	12.3	13.8	15.0	16 0	17.2
Medium- and long-term loans	19.9	14.8	23.3	21.4	18 6
Private flows	-5.8	-0.4	2.0	-0.8	-7.0
Direct investment	11.7	13.5	13.8	15 2	16.9
Private borrowing	-17.5	-13.9	-11.8	-16.0	-23 9
Other capital, unrecorded flows, errors and omissions	33.4	4.7	6.6	15.8	14.8

Source: UNCTAD secretariat calculations, based on national and international sources for 1987-1989, and SIGMA for forecasts.

a Excluding oil-dominant countries (Iraq, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, United Arab Emirates) and developing countries of Europe.

b Excluding technical assistance.

mid-1980s the ratios remained relatively stable at around these levels, allowing some resumption of growth in per capita GDP. However, from 1987 onwards maintenance of the trade surpluses brought about by these recessionary policies was mainly the result of a large expansion in the export volumes of most of the seven countries. Nevertheless, real investment and import volumes did not recover correspondingly, with the result that per capita, and in some cases total, GDP started to decline after 1987.

The trade surpluses required to service external debt have also been associated with macoeconomic instability, reflected mainly in high rates of inflation. Indeed, the efforts to generate trade surpluses have themselves tended to increase inflationary pressures. Firstly, trade surpluses achieved either directly via import compression or indirectly through macroeconomic restraint have led to economic stagnation in place of growth, thus reducing real revenues available for fiscal adjustment.[26] Secondly, in many cases countries resorted to successive currency devaluations to increase the competitiveness of their exports. While this generally had the desired effect, it also accentuated the inflationary process and caused drastic changes in the internal terms of trade between agriculture and industry.[27] The negative net transfer of resources to Latin America reflected in its surpluses militated against both growth-oriented external adjustment and non-inflationary internal adjustment.

The experience of the seven major Latin American countries is illustrative of the problems faced throughout the region. The efforts of these countries, taken as a group, to mobilize domestic saving have in general met with a certain degree of success. There was a steady

26 As pointed out by the ECLAC secretariat, the inflationary pressures had their origin in the inability of the fiscal system to simultaneously cope with their essential functions and with payment of external debt *(Preliminary Overview of the Economy of Latin America and the Caribbean, 1989)*.

27 See *TDR 1989*, Part One, chap. IV, on macroeconomic disorder in developing countries.

Table 19

DEVELOPING COUNTRIES: DEBT OUTSTANDING, [a] 1987-1989, AND FORECASTS FOR 1990 AND 1991

(Billions of dollars)

	1987	*1988*	*1989*	*1990*	*1991*
	Actual		*Estimated*	*Forecasts*	
Total debt outstanding [b]	1107.6	1079.7	1096.8	1110.5	1113.9
of which held by:					
Latin America	495.7	468.5	474.0	472.7	463.6
Africa	271.7	273.6	285.2	299.1	309.1
Asia	340.1	337.6	337.6	338.7	341.2
Memo item:					
Debt of least developed countries	71.7	73.5	76.9	81.5	85.8

Source: UNCTAD secretariat calculations, based on national and international sources for 1987-1989, and SIGMA for forecasts.

a End of year.

b Excluding oil-dominant countries (see note **a** to table 18) and developing countries of Europe.

increase in their aggregate domestic saving ratio from around 21 per cent of GDP in 1980 to almost 23 per cent in 1989. Since income growth has been generally low or negative this increase in saving involved likewise low or negative growth of consumption. Such a sacrifice of consumption would have increased welfare in the future if the resources saved could have been used to increase investment and growth. However, domestic investment ratios during the decade generally declined, from 22.7 per cent of GDP in 1980 to less than 16 per cent in 1989. Instead of financing investment, the sacrifice of consumption has been required to cope with the decline in external financing, the rise in world interest rates and the deterioration of the terms of trade (see box 3). The gap between investment and saving and the external factors to which it was due in different periods in each of the seven countries, and for the seven as a whole, is shown in table 21. The periods distinguished are 1983-1985 and 1986-1987, when growth was relatively satisfactory but the nature of external shocks differed, and 1988-1989, the main concern of this sub-section. The table also shows the effect of the net transfer of resources when net interest income (obviously negative for a net debtor country) is excluded. In the text which follows an attempt is made to relate the behaviour of the various ratios in 1988 and 1989 to the external and domestic developments which actually took place in those two years.

It can be seen from table 21 that the net transfer of resources and changes in the terms of trade, for the seven countries taken together, contributed almost equally to the difference between domestic saving and domestic investment - a difference that amounted to 6 per cent of GDP for the whole of the period 1983-1989. If net interest income is excluded there results a positive net transfer amounting to 0.2 per cent of GDP, reflecting mainly net capital inflows. These inflows would, in all probability, have been higher had it not been for the adverse effect of the debt crisis on the growth and creditworthiness of debtor countries. This period contrasts starkly with the pre-crisis period (1981-1982 - not shown in table 21), when there was almost no gap (0.6 per cent) thanks basically to the substantial net capital inflows in that period and to the fact that the terms of trade had not yet worsened. In other words, external factors did not constrain investment. While in 1981-1982 investment and saving ratios were 20.9 per cent and 20.3 per cent, respectively, in 1983-1989 the corresponding ratios were 15.8 per cent and 22.0 per cent, indicating that the decline in domestic absorption since 1983 was more the result of investment cutbacks than a fall in consumption levels.

The investment ratio, having experienced a large decline, on average, between 1981-1982 and 1983-1989, remained more or less constant

Table 20

WORLD TRADE VOLUMES, 1987-1989, AND FORECASTS FOR 1990 AND 1991

(Percentage change)

Country group	1987	1988	1989	1990	1991
	Actual		Estimated	Forecasts	
World					
Exports	5.3	9.1	6.5	6.2	7.2
Imports	6.4	9.4	7.5	5.8	6.6
Developed market-economy countries					
Exports	5.3	8.1	7.5	6.9	7.4
Imports	7.0	8.4	7.9	6.2	6.7
of which:					
North America					
Exports	11.0	17.2	7.0	6.5	7.2
Imports	3.6	7.4	5.4	5.1	5.9
Western Europe					
Exports	4.3	6.6	6.5	6.0	6.5
Imports	7.8	7.5	8.6	6.8	7.0
Pacific					
Exports	2.1	3.2	4.5	6.4	6.8
Imports	8.6	15.0	9.5	5.8	6.9
Countries of Eastern Europe					
Exports	2.1	4.3	-1.5	2.5	8.5
Imports	0.1	3.6	3.9	8.0	8.0
Socialist countries of Asia					
Exports	16.7	10.0	7.9	6.9	9.0
Imports	-7.7	18.7	3.3	-9.8	11.0
Developing countries					
Exports	5.9	13.5	6.0	5.1	6.3
Imports	8.0	14.7	5.9	5.6	6.1
of which:					
Latin America					
Exports	1.7	8.4	4.1	7.4	7.4
Imports	0.0	5.4	2.6	3.0	3.5
Africa					
Exports	1.2	8.5	2.8	5.4	5.3
Imports	2.0	8.0	0.7	2.7	2.1
Asia					
Exports	7.8	15.7	7.3	4.5	6.1
Imports	11.0	18.0	7.5	6.6	7.2
Memo item:					
Least developed countries					
Exports	18.5	-8.0	4.5	8.1	8.8
Imports	-3.5	0.3	3.9	4.4	3.4

Source: UNCTAD secretariat calculations, based on national and international sources for 1987-1989, and SIGMA for forecasts.

Box 3

NET TRANSFER OF RESOURCES, TERMS OF TRADE AND INVESTMENT FINANCING GAP

The trade deficit or surplus (goods and non-factor services) defines the net resource transfer.

The balance of payments identity is written as follows:

(1) $X - M + NFI + NCF - OB = 0$

where X(M) is exports (imports) of goods and non-factor services
NFI is net factor income
NCF is net capital flows and OB is the overall balance (change in reserves).

Equation (1) can be written as:

(2) $X - M = -NFI - (NCF - OB)$ or $M - X = (NCF - OB) + NFI$

Defining the trade deficit (or surplus) as being the difference between domestic absorption and GDP (i.e. the sum of net capital flows and net factor income) constitutes the absorption approach to the net transfer concept. It is clear from (2) that for this to hold true, the change in reserves should be netted out from NCF, which is defined to include the sum of net capital inflows to all residents, including the Central Bank. This concept of net transfer differs from that adopted by the ECLAC secretariat, where the change in reserves is not netted out and only net interest and profits are considered as NFI; this concept is useful in indicating the impact of the operation of the international financial system on a country; indeed, in the Latin American case the negative net transfer is mainly the result of high interest payments on debt and of shrinking capital inflows, and it is financed from a trade surplus generally generated by reduced domestic absorption. This contrasts with the case of many oil exporters, where the negative net transfer resulted principally from investing abroad and was financed from a trade surplus basically arising from structurally limited domestic absorption.

As for the effect of the net transfer of resources and changes in the terms of trade, the methodology used is as follows:

Domestic investment (I) is defined as the sum of national and external saving:

(3) $I = NS + M - X - NFI$

where NS is national saving and the other variables are defined as above.

Equation (3) can be written as:

(4) $I = DS + M - X$

where DS is domestic saving.

Domestic investment is therefore seen to be equal to domestic saving and net real resource transfer. This identity, which is written in terms of current prices, can be rewritten in constant price terms as follows:

(5) $I^S = DS^S - (X^S - M^S)$

where the superscript (s) indicates that the variables are measured in constant prices.

Equation (5) can be written as:

(6) $I^S = DS^S - [(X - M) - (dPx.Qx - dPm.Qm)]$

where dPx(dPm) is the change in export (import) prices from the base to the current year and Qx(Qm) is the quantum of exports (imports) in the current year.

Using (2) above, (6) can be written as:

(7) $I^S = DS^S - [(-NFI - (NCF - OB)) - (dPx.Qx - dPm.Qm)]$

or

(8) $I^S = DS^S + (NFI + NCFOB) + (dPx.Qx - dPm.Qm)$

where $NCFOB = NCF - OB$.

Box 3 (concluded)

According to (8), potential investment, which is represented by domestic saving, is affected by factors beyond the control of the government of a country, namely, the net transfer of financial resources and the evolution of the terms of trade. However, while capital flight, which is included in the definition of net transfer of resources adopted here, does lie within Government control, it is also encouraged by the deregulation of international financial markets. Moreover, since the change in reserves is netted out of the net capital inflow from abroad, an addition to reserves is considered as "capital outflow" and a drawing down of reserves is considered as capital inflow.

Note: For details on this methodology see E. Bacha, "Debt crisis, net transfers and the GDP growth rate of the developing countries" in *Studies on International Monetary and Financial Issues for the Developing Countries* (UNCTAD/RDP/1), Geneva, August 1989.

during the latter period. As the saving ratio continued to increase (table 21), it is apparent that the effect of negative net transfer and terms of trade deterioration fell primarily on consumption. Thus, both investment and consumption were negatively affected when the whole decade is taken into account, with harmful effects on growth prospects and social development. Moreover, whereas in 1983-1985 the net transfer of resources played a more predominant role in depressing consumption than the terms of trade, in the subsequent periods the reverse was true, mainly on account of the collapse in oil prices in 1986 and their weakness in 1988, which affected the three oil exporters in the group, namely, Mexico, Peru and Venezuela.

(b) Recent developments

The period 1988-1989 was characterized by a vigorous advance in the volume of exports from the seven major countries taken as a group. Consequently, and despite a further deterioration in the terms of trade, the purchasing power of exports (i.e. export values deflated by import prices) rose significantly, and stood about 18 per cent above its level in 1986-1987 (see table 22). Particularly sharp advances were experienced by Brazil and Chile. The outward transfer of resources - which must be effected by surrendering export receipts - is a first claim on this purchasing power (see box 4). Import capacity is thus determined by subtracting the outward transfer from exports. As may be seen from table 22, when this is done import capacity rose slightly in 1988-1989 over 1986-1987, but remained well below levels reached in 1980. In Argentina and Brazil the outward transfer absorbed more than one half the purchasing power of exports.

The deterioration in the terms of trade, the outward transfer of resources and the higher export earnings that allowed the transfer all worked to reduce the volume of the goods and services available to the domestic economy. With one exception (Chile, see below) this resulted in a decline in either consumption or investment or both, relative to output, depending in part on the set of policies chosen to help the economy absorb the loss of resources. The following paragraphs comment briefly and selectively on some individual cases, and are designed to illustrate the wide variety of experiences.

With respect to *Chile*, the favourable change in the terms of trade was an important factor behind its relatively high growth and low inflation, a change that was largely due to the 45 per cent increase in the price of copper in 1988, which almost completely wiped out the terms of trade losses of previous periods. In fact the gain, in export earnings due to higher export prices (mainly copper), amounting to $1.3 billion, was greater than that from the overall improvement in the terms of trade ($1.1 billion) which, in turn, exceeded the improvement in the trade surplus ($989 million).[28] In contrast, the slight decline in the terms of trade in 1989 contributed relatively

[28] The current surplus of copper exports (current export earnings less costs of production), while financing the external sector also compensated for the negative effects of the increase in public foreign debt. Whereas during 1981-1987 the servicing of public debt was consistently higher than the surplus of copper exports, the reverse was true in 1988, when copper prices rose substantially. As a proportion of GDP in current prices the current surplus of copper exports in 1988 amounted to 8.5 per cent, whereas the servicing of public debt was 5.4 per cent. The average corresponding ratios for the period 1986-1987 were 3.9 per cent and 6.2 per cent of GDP.

Table 21

MAJOR LATIN AMERICAN COUNTRIES: SAVING-INVESTMENT GAP AND THE EFFECTS OF NET TRANSFER OF RESOURCES AND CHANGES IN THE TERMS OF TRADE, 1983-1989

(Per cent of GDP in 1980 prices)

			Gap			
Country/ period	*Domestic investment*	*Domestic saving*	*Total*	*Due to net transfer* [a]	*Due to terms of trade*	*Net transfer excluding net interest income* [a]
1983-1985						
Argentina	12.4	16.7	-4.3	-2.9	-1.4	0.7
Brazil	15.8	21.0	-5.2	-3.7	-1.5	0.3
Chile	12.9	20.0	-7.1	-1.5	-5.6	4.7
Colombia	17.0	15.4	1.6	2.4	-0.8	5.2
Mexico	17.2	23.7	-6.5	-5.9	-0.6	-1.5
Peru	18.4	25.4	-7.0	-3.2	-3.8	2.0
Venezuela	17.4	28.2	-10.8	-9.9	-0.9	-6.9
Total above countries	15.7	21.4	-5.7	-4.3	-1.4	-0.3
1986-1987						
Argentina	12.3	15.4	-3.1	-0.9	-2.2	1.7
Brazil	17.1	20.4	-3.3	-2.7	-0.6	0.5
Chile	14.8	23.4	-8.6	-2.7	-5.9	2.7
Colombia	16.4	21.3	-4.9	-3.4	-1.5	-0.4
Mexico	16.3	25.8	-9.5	-3.7	-5.8	-0.5
Peru	19.2	22.2	-3.0	2.8	-5.8	6.0
Venezuela	17.6	29.4	-11.8	-0.3	-11.5	1.5
Total above countries	16.0	21.9	-5.9	-2.3	-3.6	0.7
1988-1989						
Argentina	14.2	19.4	-5.2	-3.1	-2.1	0.6
Brazil	16.5	22.6	-6.1	-4.9	-1.2	-1.4
Chile	17.2	21.4	-4.1	-4.0	-0.1	0.9
Colombia	16.2	20.0	-3.7	-0.8	-2.9	1.9
Mexico	15.7	23.6	-7.9	-1.3	-6.6	1.9
Peru	20.0	27.1	-7.1	-1.9	-5.2	1.8
Venezuela	14.3	29.1	-14.8	-0.7	-14.1	1.9
Total above countries	15.8	22.8	-7.0	-2.9	-4.1	0.5
1983-1989						
Argentina	12.8	17.0	-4.2	-2.4	-1.8	1.0
Brazil	16.4	21.4	-5.0	-3.8	-1.2	-0.2
Chile	14.9	21.8	-6.9	-2.7	-4.2	2.9
Colombia	16.6	18.6	-2.0	-0.3	-1.7	2.5
Mexico	16.5	24.3	-7.8	-3.9	-3.9	-0.2
Peru	19.1	24.9	-5.8	-0.9	-4.9	3.2
Venezuela	16.5	28.8	-12.3	-4.3	-8.0	-1.8
Total above countries	15.8	22.0	-6.2	-3.3	-2.9	0.2

Source: UNCTAD secretariat calculations, based on national and international sources.
Note: Figures for 1988-1989 are estimates.
a For the definitions of net transfer used in this table see box 3.

Table 22

MAJOR LATIN AMERICAN COUNTRIES: PURCHASING POWER OF EXPORTS AND NET TRANSFER OF RESOURCES, 1983-1989

(Index numbers, 1980 = 100)

Country/ period	Purchasing power of exports (PPE) A	PPE adjusted for net transfer [a]			
		Including net interest income		Excluding net interest income	
		Adjusted index B	Percentage adjustment [b] (B-A)/A	Adjusted index C	Percentage adjustment [b] (C-A)/A
1983-1985					
Argentina	112	47	-57.9	84	-24.9
Brazil	135	71	-47.4	90	-33.5
Chile	84	65	-21.9	81	-2.6
Colombia	94	109	16.5	126	34.6
Mexico	151	70	-53.7	91	-39.8
Peru	92	90	-2.8	102	10.7
Venezuela	90	71	-21.3	90	-1 0
Total above countries	118	70	-40.6	91	-2.7
1986-1987					
Argentina	87	53	-39.4	77	-11.1
Brazil	142	79	-43.9	97	-31.8
Chile	102	75	-26.6	89	-13.0
Colombia	128	99	-22.7	119	-7.6
Mexico	117	66	-43.5	77	-34.7
Peru	75	105	38.8	106	40.6
Venezuela	53	69	29.3	81	52.3
Total above countries	103	73	-29 5	88	-14.9
1988-1989					
Argentina	102	45	-55.8	74	-27.2
Brazil	182	87	-52.0	104	-42.8
Chile	142	102	-27.9	112	-21.3
Colombia	120	111	-7 8	128	6.7
Mexico	129	96	-25.5	100	-22.7
Peru	78	83	6.1	86	9.8
Venezuela	55	70	28.0	84	54.8
Total above countries	120	83	-30.5	98	-18.7
1983-1989					
Argentina	102	48	-52.8	79	-22.2
Brazil	151	78	-48.1	96	-36.3
Chile	105	79	-25.5	92	-12.7
Colombia	111	107	-3.9	125	12.1
Mexico	135	76	-43.5	89	-33.8
Peru	83	92	10.3	99	18.2
Venezuela	70	70	23.1	86	23 2
Total above countries	114	75	-34.7	92	-19.5

Source: UNCTAD secretariat calculations, based on national and international sources.

Note: Figures for 1988-1989 are estimates.

a For the definitions of net transfer used in this table, see box 3.

b See box 4.

Box 4

NET TRANSFER OF RESOURCES AND IMPORT CAPACITY IN LATIN AMERICA

The discussion in the text dealt with the effect of the evolution of the net transfer of resources and terms of trade on the investment-saving gap. This evolution also affected the purchasing power of exports, or the import capacity of the countries surveyed. In recent years, unlike the beginning of the decade, the trade surplus in Latin America has been generated, as discussed earlier, through a substantial increase in the export volume, which in turn increased considerably the capacity to import. The index of purchasing power has thus risen even though the terms of trade (the other factor determining the import capacity) have generally deteriorated.

While this increase defines the potential increase in imports, recent experience indicates that this potential has not been fully realized, implying that terms of trade and export volume changes were not, due to the accentuation of the debt crisis, the only variables determining purchasing power.

Import capacity, which is a central concept, is therefore determined not only by exports and the terms of trade but also by net factor income and net capital flows. In other words, for purchasing power to reflect accurately import capacity, exports should be adjusted for the net transfer of resources. Such an index is computed (with and without net interest payments) and compared with the trade-determined (export volume and terms of trade) purchasing power index. *1* Those computations are shown in table 22 together with the impact of the adjustment of exports for the net transfer of resources.

An important observation that may be drawn from table 22 is that the countries, taken as a group, were able to counter the terms of trade deterioration through considerable efforts to increase the export volume. In 1988-1989 the purchasing power index was 20 per cent higher than in 1980. However, when exports are adjusted for the net transfer of resources the purchasing power declines by some 16 per cent from its level of 1980. In other words, having overcome one shock the countries were defeated by another (financial shock), which disturbed their macroeconomic environment and growth achievements and prospects. They lost almost one- third of their import capacity; the loss falls to almost 20 per cent when net interest payments are excluded.

The indices changed substantially in 1988-1989 as compared to the previous period for the countries taken as a group. The improvement in the purchasing power index in this period was due mainly to the expansion in export volume, which apparently was also responsible for the improvement in the index when exports are adjusted for the net transfer of resources, as both the latter and the terms of trade worsened in this period.

Because Colombia and Mexico were the only countries where the net transfer position improved in 1988-1989, the loss in import capacity of the seven major countries was reduced i.e. the import volume rose. In Colombia purchasing power excluding the net transfer actually declined. The net transfer position of the remaining countries generally worsened, but only in Argentina and Peru did this affect negatively their import capacity, in the sense that the adjusted index (for the net transfer of resources) was lower in 1988-1989 than in 1986-1987. Other countries were able to avoid this; however, Brazil succeeded in doing so through a large expansion in export volume, as was also the case to a lesser extent in Venezuela, whereas Chile was helped by a substantial improvement in its terms of trade, especially in 1988.

1 This index is simply the import volume index. If the net transfer of resources is M-X, as defined in box 3, then the index under consideration is (X+M-X)/Pm or M/Pm (Pm being the import price index). This index indicates what was possible for the country to actually import after adjusting exports for the effects of positive or negative net transfers.

little to the worsening of the trade balance ($143 million, against an overall decline of $549 million).[29] The picture in 1987 was broadly similar to that of 1988. Therefore the trade elements of the external environment cannot be construed as having been hostile to growth prospects, at least in the last three years.

The favourable terms of trade evolution in Chile in 1988-1989 as compared to 1986-1987 permitted both consumption and investment to increase, in contrast to the situation in the other six countries. Private consumption experienced a notable recovery, due in the main to

[29] The main reason for the worsening trade balance in 1989 was the increase in the import volume, related to the strong increase in domestic absorption.

the relatively low inflation, and investment expenditures also increased, especially on major projects.

It was thus largely the negative net transfer of resources that determined the saving-investment gap. However, this negative net transfer reflected essentially the decision of the Government to add to international reserves.

The experience of *Mexico* in 1988-1989 was characterized by a significant expansion of capital inflows, particularly in 1989 (over $5 billion), consisting of direct investment, repatriation of capital and disbursements of multilateral financial institutions. There was in consequence a significant reduction in the outward transfer, which, despite continued deterioration in the terms of trade, provided some breathing space to the economy. This room for manoeuvre was utilized to expand consumption, as reflected, among other things, in a substantial rise in imports; the pace of investment actually decreased in 1988. The vigorous anti-inflationary policies undertaken in the context of the Economic Solidarity Pact, together with the increased availability of goods in the domestic market, produced a dramatic fall in the inflation rate. This, together with the successful application of the Brady plan, set the stage for a resumption of investment growth in the course of 1989.

Of all seven countries surveyed, financial transactions in 1988-1989 had the most severe impact on the real economy in *Brazil*. In 1988, the subtraction of purchasing power from the economy amounted to more than $16 billion, reflecting a decline in net capital inflow, a rise in interest rates, and the accumulation of official reserves. In 1989 the situation was attenuated somewhat by the cumulation of arrears on external debt service. The reduction of available resources affected both investment and consumption, and was accompanied by substantially higher inflation. The relationship among changes in net transfer and the behaviour of consumption, investment and prices thus roughly mirrored that experienced by Mexico.

The experience of *Venezuela* exhibited distinctly different patterns. The impact of financial transactions on the economy, though important, was less marked than in the other countries, in part because official reserves were drawn down in 1988. The terms of trade, on the other hand, had a sharply negative impact on the economy. The policy responses in 1989, which focused on external adjustment and domestic stabilization, led to a reduction in investment, particularly in the public sector. As a result, Venezuela, which in 1988-1989 had the highest saving ratio of the seven countries, also had the lowest investment ratio.

The national experiences described above call for the following broad comments. Firstly, the combined impact of changes in terms of trade and the outward transfer of resources continued to dominate economic performance. These two factors had a combined annual negative impact on incomes in 1988-1989 that ranged from 4 per cent to 15 per cent of GDP, averaged 7 per cent for the seven countries together, much more than their average output growth for those years. Secondly, while good export performance was a necessary condition for economic recovery, its impact on domestic growth was offset - sometimes substantially - by worsening terms of trade and/or increased outward transfers. Thirdly, although domestic policies undoubtedly had a dominant role, it is significant that countries that made substantial progress in achieving stabilization (e.g. Mexico) or secured rapid growth with relative price stability (e.g. Chile) did so in an environment characterized by increased command over external resources. It did not matter whether these were secured through improvements in the terms of trade (as in Chile) or a reduction in the outward transfer (as in Mexico). Finally, and following from the preceding two points, debt and debt service reduction can play an important role in ensuring that improvements in export performance translate more directly into improvements in the domestic economy, and in creating an environment in which domestic policy efforts can produce the desired results.

(c) Prospects

The prospects for growth in Latin America depend, initially, on the extent to which macroeconomic order is restored, which, in turn, requires a supportive external environment. Overall growth in Latin America in 1990 is expected to be negative due to the deflationary effects of the adjustment programmes, especially in Brazil. In that country a severe adjustment programme was put in place by the new Administration, which placed a ceiling on payments of foreign debt of 1.5 per cent of GDP. Inflation can be expected to be greatly reduced, but growth will also be negatively affected. The growth outlook will remain sensitive to the behaviour of commodity prices in the coming year, with a number of key prices expected to be lower (copper for Chile and coffee for Colombia). This may exert some pressure on fiscal positions.

2. *Africa*

(a) Recent developments

Compared to earlier years, 1989 was a reasonably encouraging year for developing countries of Africa as a whole, though a number of countries suffered economic setbacks. Relatively good weather in many parts of the continent favoured continued growth in food crop production; however, several countries still confront food shortages. Some countries of Central and Eastern Africa experienced grasshopper and locust plagues and a lack of adequate rainfall in the last agricultural season.

Africa's combined GDP growth rate is estimated to have reached 2.8 per cent in 1989, against 1.7 per cent in the previous year. However, this faster growth was lower than that of population, entailing a further decline in per capita GDP in most countries.

A widespread decrease in prices of primary commodities exported (above all, the collapse of prices of tropical beverages), coupled with a continued growth of food imports, worsened the trade balances of many African countries, and the overall current account balance deteriorated further in 1989. At the same time, the external position of oil exporters, primarily of North Africa, recorded a slight improvement due to the increase in oil prices and in the volume of exports. Despite some debt relief measures undertaken by some developed countries, the mounting external debt burden continued to aggravate the external imbalances of the continent.

The vulnerability of the African countries to the external economic environment, notably to movements in commodity prices, is in many cases compromising their ability to implement reforms envisaged in their respective recovery programmes. Since for many of them the export production of commodities remains the main stimulus to growth, fluctuations on world markets can have serious effects on their economic development. 1989 witnessed the further confirmation of a handicap common to most countries of the region: primary commodity producers, above all cocoa and coffee producers in the East and Central African sub-regions, were severely hit by the collapse of world prices. For countries which depend largely on coffee or cocoa for export earnings the price collapse poses enormous handicaps to recovery and could provoke social unrest. In Côte d'Ivoire, for example, the economic austerity programme, agreed with IMF and the World Bank in July 1989, has been seriously compromised by the slump in prices of the country's traditional exports. The continuing fall of export receipts exacerbated the already severe liquidity crisis, with the result that important social tensions have accompanied the implementation of the measures envisaged in the programme. At the same time, the experience of Gabon shows that good performance by a predominant economic sector can lift the economy from long-term recession. In that country good results in the oil sector permitted a reversal in 1989 of previous negative economic trends. However, this improvement does not necessarily imply a solution of Gabon's long-term development problems, and the risk of instability remains.

The overall macroeconomic results of the continent reflect varied performance of different African countries and sub-regions. On the one hand, several countries achieved a significant rise in GDP in 1989, notably Botswana and Ghana. On the other hand, there were declines in countries such as Cameroon and Côte d'Ivoire. In Sierra Leone and Sudan output declined respectively for the seventh and fifth successive year. During the last decade for most African countries the alternation of economically good and bad years has been the dominant reality. Only a few countries (Mauritius, Botswana and, to a lesser extent, Kenya), were exceptions to this generally rather pessimistic picture.

The almost 3 per cent GDP growth in *sub-Saharan Africa* reflected the good performance of oil-exporting countries in the region, where firm hydrocarbon exports and favourable trends in world prices remained a major source of economic dynamism throughout the year. Because of these developments, growth in 1989 was stronger than expected. In Nigeria, for example, the economy grew by nearly 4 per cent for the second year running. The renewed strength of the oil sector, which for the last few years had been the most dynamic sector of the economy, was supported in 1989 by other productive sectors, in particular by agriculture, with a rise of output in food crops. All these developments eased the country's external financial position.

At the same time, due to the depressed world coffee market, total foreign exchange earnings of some important African coffee producers were substantially reduced. In particular, the depressed prices of coffee, as well as of cocoa (as already mentioned), adversely affected the economy of Côte d'Ivoire. In Ghana, despite an overall growth rate of 6.1 per

cent in 1989, foreign exchange receipts from exports of goods and services fell by 7.5 per cent. As a result, painful revisions of targets have had to be made for 1990. On the other hand, Kenya which has a more diversified export structure, has not only achieved a substantial rate of growth since the mid-1980s but, despite a fall of coffee prices, has also succeeded in increasing its total earnings from merchandise exports, due to the development of horticulture exports.

African metal and mineral producers were favoured by excellent external conditions. However, only some of them, such as Botswana and Togo, benefited from this situation. In Togo, the strong performance of the phosphate industry in 1988-1989 boosted overall economic growth and largely contributed to positive developments in the external sector. On the other hand, in Zambia the economy virtually stagnated in 1989 and the external position worsened, in spite of a very good performance by the mining sector, because of setbacks in agriculture and the devaluation of the national currency.

In *North Africa* 1989 witnessed a reversal of the negative trends of 1986-1988, with a resumption of a more normal rate of growth, thus exceeding the average for the 1980s. The balance of payments situation was mixed: while major oil exporters of the region modestly improved their trade and overall balances, especially in the second half of the year, other countries (such as Morocco and Egypt) recorded growing deficits. The sub-region's overall trade deficit, which widened substantially in 1988, increased further in 1989. High interest payments on external debt, due by some countries, also contributed to a further deterioration of overall current account balances.

In spite of the generally favourable trend in 1989, growth in some countries was less than expected. In Sudan continuing internal conflict, combined with drought, brought about a further decline in activity.

In Algeria the increase in GDP in 1989 was less than originally expected, reflecting unfavourable weather (a large part of the cereals crop was lost due to drought) and a slowdown in industrial activity due to uncertainties linked with the country's economic reform programme. Nevertheless, because of the good performance of the oil sector GDP growth rose slightly, after marginal growth in 1987 and an absolute decline in 1988. Despite the continuing necessity to import food, the trade balance remained in surplus, owing to increased natural gas sales.

Likewise, in Morocco growth was disappointing, despite results in agriculture close to the peak achieved in the preceding season. The widening trade deficit and high debt service obligations, coupled with an acceleration of inflation, were among the reasons for this outcome. The trade deficit continued to widen on account of reduced earnings from phosphates and a significant decline in exports of semi-finished goods. Furthermore, the import bill increased owing to higher oil prices. Morocco, which is one of the most indebted African countries, continued to make high interest payments on its external debt. After two years in which the current account was marginally in surplus, the combination of a large trade deficit and a deterioration on account of invisibles brought the current account back into deficit.

In Egypt, though real GDP is estimated to have grown marginally, the rise was well below that of population. Despite a slight increase in cotton export prices, the foreign exchange earnings from this source fell sharply, as cotton output was lower than in 1988. Even the increase in oil exports was not able to prevent a growing trade deficit, caused by substantial imports as a result of a decline in agricultural production.

(b) Prospects

Some modest improvement in the economic situation of Africa is expected in the short run. However, a further deterioration of both trade and current account balances seems likely, taking into consideration the meagre prospects for major commodity prices (with the possible exception of oil), growing import requirements (primarily of food) and persistent debt servicing problems.

The prospects for North Africa are somewhat better, although much depends, as in previous years, on weather conditions, the evolution of tourism to those countries and private transfers. Faster growth in almost all countries is likely to raise the regional growth rate in 1990 by one percentage point over 1989. Export prospects are favourable, which could bring about some alleviation of the trade deficit, but current account balances are likely to deteriorate further, although at a slower pace.

As in the past, the motor of growth, if not development, for many countries of sub-Saharan Africa will be agriculture, with its various multiplier effects on manufacturing, transport, construction and other economic sectors. The prospects for agricultural output depend much on highly unpredictable climatic

factors. In any event, cocoa and coffee producers are likely to suffer another bad year as world prices in 1990 continue to be weak. At the same time, oil-exporting countries may well benefit from the multiplier effects of increased oil production as the increased revenues of 1989 feed through the economy. As a consequence, their growth rates are expected to be at least at the level of the previous year. Forecast lower mineral and metal prices could considerably worsen the external positions of countries producing copper (e.g. Zambia) and phosphates.

Because of its dependence on imported inputs, the manufacturing sector in a number of African countries will be affected by foreign exchange shortages. Investment, which is likely to be one of the engines of growth in some countries of the region, is highly dependent on foreign capital inflows, and thus on continued donor support.

3. Asia

(a) East Asia

(i) Recent developments

After two years of particularly rapid expansion, growth slowed down in 1989 in many countries in East Asia, particularly among the major exporters of manufactures. Nevertheless, East Asia continued to outperform other regions of the world, with the focus of growth shifting to the southern countries of the region.

Among the major exporters of manufactures, growth decelerated significantly in Hong Kong and the Republic of Korea, to 2.5 per cent and 6.1 per cent respectively, which was only half the rate of 1988. In Singapore and Taiwan Province of China the economies grew by 9.2 per cent and 7.7 per cent, respectively. The rapid expansion of previous years in most of these countries had created a tight labour market, with rapidly rising wages and a build-up of inflationary pressures. The continued appreciation of the won, the weakening of the yen against the dollar and the emergence of competition from other countries in the region reduced the price competitiveness of manufactured exports from the Republic of Korea. As a result, and also because of frequent strikes, and weaker import demand in the developed market-economy countries, the value of exports increased by only 2.7 per cent, against 28.4 per cent in 1988. The electronics industry, one of the main sectors of growth, lost much of its momentum, with an increase in the value of exports of only 6 per cent, against almost 20 per cent the previous year. At the same time, Hong Kong, through its traditional role as an entrepôt for re-exports, suffered from the weak economic performance of China. Growth slowed down in various sectors and was also affected by a fall in the number of tourist arrivals.

Efforts to reduce dependence on external trade for the maintenance of economic growth have forced many countries to liberalize domestic markets and stimulate domestic demand. Rising private consumption in the Republic of Korea, attributable to substantial wage increases and a declining savings rate, boosted the consumption of tradeables and sharply decreased the relative contribution of net exports to economic growth in 1989. This shift from export-led to domestic demand-led growth more than halved the current account surplus, which fell from $14.1 billion to $5.1 billion. Characteristic of this switch to consumption was the increase, by almost 50 per cent, in the number of cars sold in the domestic market, whereas the number exported fell by 38 per cent. Fixed capital formation remained strong in most countries, particularly in Singapore and Taiwan Province of China, due to increased spending for technological improvements in industry (incorporation of a higher value-added content) and rising public expenditures on social and infrastructure projects.

Singapore benefited from expansion in other countries of the region (such as strong demand by assembly plants for components of electronic and telecommunications equipment, and refined petroleum products) and from the growth of intraregional trade. Increased ship-repair business, active banking and financial services and an important increase in tourist arrivals helped the service sector to expand by 14 per cent in value terms in 1989. Higher net receipts from services made up for the larger trade deficit.

Monetary and fiscal policies aimed at a gradual move to a lower growth path were considered necessary in order to cool down some overheated economies and reduce inflationary pressures. In Taiwan Province of China, where large balance of payments surpluses had been achieved and international reserves reached high levels, money supply (M1) was allowed to grow by only 6.1 per cent, compared with 24.4 per cent the previous year, so as to curb speculative activities in the stock

and real estate markets and reduce liquidity, the excess of which was partially responsible for increases in rents and wage rates. Tax incentives were granted for direct investment abroad with a similar aim of reducing excess domestic liquidity and curbing the growth of foreign exchange reserves. Much of this capital outflow has been directed to lower labour-cost countries of South-East Asia for direct investment. Among other measures introduced to reduce the trade surplus were reductions in tariffs, relaxation of import restrictions, currency appreciation and heavy imports for infrastructure development.

High domestic as well as foreign direct investment in major countries of the southern part of the region since 1987 continued to sustain very high rates of GDP growth in 1989, which were only marginally lower than those recorded for the previous year. This expansion stemmed in part from the ability to implement fiscal and financial reforms combined with incentives to reinforce business confidence for promoting production and exports. Relatively stable domestic oil prices, interest rates and exchange rates were also contributory factors. As these investments were concentrated in the manufacturing sector, some countries were able to reduce their reliance on exports of primary commodities, speed up the pace of industrialization and widen their productive base.

Malaysia and Thailand led the growth in the sub-region, growing respectively by 8.5 per cent and 10.8 per cent in 1989. Domestic activity picked up rapidly as private consumption, with higher disposable income, increased by more than 10 per cent. While the construction sector grew rapidly, manufacturing remained the most dynamic sector, with an increase in output of about 15 per cent in both countries, induced by both domestic and external demand. Agricultural output grew by as much as 5.5 per cent in Malaysia and 4.1 per cent in Thailand. Faster growth in 1989 in Indonesia (7.3 per cent, compared with 5.7 per cent the previous year), was attributable to the continued strength of non-oil/gas exports (foreign exchange earnings from which more than doubled in the last three years) and to financial stability with declining lending rates, low inflation and higher savings rates. Economic growth in the Philippines slowed down somewhat; imports rose more than exports and there was some deceleration in the manufacturing sector.

In the foreign trade sector, imports grew more rapidly than exports in most countries of the sub-region, particularly in Malaysia and (as just noted) the Philippines. The sharp increases in imports affected capital and intermediate goods, in response to growing investment demand, although consumer goods imports also tended to increase, as a result of higher wages and employment. There was a consequential worsening of trade balances; the surplus of Malaysia contracted by $1.8 billion and the deficit of the Philippines widened by $1.5 billion. In Malaysia there was also an increased deficit on invisible account, due to a sharp increase in net investment payments and rapidly rising freight and insurance charges. The combined current account deficit of countries of the sub-region rose to $5.7 billion in 1989, from $2.4 billion in the previous year. Malaysia's external debt, which started to decline in 1988, with pre-payments of outstanding loans, declined further in the following year and the debt service ratio fell to 19.9 per cent, from 23.5 per cent in 1986. The debt service ratio improved in Indonesia and Thailand, due to higher export revenues. International reserves continued their upward trend in most countries.

Monetary policies were generally accommodating in South-East Asia. Liquidity increased, partly as a result of large capital inflows, while rapid growth in private investment as well as foreign trade fuelled an expansion of commercial bank credit. In Thailand, while continued rapid growth has been putting a strain on infrastructure and on prices (especially for construction materials, where some shortages have arisen), government spending remained generally cautious, in order to avoid overheating. Consequently, the budget surplus almost doubled in fiscal year 1989 to B60 billion, from B35 billion in the previous year. In Malaysia and the Philippines, where some increase in budget deficits was registered, interest rates on deposits were raised and reserve requirements of banks were increased to tighten liquidity.

(ii) Prospects

Growth in the East Asian economies will decelerate further in 1990, reflecting in part a slower growth of export demand. The impact of falling external demand will be partially offset by higher domestic consumption in most countries, with the exception of Hong Kong. A strong advance in fixed capital formation, particularly in Singapore and Taiwan Province of China, due to high spending on new housing and infrastructure projects, should help stimulate economic activity. Major efforts to upgrade industrial technology, which have already begun, will continue in the next two years. It is expected that products with a higher value added content will be coming onto the production line. In Singapore, the services sector,

including tourism, will continue to be a major source of growth.

In countries other than the major exporters of manufactures, though export growth will not be as strong as in 1989, overall GDP growth is expected to remain high and to be only marginally lower than in 1989. Sustained foreign direct investment, strong manufacturing output and high personal consumption will continue to fuel growth. Moreover, public spending on infrastructure projects, which had fallen behind schedule in order to avoid crowding-out private sector investment, will be increased. In Thailand, more funds will be allocated for the development of human resources to meet the rapid increase in demand for skilled manpower in some professions. To narrow the income inequality and regional disparities brought about by rapid economic growth in certain countries, such as Indonesia and Thailand, programmes designed to widen employment opportunities and improve the provision of educational and social services in rural areas will be set up. Growth performance in the Philippines will be influenced by the success of policy in reducing imbalances, containing inflationary pressures, and reinforcing business confidence.

(b) South Asia

(i) Recent developments

In South Asia, growth slowed down significantly in 1989, partly reflecting the relatively modest growth of agricultural production in India after an exceptional year that followed two years of drought. GDP growth in India thus fell to an estimated 4.3 per cent, after a rise of 10.6 per cent in 1988. Other factors contributing to slower growth in the sub-region were efforts made to control trade and budget deficits, higher costs of raw materials and industrial inputs, low investment ratios and declining international reserves. In Pakistan manufacturing output was further affected by social unrest, while Bangladesh still suffered from the lagged effect of floods in previous years. Unrest in Sri Lanka continued to depress many sectors, resulting in declines in tea production and manufacturing and reduced revenues from tourism. Although exports from India improved significantly in the last three years, growing by almost 20 per cent in value in 1989 in response to trade incentives and a managed depreciation of the rupee, in other countries export growth weakened as a result of supply disruptions. On the other hand, imports continued to grow moderately in Bangladesh and Pakistan, following liberalization measures, while a sharply reduced growth of imports in India (an increase of only 2.6 per cent in value terms) led to an improvement of $2 billion in the trade deficit. Reducing the large budget deficit, through proper management of revenue, expenditure and debt, remained the main concern of most governments. Reforms in the management of the public sector enterprises and the privatization of State-owned enterprises, accompanied by some liberalization of the banking system to encourage private initiatives, were in an advanced stage of implementation. Incentives to attract foreign investment in some low-cost manufacturing industries have been announced in Bangladesh and Sri Lanka.

(ii) Prospects

Better performance in agriculture is expected during the coming year for most countries, resulting from improved social stability and the implementation of policy measures to encourage investment and diversified cropping patterns. Prospects for food grain output in Bangladesh are encouraging and a good harvest, partly the result of increased irrigation and more widespread use of high-yielding varieties, is expected to result in an overall GDP growth of more than 5 per cent. Industrial production in India should rise in response to stronger domestic demand. Exports are expected to improve only moderately in both India and Pakistan, due to bottlenecks on the supply side, while export growth in Bangladesh should recover rapidly from the relatively low level of 1989 and tea exports from Sri Lanka should revive. Overall prospects are for higher economic growth in most countries, with an increase in rural employment.

(c) West Asia

(i) Recent developments

Because output, exports and public finances in the countries of West Asia depend to a large, though varying, extent on oil, the evolution of oil prices and exports plays an important role in determining the growth performance and financial stability of those countries. For some countries, like those in the Gulf, oil is all-important, since they lack more diversified structures such as exist in Iraq, Egypt and the Syrian Arab Republic. While it

is not an oil-exporting country, Jordan is strongly affected by developments in the oil sector due to the importance of financial flows from the Gulf states, whether in the form of ODA or of workers' remittances.

In 1989, the average price of oil rose to $17.31 per barrel, against $14.28 in 1988, an increase of about 21 per cent.[30] In addition, output by OPEC members significantly increased (by more than 9 per cent), production ceilings having been raised three times during the year.

These developments, together with the improved confidence engendered by the ceasefire in the Gulf area, brought about a further stimulus to economic activity in the region. GDP growth, which had already recovered in 1988 from earlier setbacks following the collapse in oil prices in 1986, accelerated further in 1989, rising to 3.1 per cent, as against 2.9 per cent in the previous year. In both years, however, the Gulf countries registered higher-than-average growth (3.3 per cent and 3.5 per cent in 1988 and 1989, respectively). Growth in 1989 was highest in Kuwait, reflecting essentially a 15 per cent increase in oil production following the quota enlargements of that year. In conjunction with the firming of oil prices, this is thought to have boosted the government budget.[31] In contrast, oil production declined in Saudi Arabia, with consequent lower growth of overall GDP. However, due to the increase in oil prices, export earnings rose, with beneficial effects on the budget deficit. In addition, the deficit has been increasingly contained via non-oil revenues, such as import taxes, or been financed by domestic borrowing. Direct taxation measures were contemplated but later shelved. Public expenditure cuts were made in most areas, the major exceptions being allocations to lending institutions such as the Saudi Fund for Development. It should be noted that the budget deficits of recent years were also financed by the the drawing down of reserves.

Other Gulf countries, such as the United Arab Emirates and Bahrain, witnessed some degree of economic recovery. In the Emirates this resulted largely from an increase in export earnings from oil of about 50 per cent, but there was also a recovery in other sectors, notably in construction, both private and public. Private construction was encouraged by the increase in rents and the availability of cheap financing and public construction by the climate of confidence emanating from firmer oil prices and political stability in the region. While this led to an increase in imports, there was a boom in re-exports, which increased by about 36 per cent, especially from the Emirate of Dubai. Tourism, a relatively recent area of generation of non-oil income, continued to expand, especially in Dubai. Banking activity also recovered; the major banks registered large increases in the pre-tax profits over the 1988 levels, ranging from 10 per cent to 80 per cent. A similar evolution has taken place in Bahrain as a result of oil prices and the ceasefire in the area. There was an expansion in 1989 in the financial and services sectors, whose combined contribution to GDP surpasses that of oil.

The combined growth in 1989 of other countries of the region[32] was somewhat higher than in the previous year, although at 2.4 per cent it remained below the average for the region as a whole. Most of the countries in this group face severe payments problems as a result of reduced external financial flows, especially to Jordan and the Syrian Arab Republic. Growth has also been impeded by security concerns flowing from the failure to resolve the Arab-Israeli conflict and the associated high levels of military expenditure in some countries.

The payments position of Jordan, being dependent to a large extent on external financing and workers' remittances, was adversely affected when aid from Arab countries declined in 1988, largely as a result of the expiration of the aid commitments established at the Baghdad Summit of 1978. The weakening oil market was reflected in a reduced volume of workers' remittances.[33] Consequently, and also because of budgetary problems, the Government was forced to adopt austerity measures, including import cuts, with adverse effects on growth. The worsening external environment exerted pressure on the national currency, which depreciated in 1988 and again in 1989. The devaluation induced an increase in exports

30 This was basically the result of a rise in world consumption and a decline in non-OPEC supplies. While the latter is thought to be part of long-term trend in reserves, it was also caused by the decline in exports from Eastern Europe and by supply interruptions in the North Sea because of accidents.

31 The budget deficit, however, increased in fiscal year 1988 89 (*Middle East Economic Survey*, 5 March 1990) as a result of an increase in wages and salaries and transfers to parastatal agencies. Development spending on non-oil activities declined, indicating the larger role played by the oil sector in 1989. It should be noted that, while the expenditures include transfers to the Reserve Fund for Future Generations, an obligatory payment by the Government, the revenues do not include Kuwait's income from its investment abroad which, in some years, exceeded oil revenues.

32 Iraq, Jordan, (former) Democratic Yemen, Syrian Arab Republic and (former) Yemen.

33 However, there was an initial, once-for-all, jump in remittances to Jordan, as many expatriates were faced with diminished job opportunities and returned home with their savings.

of goods and of non-factor services, especially tourism. In addition, the resultant increase in the domestic currency equivalent of workers' remittances (which actually declined in dollar terms) improved the budgetary position. Recently the Gulf states decided to make deposits on Jordan's behalf in the Arab Monetary Fund equivalent to $300 million, and at the last Arab Summit (Baghdad, May 1990) an aid pledge was made to Jordan according to which $70 million has already been disbursed by Iraq, Kuwait and the United Arab Emirates.[34] Despite these favourable developments and despite the fact that Jordan reached agreements with the Paris and London clubs on the rescheduling of part of its official and commercial debt, Jordan's policy is to depend primarily on domestic sources to finance the deficit, including the imposition of new taxes and increasing the yield from income tax.

Like other oil exporters, Iraq benefited from an improvement in the international oil market in 1989, which contributed to accelerated growth in that year. Iraq has recently been striving to generate additional resources from the non-oil sector in view of the major requirements arising from post-war reconstruction and development and the servicing of its external debt. Among the measures employed to that end have been reduced public expenditures through privatization and the encouragement of investment from other Arab countries and of the repatriation of flight capital through "Imports without foreign exchange allocation". Iraq has been negotiating its debt repayment with its commercial creditors on a bilateral basis and has reached agreements with some of them.

Economic activity slowed down in 1989 in the Syrian Arab Republic, partly as a result of reduced aid from Arab countries on expiry of the Baghdad Summit agreement. The reduced level of aid apparently more than offset the increase in foreign exchange earnings from higher oil prices. Budget revenue has consequently become more dependent on domestic sources. A heavy devaluation in 1988 (by more than 200 per cent) had the effect of increasing the domestic currency receipts for oil, which had become all the more necessary in order to finance higher defence expenditures, which constitute 40 per cent of total budget outlays.

(ii) Prospects

The short-term outlook will continue to depend heavily on developments in the international oil market. Oil prices assume crucial importance for structural and fiscal adjustment since they influence budget receipts directly and also - by raising import capacity and import tax receipts - indirectly.

Oil prices, which started to weaken in January 1990, had fallen to $14.24 per barrel by mid-June, reflecting an excess of supply over demand in the second quarter of the year, amounting to 2-3 million barrels per day.[35] This recently, on 26 July 1990, induced OPEC to reinforce efforts to limit production in order to reach a target price of $21 per barrel. Such efforts have a reasonable prospect of success, since the underlying market developments point to firmer prices in the 1990s. For one thing, while demand for oil has been increasing, world production capacity, as indicated by the level of reserves, has increased little; the required investment for capacity increases has been discouraged by the weak oil market of the 1980s. Secondly, countries where additional reserves are most likely to be found are in the Gulf region, but these countries are beset with budgetary and technical difficulties. In addition, they may deem that the current level of reserves at their disposal is sufficient for medium-term demand. Thirdly, it remains true that the increasing demand will be met initially by non-OPEC sources, with OPEC suppliers acting, as always, as residual suppliers. As no significant discoveries have taken place outside OPEC member countries in the last decade, the demand for OPEC oil will increase, thus contributing to the firming of oil prices.

Be that as it may, in the short run lower production and exports, though helping to make oil prices firmer in the remainder of 1990 and in 1991, may have negative effects on growth unless the increase in price is large enough to bring in higher export revenues. For non-oil exporters, such as Jordan, growth prospects could be less severely affected, as commitments of external finance made to them by Arab donors are likely to ease the burden of adjustment.

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[34] See *Alhayat* (London), 20 June 1990.

[35] *Middle East Economic Survey*, 28 May 1990.

C. China

1. Recent developments

After two years of rapid economic growth averaging 10.6 per cent annually, the Chinese economy experienced a significant slowdown in 1989, when it grew by only 3.9 per cent. This was the result of adjustment policies, initiated in September 1988, to cool down inflationary and balance of payments pressures and to restrain high consumer spending (particularly on consumer durables). Economic strains also emerged following social and political unrest in mid-1989, which provoked widespread confusion in the Chinese economy. Disruptions in the transport system brought about delays in distribution and influenced production unfavourably. A further tightening of macroeconomic policy was enforced when public order was restored. Among the austerity measures taken were: tightening of bank credit and money supply, raising interest rates on savings deposits while at the same time increasing indirect taxes on consumer goods, curtailing government expenditures to lower financial deficits and reducing investment in fixed assets.

Although the rate of inflation eased only slightly for the year as a whole compared with 1988 (17.8 per cent, against 18.5 per cent), the year 1989 began with a very high rate of more than 30 per cent, falling sharply thereafter to only 6.4 per cent by year-end. As inflationary expectations fell, consumption demand slowed and the saving ratio increased rapidly. However, total fixed capital investment declined in volume by 11 per cent, compared with an increase of 18.5 per cent the previous year. Some factories even temporarily stopped production because of lagging demand and/or lack of operating capital. Many rural enterprises closed down because of the austerity policy aimed at rationalizing production and saving on raw materials and energy consumption. Light industries, especially consumer durables, with large inventories, were the most affected. To avoid a further decline in industrial production, additional units of coal and electric power generation were brought onstream and output from these two sectors rose respectively by 6.1 per cent and 6.7 per cent in 1989. Investment in the transport and telecommunication sectors also increased by 3 per cent. Overall, industrial growth decelerated to 8.3 per cent, compared with 20.7 per cent in the previous year.

Thanks to a good harvest and stimulated by higher producer prices and greater availability of inputs, agricultural output rose 3.3 per cent, to reach the highest level since the record crop of 1984 (in spite of an earthquake in the northern part of China). An increase in area cultivated and better irrigation facilities, as a result of increased funds allocated for agriculture, also contributed to this output growth.

The substantial trade deficit in the first half of 1989 ($5.8 billion on the basis of customs data, a level five times that of the same period a year earlier) was reduced considerably in the second half as a result of tighter controls on imports and stimulation of exports. Though tourist earnings fell sharply during the year, by an estimated 20 per cent, the current account deficit widened only marginally (to around $4.2 billion, against $3.94 billion in 1988).

Aware of the approach of the peak period for repayment of foreign debt, while at the same time pursuing the problem of the deficits of State-run enterprises and curbing growing unemployment, the Government revised its priorities for investment, accelerated the modernization of existing industries and devalued the currency by 21.2 per cent against the dollar in December 1989, in order to stimulate production and foreign trade. To improve the investment climate for foreign investors, credits were released for joint ventures and inventories of finished products were bought by the Government. The basic policies adopted for the special economic zones and coastal regions remained unchanged. For example, joint ventures still enjoy exemption from import taxes. Simultaneously, martial law was lifted, a step which may be expected to reinforce implementation of economic policy measures and opening the door to the outside world.

It appears that China is gradually regaining access to international finance. After the World Bank's approval of a $30 million loan in Febuary 1990 for earthquake relief, the first since martial law was declared in June 1989, loans were announced by the United States Export-Import Bank for the Shanghai transport system and for the oil sector. In March, the World Bank approved another loan to

China ($60 million) for the agricultural sector. It is probable that bilateral development lending will be resumed by other developed market-economy countries. Japan has already announced its intention to resume lending. Foreign banks expanded lending to China in the second half of 1989; according to BIS data, outstanding loans rose to $23.0 billion at year-end, from $17.5 billion in June 1989.

2. *Prospects*

With inflation continuing to abate and expected to settle at around 8 per cent for 1990, the strict controls on credit and the money supply were relaxed and interest rates and the volume of lending adjusted in consequence. Consumption is expected to rise more slowly in 1990. Total investment and industrial output are expected to increase, the growth of the latter reaching around 9 per cent. Efforts are being made to improve and accelerate the distribution of raw materials and energy, particularly to large State-owned enterprises, so as to help them meet production quotas of finished goods for delivery to the State. Agricultural production is expected to grow by 4 per cent, following efforts initiated last year. The trade balance is likely to show a sizeable surplus, facilitating debt repayment. In the first half of the year, the trade surplus had already reached $2.5 billion (on the basis of customs data), compared with a deficit of $5.8 billion for the same period a year earlier. Overall prospects for 1990 are for improved economic conditions, with growth of around 5 per cent.

D. Countries of Eastern Europe

1. *Recent developments*

After a modest upswing in 1988, growth in Eastern Europe slowed down in 1989. This result contrasted sharply with the objectives laid down in development targets for 1989, which envisaged some acceleration of economic growth (from 4.0 per cent to 5.1 per cent in the USSR and from 3.1 per cent to 4.5 per cent in the other countries). It has been expected that there would be strong output increases in industry, as well as in agriculture, throughout the area.

However, these expectations failed to materialize and on the whole economic growth in Eastern Europe in 1989 not only decelerated but came to a virtual standstill. This can be attributed primarily to serious economic imbalances, a slowdown in investment, and growing difficulties in the foreign trade sector. In addition, the transition from heavy reliance on central planning has proved to be difficult and painful. In many cases the old administrative system ceased to be sufficiently supportive to ensure a smooth functioning of the economy, while at the same time market incentives and instruments of economic regulation have not yet become fully functional.

Economic performance in 1989 (as measured by NMP) varied among countries, ranging from 1.9 per cent growth in the German Democratic Republic to a fall in output of 2 per cent in Hungary. Negative economic growth of about -0.5 per cent was registered also in Bulgaria. The economies of Poland and (probably) Romania underwent stagnation. Czechoslovakia managed to reach its 1989 output target, although growth was markedly slower than in the previous year.

Available data point to a slight increase in industrial output in Eastern European countries as a whole, with negative growth in Hungary (-3 per cent) and Poland (-2 per cent), virtual stagnation in Bulgaria, Czechoslovakia and (probably) Romania and a modest increase in the German Democratic Republic.

In the USSR the net output of enterprises producing material product[36] increased in 1989 by only 1.5 per cent, reflecting a very low rate of industrial growth (1.7 per cent) and a slight increase in agricultural output (1 per cent). The slowdown was caused primarily by increasing imbalances in the economy, inter-

[36] This statistical indicator was introduced only recently.

ruptions in enterprise-to-enterprise deliveries and losses connected with strikes equivalent to around 7 million man-days. Supply shortages for consumer goods persisted and the situation was complicated by an acceleration of inflation. One of the most serious problems of the Soviet economy has become the huge budget deficit.

A major limitation to the overall economic performance of the countries of Eastern Europe was unsatisfactory agricultural performance, which in general remained well below expectations. In Bulgaria, for example, agricultural production fell by 0.4 per cent from its 1988 level, and in Hungary by 2 per cent. Output probably also declined in Czechoslovakia and Romania. In contrast there was a marked increase in Poland where, *inter alia,* wheat output reached in 1989 a record 8.3 million tons; crop production also rose in the German Democratic Republic.

The foreign trade of Eastern European countries also underwent some unfavourable developments in 1989. In contrast with overall trends in world trade, there was an estimated 1.3 per cent fall in export volume for the region as a whole and a modest increase in the volume of imports. In value terms total exports decreased by some 2.8 per cent, while imports rose by an estimated 2.4 per cent. As a result, the traditional surplus in the overall trade balance turned into a deficit in 1989.

Most of the deterioration in the 1989 deficit for the region as a whole was due to a decline in the trade balance of the USSR. Its terms of trade with other Eastern European countries deteriorated, but this was partly offset by an improvement vis-à-vis the rest of the world, so that its overall terms of trade worsened only slightly, in contrast to 1988, when a fall of 7.8 per cent was recorded. Both the volume and the value of Soviet exports declined in 1989. However, the fall in the volume of fuel exported, due largely to domestic supply problems, was more than compensated by the rise of world oil prices, at least on Western markets. The growth of the value of exports to the developed market economies was thus maintained at the 1988 level. Exports to developing countries rose slightly in value, but were virtually unchanged in volume. The value of exports to other Eastern European countries continued to fall, for the third consecutive year.

On the other hand, USSR import growth, both in volume and in value, was rather pronounced. With the exception of trade with other Eastern European countries, where import growth remained at the 1988 level, the value of imports rose impressively. The liberalization of imports and the transition to direct links at the enterprise level was partly responsible for this growth. On the other hand, there were also important imports of consumer goods by the State.

Some important changes were also recorded in the geographical distribution of the region's trade. Intraregional trade, which was predominant in these countries' overall trade turnover in previous years, experienced a second successive year of decline and accounted for the bulk of the general decline in trade turnover.

2. *Prospects*

The fundamental political transformations presently taking place in Eastern European countries are being accompanied by efforts to introduce market features into their economies. This process is complex and difficult and raises a host of fundamental questions. A first question is with regard to the end result to be sought. Should it be a market economy organized strictly along laissez faire lines or a mixed economy in which the State retains major production responsibilities but a small, though strategic, part of the economy is governed by the free market? Or should it be any of the innumerable possibilities that lie in between? A second question concerns the optimal pace of change, and the resultant length of the transition period. A third, inevitably linked to the first two, is how to mitigate the short-term social costs of reform. A final issue, less fundamental but nevertheless important, is what role CMEA can play in the process.

The process of transition to market economies will undoubtedly be rather long and painful. Its duration and social consequences will be different for each country depending on the size and structure of the economy and the current economic situation, as well as on the scope, sequence and proposed pace of the reforms. Developments in the world economy will also be of considerable importance in this context.

A successful transition to a market economy requires fundamental changes to be made in economic structure, including new economic legislation, demonopolization and the decentralization of property rights, as well as, for example, substantial changes in the banking and financial sectors. Even where Eastern European countries successfully carry out macroeconomic stabilization programmes over

Box 5

ECONOMIC TRANSITION IN HUNGARY

Hungary was the first of the Eastern European countries to experiment with market-oriented economic reforms, its starting point dating back to more than 20 years ago. However, until the late 1980s, the process of reform, which had been gradual, was aimed at the improvement of the existing system of planning and management and at integrating market elements into the traditional centrally planned system. As a result, few real market conditions were created: despite some liberalization of policy as regards the private sector, its development was limited on the whole to consumer services. There was no real competition between the state and private sectors in industry, and state enterprises, though freed from many central controls, were protected from external and internal competition through state-controlled prices. The State also continued to exercise tight control over foreign trade operations, with adverse effects on the external competitiveness of Hungarian products.

However, in the last two years the reform process has sharply accelerated. Enactment on 1 January 1989 of a new Law on Economic Associations marked a turning point in the pace of transition to a market economy. This law abolished restrictions on the variety of company types (company limited by shares, limited liability companies, etc.), and also recognized state and co-operative property, private property and foreign capital as partners of equal standing in economic associations. Simultaneously, the foreign trade monopoly of the State was eliminated and foreign trading activity became the substantive right of each and every economic actor. Such activity was radically liberalized with regard to both exports and imports of a wide range of commodities.

The creation of the legal and institutional basis for the new economic structure will continue through 1990. Further liberalization of imports and the establishment of an institutional framework for the reform of ownership are expected. Also envisaged in connection with the further restructuring of the Hungarian economy is the creation of a stock exchange, modification of the legal system to regulate competition, the continued liberalization of prices and reform of the tax system.

While coping with the creation of an appropriate institutional infrastructure, Hungary faces the equally difficult problem of creating an adequately functioning competitive environment for producers. Further, while moving in this direction, the viability of the economy must be maintained and the grave internal and external disequilibriums kept within manageable proportions.

The Hungarian concept of restructuring has at its centre a programme of privatization supported by an important inflow of foreign capital. The privatization prospects are still unclear - in the sense that the extent of privatization conducive to improvement in efficiency and increased competitiveness of the Hungarian economy cannot be identified in advance.

It is considered, however, that the process itself will take some 6-10 years, and as a result the private sector will become predominant in the economy. (At present the State owns about 92 per cent of the assets in the economy.) Some doubts also concern the scope of foreign capital involvement. The experience is somewhat contradictory: despite some successful takeovers of Hungarian enterprises by western companies or the setting up of various forms of joint venture, many attempts to involve western capital in privatization have failed.

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the next year or so, structural problems will persist for many years. Radical changes in economic relations will almost certainly entail the risk of recession, steep rises in prices and unemployment. Thus the process of transition to properly functioning market economies could be a lengthy process.

Most Eastern European countries are entering the transition period with common macroeconomic problems: inflation, budget deficits, structural desequilibrium and external indebtedness. However, the scale and the acuteness of these problems varies, so that ways and means of overcoming the problems may differ significantly from country to country (see boxes 5 and 6 for a discussion of the experience of Hungary and Poland).

The state of implementation of the programmes of economic reform varies considerably among Eastern European countries. While Hungary and Poland may be said to be furthest advanced, the approaches of their

Box 6

ECONOMIC TRANSITION IN POLAND

The Polish approach to the establishment of a market economy differs from the Hungarian one, most significantly in respect of the intended pace of change. The starting point for economic reform is, in many respects, less favourable than in Hungary: internal problems are more pronounced and the problem of external indebtedness is more acute. The new Polish Government has decided to carry out simultaneously both radical structural adjustment and a programme of economic stabilization designed to stem inflation and eliminate the budget deficit through so-called "shock therapy" treatment. During the first phase of reform, until the middle of 1990, the objective is to slow down inflation and stabilize prices within socially acceptable limits, as well as to strengthen the national currency (zloty). The second, and longer phase deals with structural adjustment, including privatization of industry, transport and trade.

Two major elements of the programme are total deregulation of prices and a freeze of wages. It should be noted that such policy measures had been attempted in Poland in the past, but the liberalization of prices was limited and was not accompanied by wage restraint, so that the result was even higher inflation.

Initial success in the implementation of Poland's macroeconomic stabilization programme has been achieved. During January 1990, the first month of implementation of a new programme, prices rose on average by 90 per cent, but in February by 4 per cent. Nevertheless, the price rise during the first phase was 45 per cent higher than expected. It was accompanied by a decrease in consumption and real wage levels, though there was a noticeable improvement in the supply of consumer goods. Progress towards some important macroeconomic goals is already evident in the following areas: stabilization of the internal market; alleviation of the budget deficit; internal convertibility of national currency; establishment of a unified and relatively stable exchange rate without recourse to credits from a special stabilization fund, set up by a number of developed western countries.

Thus the process of rehabilitation of the Polish economy is moving in the intended direction, though sometimes more slowly than envisaged. Certain problems have emerged, however. For example, production continued to decline - by as much as 30 per cent in the first quarter 1990 as compared to the same period of 1989. Many small and medium-sized enterprises have been closed. Consumer demand for many products also declined and many manufactured goods could not find markets. The structural reorganization of the Polish economy has not yet been initiated. The first encouraging signs of recovery in the consumer market cannot overshadow the imbalances in the capital goods, financial and labour markets.

Unemployment is another growing concern. In February 1990 more than 100,000 persons were registered as unemployed (more than 0.6 per cent of the economically active population), as compared to around 10,000 in December 1989. According to some estimates, the level of unemployment in Poland may reach 400,000 in the near future, and several million in the long-term.

Privatization represents the second and a longer phase of the Polish programme of economic reforms. The specificity of the Polish case can be related to a relatively high proportion of private property already existing in agriculture, trade and transport. A large-scale privatization of industrial enterprises is now proposed.

The programme of privatization, as in Hungary, faces many problems. Firstly, a revision of more than 100 laws is necessary to legalize the process. Secondly, the Polish Government understands privatization primarily in the sense of increasing the number of private companies and not of transferring existing public sector firms to the private sector. Finally, the extent of the overall progress in privatization is not yet very clear. However, the associated political decisions have proved to be difficult in view of the current social situation in the country.

Governments with regard to the objectives, scope and pace of these programmes differ notably (see respective boxes). In the USSR, though the Government's strategy for the transition to a regulated market economy has been made public, market reforms have not really started. The discussions in the Supreme Soviet (the main legislative body) revealed not only differing opinions on how to make the transition to a market economy, but also contradictory concepts of the nature of market relations. Attention was drawn to differences

between the principles of a market economy declared by the government programme and the system of measures envisaged so far for their implementation. Vastly different views as to the best ways of achieving the proposed goals also emerged during the discussions. Final adoption of the programme is scheduled for autumn 1990.

The schedule of reforms in countries other than Hungary, Poland and the USSR has yet to be fully defined, though parliamentary elections due in these countries during the course of 1990 will certainly speed up the process of their formulation.

The more or less inevitable short-term consequence of all these restructuring measures will be economic recession. For example, for Hungary, and despite the fact that it is already well engaged in the process of reform, the most optimistic scenario (given the present pace of reforms and the evolution of the political situation) indicates that the country may overcome these restructuring problems and return to positive growth by 1992. As regards Poland, it should be noted that the programme of a rapid transition to a market economy will also almost certainly lead to a decline in output. Input constraints in the state sector (imports and labour), especially in manufacturing, will significantly influence overall performance. The projected expansion of the private sector is likely to be insufficient to offset the decline of net output in the state sector for at least two years. Steep declines in rates of capacity utilization, already noted in 1989, will continue in 1990. In addition, more difficult financing conditions are expected to result in a fall in agricultural output. While overall recovery can eventually be expected, it is unlikely, even on the most optimistic assumptions that output will exceed 1988 levels before 1992.

Given the extremely difficult economic situation in the USSR at the beginning of 1990 and the fall in the values of the main economic indicators, the overall economic prospects of the country are uncertain and difficult to quantify. Negative growth rates are in prospect no matter what the assumption about the pace and nature of the reforms. The preservation of the present system of economic management without any serious effort at reform could lead, according to some estimates, to a decline of NMP not only in 1990 but also for several subsequent years; the adoption of radical reforms could even aggravate the situation during the first stage of implementation. Of course, much will depend on how fast the government programme is implemented, on the further development of its legal basis and on the internal political situation. The most likely short-term prospect, taking into account the actual economic situation and the scale of the changes proposed, is for recession over the next few years. The question is how long this recession will last and how deep it will be. The Government expects to adjust the economic structure to a market-oriented basis within two years, in which case a resumption of growth may be envisaged in 1993.

The future of CMEA is of crucial importance for the foreign trade prospects of its member countries. The intensification and different pace of economic reforms in Eastern Europe have made inevitable radical changes in the nature of their mutual economic relations. Much will therefore depend on the ability of CMEA to adapt to the systemic changes taking place in the individual countries. It is evident that bilateral trade commitments at the level of the State, based on more or less co-ordinated plans, will have to give way to links at the enterprise level. The introduction of market relations involves the design and harmonization of new tariff and non-tariff regulations, creation of genuine multilateral payments arrangements, development of regional banks and harmonization of codes of conduct at the sectoral level, among other things. Attempts to create a free trade zone within Eastern Europe do not necessarily contradict the process of wider European co-operation within the framework of a European Economic Space (which is discussed in section A of the following chapter).

At the same time, the real problem lies in the unevenness of the reform process in different countries as well as in institutional inertia. The institutional setting of CMEA needs to be rapidly transformed so that it can be effectively used as a multilateral body adopting "new rules of the game" in foreign economic relations of its member countries and as a watchdog for their implementation. The transition to the use of convertible currencies as a means of payment among Eastern European countries, through its strong disciplinary impact, may actually bring about trade contraction in the region in the short run.

However, the necessity of expanding trade may eventually drive countries into a more active use of national currencies in their mutual settlements, bringing about partial convertibility at the regional level. This will probably be implemented in the context of multilateral arrangements based on realistic exchange rates. Ultimately, all depends on the credibility of national economic policies pursued, including the transition to a market economy, fiscal, monetary and financial reforms, elimination of internal monetary overhang, and improvement in the supply and

quality of goods to satisfy pent-up internal demand.

A gradual liberalization of payments arrangements, supervised by the central banks, could facilitate the development of trade and co-operation in the region. Should there be persistent monetary disturbances in these countries a financial mechanism could be devised in support of multilateral exchanges among CMEA countries, as a transitional solution, until such time as it became possible to put in place a lasting multilateral payments agreement among Eastern European countries as a first step towards full national currency convertibility.

The creation of a free trade area among Eastern European countries, accompanied by a steep, once-and-for-all devaluation of their national currencies (vis-à-vis hard currencies) could exert a strong stimulus on the flow of investment and "know-how" into the region and considerably improve productive capacities, provided that the transition towards market mechanisms is successfully implemented.

Moreover, the strong trade links of the German Democratic Republic with the USSR and other Eastern European countries could lay the ground for expansion of economic links between East and West after unification with the Federal Republic, which would be to the benefit of the international economy even though it could have a contractionary impact on intra-CMEA trade in the short or even medium term.

Taking into account the above, the short-term outlook for the external economic relations of the Eastern European countries is hardly encouraging. The persistence of the problems in trade within CMEA is very likely, and it is thus probable that almost all the indicators of foreign trade will fall.

In the Soviet Union the deterioration of the trade balance will probably continue at least for the next two years. A significant increase in imports of consumer goods is likely, linked with the overall programme of social reorientation. As regards exports, the supply difficulties for oil that were experienced in 1989 seem likely to continue, with a consequent further fall in the volume of oil exports. The pace of domestic production during the second half of 1989 and first months of 1990 does not give much hope that exports, in general, will expand this year. Similarly, significant declines in domestic output of a number of key inputs will not allow savings to be made in imports of such inputs in favour of continued higher imports of food and other consumer goods.

In Hungary, unless demand is compressed, the liberalization of imports can be expected to lead to a further deterioration of the balance of payments, thus compounding the present difficulties. Another matter of concern, which could seriously influence the overall performance of the Hungarian economy in the short run, is the unfavourable prospects for trade within the CMEA framework. For example, traditionally the exports of Hungarian engineering products are oriented to the Soviet market. (In some Eastern European countries sales to that market represent more than 50 per cent of production.) A substantial surplus in trade with the Soviet Union (in transferable roubles) has been created in recent years which many observers associate with the underpricing of Soviet raw materials exports and/or overpricing of Hungarian machinery exports. If this is indeed the case, it may be corrected in the near future - for example, by the expected transition in trade relations within CMEA to convertible currencies and world prices. Either way, the terms of trade of Hungary in its trade with the USSR would deteriorate, perhaps substantially. In addition, a drop in the demand for investment goods in the USSR has already caused a reduction in the volume of Hungarian exports, which may well continue.

Export deliveries in Poland will most probably follow the declining trend in general economic activity. Total exports may well stagnate or even fall in 1990 and only return to former levels by 1992. The projected increased scope of foreign financing of imports of investment goods will lead to a further deterioration of trade and current account balances, which could take more than five years to overcome.

E. Developed market-economy countries

Expansion in the developed market economies, which had shown remarkable convergence and stability in recent years as compared to the early 1980s, has begun to show some divergent trends. While in North America and in the United Kingdom the pace of economic expansion slackened noticeably in the second half of 1989, the buoyant growth in continental Europe and Japan appears to be continuing virtually unabated (see chart 3). Europe has

become one of the most dynamic regions of the world economy as attention is increasingly focused on the completion of the single EEC market[37] and economic and political restructuring proceeds in Eastern Europe.

Chart 3

REAL GROSS DOMESTIC PRODUCT AND CONSUMER PRICES IN MAJOR DEVELOPED MARKET-ECONOMY COUNTRIES, 1980-1988

(Percentage rate of growth)

Source: Data of OECD.

In most developed market-economy countries there was a slight increase in the rate of inflation in 1989: typically, the rise in the rate of increase in prices (as measured by the GDP deflator) was about 1 percentage point. However, the firm stance of monetary authorities seems to have succeeded in keeping price increases within acceptable bounds. The price of oil, which rose in 1989 by about 21 per cent, weakened in the first half of 1990, but a renewed firming in the second half of the year cannot be ruled out. Overall, non-oil primary commodity prices are expected to remain virtually unchanged in the short term.[38] The anticipated gradual slowdown in demand may also ease somewhat inflationary pressures stemming from unusually high rates of capacity utilization and growing shortages of skilled labour. While inflation is not expected to accelerate, monetary authorities are likely to maintain their cautious policy stance. The global trend towards liberalization of capital markets has left them with the difficult task of pursuing domestic policy objectives while at the same time trying to avoid unwanted exchange rate movements induced in part by changes in interest rates in major partner countries.[39]

Fiscal policies are expected to contribute to a further budgetary consolidation in most OECD countries (with certain important exceptions). Moreover, there are indications that in the medium term the overall improvement in the political climate will lead to reductions in military expenditures in both East and West which should alleviate budget deficits and/or release resources for other priority needs. In the Federal Republic of Germany, however, the costs involved in the unification process will probably increase the budget deficit, in spite of probable increases in revenues due to buoyant growth.

In the United States, monetary policy eased slightly in the second half of 1989 as preliminary figures indicated a slowing down of the economy. Output growth in the first quarter of 1990 was estimated at 2.1 per cent, up from 1.1 per cent in the last quarter of 1989. There is still some uncertainty about the strength of the economy and the balance of inflationary and deflationary forces operating on it. There continues to be a need to reduce the budget deficit, which exceeded the target for fiscal year 1989 of $136 billion (by $16 billion) due to outlays associated with the thrift rescue legislation of August. While the bail-out of the savings and loan institutions is expected to put some strain on the budget, since mid-1990 the executive and legislative branches have been attempting to reach an understanding on a fiscal package, containing measures to both increase revenue and to decrease expenditure, significantly reducing the budget deficit. Should a credible understanding emerge, there

37 The potential impact of the completion of the single EEC market is discussed in box 7 below.

38 For further details see chap. I above, sect. B.4.

39 For a more detailed discussion see chap. I, sect. C, and Part Two, chap. II.

Box 7

A SINGLE EEC MARKET: ITS IMPACT ON GROWTH AND WELFARE

Although internal tariffs and quantitative restrictions within EEC were already eliminated in 1968, intra-Community trade was still hampered by many obstacles including fiscal and regulatory ones. The new integration effort aiming at the removal of these remaining barriers has received considerable impetus during recent years. To achieve the single market legislation based on 279 directives that will govern intra-Community movements of goods, services, capital, and labour will be enacted. The purpose of the directives will be to eliminate border controls, promote capital mobility and access to government procurement as well as to increase intra-Community competition.

It is an indication of the recent momentum for integration that by June 1989, over half of the 279 directives had been approved by the Council. Progress has been most rapid in the area of technical harmonization and standardization of industrial products. Much, however, remains to be done in the harmonization of indirect taxation, a particularly difficult hurdle. In the meantime, at the Madrid Summit of June 1989 the Council also decided to launch the first stage of the Economic and Monetary Union by the middle of 1990, although full monetary integration is not part of the 1992 project.

What will be the likely consequences for growth and welfare? Recent research, including a detailed analysis undertaken for the Commission of the European Communities, [1] and subsequent reactions to it, as well as other independent work, has afforded elements of an answer. Needless to say, the task of analyzing and estimating the likely effects is a complex one. Schematically, gains in welfare could arise directly from the lowering of costs associated with the abolition of existing barriers such as border delays, differences in product standards, and restrictive public procurement practices. Integration will thus probably have a large impact in industries with a significant share of public procurement, which very often favours domestic sources of supply, as in telecommunications equipment and energy production plants. The impact will probably also be more pronounced in industries operating under national regulations of industrial standards such as pharmaceuticals and electrical appliances. The resulting lower costs and prices will benefit both consumers and producers. Indirectly, welfare is raised through the exploitation of economies of scale in an enlarged market. Scale effects may vary significantly across industries. They are expected to be substantial in heavy electrical equipment or transport equipment (other than cars) but much less in sectors such as petroleum. It is also expected that improved competition within the Community will lead to the reduction or elimination of monopoly profits and other forms of inefficiency that arise when there is a lack of competitive pressures and firms operate below their optimum level, thus benefiting consumption and stimulating exports. But estimates of the likely order of magnitude of the resulting increase in welfare are subject to wide margins of uncertainty. *A priori*, such estimates are by nature very sensitive to both the methodology used and the underlying assumptions concerning the extent of the implementation of the programme. The ideal situation is one in which all the directives are implemented and the internal market is a truly integrated one where production takes place at the lowest cost and intra-Community price differences reflect only differences in transport costs. The most optimistic estimates of the gains from integration also assume that all economies of scale will be realized. Departures from any of these conditions necessarily lead to very different estimates of the potential welfare gains.

All in all, given the existing structure of the member countries' economies, available estimates suggest that gains in welfare for the Community [2] can be broken down as follows: gains of about the same order of magnitude would come from the removal of internal barriers affecting Community trade and production and from more optimum exploitation of economies of scale; somewhat lower gains would come from enhanced competition within the Community. According to estimates by the Commission of the European Communities, the sum of these gains might amount to some 4.3 - 6.4 per cent of GNP. These are strictly static gains and are believed by some quarters to be too optimistic; but it has also been suggested that in a dynamic context, improved efficiency will also result in higher return to capital and thus higher rates of investment and faster growth, thus leading to gains larger than those estimated by the Commission.

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1 *Research on the "Cost of Non-Europe"* (known as the Cecchini report), a massive body of analysis, the main findings of which are summarized in Paolo Cecchini, *The European Challenge 1992. The Benefits of a Single Market* (Aldershot, Wildwood House, 1988).

2 For an analysis of the impact on trade with the rest of the world and, in particular, the trade of the developing countries, see Part One, chap. III.

is a strong presumption that monetary policy would ease - at least somewhat. Long-term interest rates in the United States are now lower than in the Federal Republic of Germany and the differential with Japan has narrowed significantly in the last 12 months. An easing of monetary policy would confirm these trends and create a different configuration of short term interest rates. The outcome could be an increase in investment demand, a further weakening of the dollar in exchange markets, and some strengthening in net exports, leading to an improvement in internal and external imbalances in a context of relative price stability and continued growth. Whether such a benign scenario will in fact emerge depends in part on the skill with which monetary policy is executed. But it also depends critically on investment responding more forcefully to a reduction in interest rates than to the cutbacks in aggregate demand implied by the budget correction. There is also an assumption that the expansion of investment and net exports will together roughly offset the contractionary impact of deficit reduction.

Japan continues on an expansionary path driven by strong domestic demand led by both business fixed investment and private consumption. The weakness of the yen and increasing inflationary expectations have forced the Bank of Japan to more than double its official discount rate during the 12-month period ending in March 1990, so that it now stands at 5.25 per cent. A further increase, in order to underpin the yen and avoid overheating the economy, cannot be excluded. There is a growing feeling that the employment situation is tightening, with unemployment in March 1990 at 2.2 per cent of the labour force.[40] Fixed investment is rising in both the manufacturing and the non-manufacturing sectors in response to capacity constraints. High employment will keep disposable income high and consumer demand is expected to grow at about the same rate as in 1989. Housing investment remains strong. In value terms, exports were flat in the fiscal year ending in March 1990, while imports rose by 15 per cent, reducing the trade surplus by 31 per cent. GDP growth is expected to be well above 4 per cent in 1990.

In Western Europe preparations for the single EEC market continue to stimulate investment, much of which is destined for modernization and rationalization, and increasingly also for capacity expansion to help relieve production constraints, in anticipation of increased sales. Capacity utilization rates are higher than in previous peak periods in many countries and a lack of skilled manpower is increasingly being felt. Industrial production is therefore expected to maintain the high rates of increase achieved in the last two years. Private consumption has remained buoyant, especially in Italy and Spain, and is expected to pick up in the Federal Republic of Germany, as the employment situation continues to improve. While exports from continental Western Europe to North America and the United Kingdom are likely to slacken due to slower growth in those countries, trade among the continental countries continues to grow vigorously. Developments in the economies of the countries of Eastern Europe have provided a further stimulus to trade, though in the short-term the effect will be limited, since Eastern Europe accounts at present for only a small fraction of Western European exports. However, the huge capital requirements for financing the transition and restructuring of the Eastern European economies will put some strain on capital markets and leave little room for a lowering of interest rates in the short and medium term. In addition, a shortage of foreign exchange will tend to restrain any sudden surge in import demand in Eastern Europe. A redirection of exports to hard currency countries from currently dominant intra-CMEA trade will take some time as contractual obligations are fulfilled and as product quality and supply is adapted to world markets.

In the Federal Republic of Germany growth in 1989 largely exceeded earlier expectations, while the rate of inflation was less than 3 per cent. Following buoyant growth in domestic demand, capacity utilization in manufacturing reached very high levels in 1989. The unemployment rate in May 1990 fell to well below 7 per cent, despite the large influx of immigrants from the German Democratic Republic and other Eastern European countries.[41] Private consumption should provide the main stimulus to domestic demand in 1990. Orders for housing construction in the first quarter of 1990 exceeded those of the corresponding quarter of the previous year by 26 per cent in real terms. Imports continued to grow strongly, reflecting increasing capacity constraints. In contrast, export growth has slowed down, due to weaker demand in the United States and the United Kingdom. However, an increase in demand from Eastern European countries may partly compensate, although the

[40] The ratio of job offers to job seekers is, at 1.37, the highest for over a decade. See *National Institute Economic Review*, No. 2, 1990, p. 34.

[41] In 1989 720,900 immigrants arrived in the Federal Republic of Germany, i.e. an increase of 1.2 per cent in population. See ECE, *Economic Survey of Europe in 1989-1990* (United Nations publication, Sales No. E.90.II.E.1), footnote 76.

full potential of this source of demand is likely to be realized only in the medium term. The record trade surplus of DM 135 billion in 1989 is expected to fall slightly in 1990. Interest rates are likely to remain firm as the Bundesbank is expected to maintain its strongly anti-inflationary stance, particularly in the light of the monetary union with the German Democratic Republic which came into force in July. The discussions and negotiations preceding the introduction of the monetary union had already led to expectations of higher inflation and to a rise in interest rates in the Federal Republic in the last quarter of 1990. So far, however, there has been no further rise in interest rates. Indications are that inflation will not accelerate significantly in 1990. However, given the monetary union and the prospective unification of the two countries, much will depend on the time and cost involved in revitalizing and modernizing the productive capacity of the German Democratic Republic.[42]

Stable and co-ordinated policy formulation and implementation in the EEC countries participating in the European Monetary System have resulted in converging rates of growth of output and of inflation in recent years. As a consequence, no major realignment of currencies has taken place since 1987. Especially noteworthy is the relative strength of the French franc and the Italian lira, which has enabled both countries to advance the liberalization of their capital markets, initially planned for July 1990. In the United Kingdom the monetary authorities were forced to maintain relatively high interest rates to fight persistent inflationary pressures and to prevent a further fall in the exchange rate (in 1989 sterling fell by about 10 per cent vis-à-vis the ECU). Economic indicators of the last few months suggest that the economy is starting to cool down, though less than expected.

Trade imbalances among EEC countries remained large and are not expected to undergo much change in the near future. The surplus of the Federal Republic of Germany is unlikely to fall significantly in 1990, while the large deficits of the other major EEC countries are not expected to contract much. Hence, the position for the Community as a whole is expected to remain close to balance.

F. Current uncertainties and the prospects for developing countries

Of primary importance in the 1990s to the development of the world economy in general and the developing countries in particular are the major events currently taking place in both Western and Eastern Europe, the effects of which are still in the process of working themselves out. The completion of the single EEC market in 1992 not only has the potential of bringing about once-for-all gains to the Community and its member States but also, and more importantly, will have major implications for the rest of the world. Potential benefits arising from higher income and imports or lower inflation with the Community may be offset by protectionist barriers. The effects on developing countries, however, have not been taken into consideration in the various studies undertaken by the Commission of the European Communities.[43]

For countries in Eastern Europe, the consequences of the transition to a market economy will depend greatly on the strategy adopted, and especially on the speed of transition - slow and gradual, as intended in the case of Hungary, or fast and radical, as intended in Poland. It is likely that the newly created market economies will turn to developing

[42] The situation in the German Democratic Republic is unique in that the restructuring of its economy will follow the principles of the social market economy system of the Federal Republic of Germany. Like other Eastern European countries, the country faces serious systemic problems due to outdated production structures and output product mix, both of which were accentuated after monetary union. In addition, certain sectors such as construction suffered from severe losses of manpower. For example, the construction industry lost more than 6 per cent of its work force in 1989. Consumer goods industries find it hard to sell their products, now that goods from Western countries are so easily available. In the transition period prospects are for unemployment to rise sharply as unprofitable enterprises are closed down or rationalized.

[43] See, in this connection, Part One, chap. III.

countries to meet their needs for consumer goods, with a consequent increase in their trade with such countries.

With regard to development finance, there is concern that assistance to Eastern European countries may well be at the expense of flows to developing countries. On the other hand, the scaling down of military expenditures which seems likely in the present political climate may release additional resources for development finance.

The primary purpose of this section is to explore alternative long-term growth prospects for developing countries in the light of new policy initiatives or changes in the nature of international finance and trade linkages. The approach is based on the UNCTAD secretariat's System of Interlinked Global Modelling and Analysis (SIGMA), briefly described in box 8). The simulations involve assumptions which reflect the effects of specific policy measures. In order to facilitate comparison of the results of the various scenarios, a baseline scenario is first constructed. Certain assumptions of the baseline scenario are then modified, and the results of each set of modifications are compared with those of the base run. Finally, the assumptions of the various runs are combined into a single scenario to provide an overall picture of the prospects for developing countries in the 1990s under generally optimistic conditions.

1. The baseline scenario

A baseline scenario is normally carried out under the assumption that there are no significant changes in current trends, policy measures, or major behavioural relationships, and is intended to serve as a reference basis for evaluating situations where such changes are assumed to have taken place. Thus, it is assumed that rates of growth of labour productivity will be the same in the 1990s as in the 1980s for the developed market economies. Combining this assumption with a predicted slowing in the rate of growth of the working age population (partly compensated by somewhat increased participation rates) implies that the developed market economies would grow by about 2.7 per cent per annum over the rest of the decade as a whole, compared to 2.9 per cent for the 1980s.

Similarly, no radical changes are assumed in the area of international finance. Recent performance of donor Governments is projected to continue for the 1990s and no new private lending is assumed to be forthcoming for currently indebted countries. Nevertheless, the baseline scenario assumes that outstanding debt will be repaid as scheduled. The one-year LIBOR rate is forecast to be the United States dollar inflation rate plus the average real rate of growth of the developed market economies plus 1.5 percentage points, i.e. about 8.7 per cent.

Bilateral trade is assumed to be governed by estimated trade shares which prevailed at the end of the 1980s and prices of internationally traded foods are assumed to increase only modestly, at about 3.3 per cent per annum.

Results of the baseline scenario for the various groupings of developing countries are summarized in table 23. As can be seen from the table, the prospects for developing countries are bleak. For the developing countries as a whole, given that population is projected to grow at 2.3 per cent per annum during the 1990s, per capita income would rise by only 1.3 per cent. While for Asian developing countries per capita income would grow by 2.4 per cent per annum, the corresponding rate would be merely 0.7 per cent for Latin America and -0.7 per cent for Africa. For the least developed countries taken together, per capita income is expected to be practically stagnant during the decade.

For Latin America, one key underlying assumption in the baseline scenario is that there will be no new net private lending in the 1990s, whereas interest payments will continue to be made. The absence of new net private lending accounts for the relatively slow income growth as well as for much of the decline in the debt and interest payments ratios during 1991-2000. For Africa, as for Latin America, adopted structural adjustment policies and debt initiatives have so far failed to eliminate the debt overhang. In fact, since the emergence of the debt problem in Africa in 1982, debt ratios, and until quite recently also debt service ratios, have continued to rise, particularly for the low-income countries of the region. These ratios are projected to decline in the 1990s but at the expense of a relatively stagnant per capita income.

2. Assumptions of alternative scenarios

In modifying the assumptions of the baseline scenario, consideration has been given

Box 8

A SYSTEM FOR INTERLINKED GLOBAL MODELLING AND ANALYSIS

The UNCTAD secretariat's System for Interlinked Global Modelling and Analysis (SIGMA) [1] is used to support its global macroeconomic analysis, including both short-term forecasts and long-term projections. The system consists of macroeconomic models for 58 countries and sub-regional aggregates linked together via various modules for international prices, trade and financial flows, in a manner which ensures that the global balances are internally consistent. For purposes of bilateral linkages the individual modules are organized into 15 regional blocks. For long-term projections a set of 15 regional macroeconomic models take over from the country-based forecasting models, while the rest of the system remains the same.

International dollar price indices by SITC groups are computed on the basis of detailed forecasts of international prices for individual commodities. The country and regional trade price indices are then compiled using country- and region-specific weights. The export prices are then passed through the relevant trade matrices to derive regional import prices by SITC groups. By the same token, regional export volumes are derived by applying the commodity-specific bilateral import share matrices to the regional imports. The capital-flows module controls the allocation of various forms of international capital flows: ODA (grants and loans), other official flows, private long-term financial flows, direct investment and short-term flows.

The regional macroeconomic models are essentially neoclassical, two-gap growth models designed to capture the interaction between the internal and external constraints facing developing economies. Their function is to determine import demand and output consistent with domestic consumption, export demand and external financial flows from the rest of the world.

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1 An earlier version of SIGMA was described in the annex to the UNCTAD secretariat's "Scenarios of Growth, Trade, Finance and Debt: A Technical Note" (UNCTAD/ST/MFD/5), Geneva, 19 June 1987, pp. 18-22.

mostly to parameters which are external to the national economies of developing countries. The importance of domestic policies, however, should not be overlooked. Most developing countries will still need to carry out policy reforms and structural adjustments geared to raising productive efficiency, especially those with relatively high population growth. And because of the debt overhang, some countries may be forced to rely more on domestic savings and foreign direct investment for financing domestic investment projects.

The modifications of the assumptions of the baseline scenario are described below. It should be noted that, in practice, it is not always possible to adopt policies which affect a specific set of parameters without at the same time directly changing the value of others.

Eight alternative scenarios have been constructed (A-H). In scenario A, the rate of income growth in each OECD member country is assumed to accelerate by 0.5 per cent per year during 1992-2000 over the baseline scenario. Such a situation could arise from various policies which, independently or in response to the process of market integration within EEC, result in productivity gains, higher investment or employment rates or greater efficiency in resource utilization, including a more effective co-ordination of policies among OECD countries. Although higher rates of income growth are the underlying objectives of most policies, they are not generally specified as policy targets *per se*.

Scenario B shows what happens when exports of developing countries are assumed to expand more rapidly than those of developed market economies. In the base run, for each major SITC group, exports of each region are derived by applying the import margin of a bilateral trade flow matrix to a bilateral import-share matrix which has been assumed to be constant. In the modified run, bilateral trade flows originating from developing countries for each SITC group during 1992-2000 are set to increase by 1 per cent over the previous year before they are normalized to become import shares. The implicit weighting scheme is thus in favour of trade flows which have a more-than-average market share. In any case, the resulting exports of each region would also be dependent on the affected import margins.

The case of higher domestic saving rates is given by scenario C. Since savings are de-

Table 23

BASELINE PROJECTIONS OF GDP GROWTH, DEBT SERVICE AND EXTERNAL BALANCES OF DEVELOPING COUNTRIES

(Per cent)

	1990		*2000*
All developing countries			
GDP growth [a]	—	3.6	—
Debt/exports	106.4		58.0
Interest payments/exports	7.4		3.4
Current account balance/exports	-4.2		-5.4
Latin America			
GDP growth [a]	----	2.6	—
Debt/exports	222.9		73.9
Interest payments/exports	19.2		5.8
Current-account balance/exports	-4.5		-5.8
Africa			
GDP growth [a]	—	2.4	—
Debt/exports	320.7		194.2
Interest payments/exports	17.3		9.4
Current account balance/exports	-28.6		-18.8
Asia			
GDP growth [a]	—	4.5	—
Debt/exports	45.5		38.8
Interest payments/exports	2.8		2.2
Current account balance/exports	-1.1		-3.8
Memo item:			
Least developed countries			
GDP growth [a]	—	2.9	—
Debt/exports	460.3		363.0
Interest payments/exports	11.4		8.4
Current-account balance/exports	-68.4		-54.4

Source: UNCTAD secretariat calculations, based on SIGMA projections.
a Average annual rate for 1991-2000.

rived as a residual in SIGMA, the exercise is carried out by compressing consumption in all developing countries, except for those in Asia which are oil-dominant or major Eurocurrency borrowers. Specifically, it is assumed that both private and public consumption are reduced by 5 per cent as compared to baseline levels. In terms of policy, the purpose is to increase the level of savings available for investment, preferably through greater mobilization of domestic resources or other means rather than by an absolute reduction in either private or government consumption.

In scenario D, the assumptions of scenario B are applied to the countries of Eastern Europe as a group. Since the shares of developing countries in the exports and imports of the region are small relatively to those of intra-regional trade and trade with Western Europe, exports of the region are assumed to grow at 2 per cent, instead of 1 per cent, in order to make the effects on developing countries more evident. Since this amounts to increasing the share of Eastern Europe in the imports of all trade partners, the developing countries may be adversely affected in terms of their current account balance and income growth.

The effect of a 2-percentage point reduction in international interest rates (LIBOR) is given in scenario E. The determination of

interest rates is greatly influenced by such factors as rates of inflation and the extent of budget deficits and trade imbalances.

In scenario F, official development assistance (ODA) to developing countries is increased by doubling the parameters which define the proportion of donor income assigned as such flows to recipient regions on a bilateral or multilateral basis.[44] The major ODA donors are the developed market-economy countries and the members of OPEC. There is room for improvement in donor performance, since the target of 0.7 per cent of GNP has yet to be achieved.

Scenario G reflects the proposal in *TDR 1988*,[45] of writing off 30 per cent of the commercial debt of some of the most heavily indebted countries, which was considered to be the minimum necessary to enable those countries to break out of their foreign exchange constraints. The present exercise, however, is limited to seven of the 15 most heavily indebted countries covered by the original proposal.[46] The write-off is assumed to apply to the debt outstanding at the beginning of 1992.

Finally, all the above assumptions, with the exception of those of scenario D, are combined into a single run to give scenario H.

Scenarios A to G, unlike scenario H, are in the nature of a proper sensitivity analysis. In addition, with the exception of scenario D, each is selected to incorporate assumptions which appear to be realistic in terms of policy. They are also interdependent in the sense that the realization of a given scenario may well be dependent on that of another. Crucial to scenario H, for example, is the attainment of an effective solution, implicit in the debt write-off scenario G, to the problems of debt overhang. Given the appropriate political will and international co-ordination, however, the projected growth for developing countries under scenario H should be attainable.

3. Analysis of results

The results of the various simulations are presented in table 24. In analysing the results, it is essential to keep the following considerations in mind:

- Changing the initial conditions implicit in the baseline scenario may have a significant impact on the results obtained for alternative scenarios;
- The impact arising from changes in parameter values should not be assumed to be linear. In other words, doubling the value of a given parameter does not necessarily imply that its effect on a given variable will be correspondingly doubled;
- Similarly, the effects of individual sensitivity runs may not be cumulative when they are combined into a single run, as in scenario H;
- The figures in the table have been derived as *algebraic increments* from the corresponding values of the variables in the baseline scenario, in order to facilitate the comparison of results of the various scenarios. Thus, the figure of 1.5 for the current account to exports ratio under scenario A for all developing countries indicates that the value of the ratio has increased from -5.4 per cent in the base run to -3.9 per cent in the year 2000;
- Since population growth is projected exogenously in the system, what is shown in the table as the difference in the rate of income growth between a given run and the base run is for all practical purposes the same as that in terms of the difference in per capita income.

As can be seen from the table, the effects of different scenarios vary from region to region. As a whole, however, the effects of changes in assumptions which are of a financial or monetary nature seem to be more localized than those which affect real variables. The effects of debt write-offs, for example, are largely confined to the countries directly affected by the exercise, viz. Latin America in scenario G. The apparent dramatic and immediate impact may be attributed to the debt structure specific to Latin America, as well as to the fact that commercial loans generally carry fairly high interest rates and short repayment periods. For similar reasons, the region which benefits least from a reduction in LIBOR is Asia (scenario

44 Excluded from SIGMA computations are technical assistance flows.

45 Part One, chap. IV, sect. C.

46 These seven countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela) constitute an entire regional entity in SIGMA. The eight excluded countries are Bolivia, Côte d'Ivoire, Ecuador, Morocco, Nigeria, Philippines, Uruguay and Yugoslavia. Including these eight countries in the exercise would have meant writing off the debt of all other countries in the regions to which they belong since debt data have been aggregated to the regional level in SIGMA.

Table 24

ALTERNATIVE PROJECTIONS OF GDP GROWTH, DEBT SERVICE AND EXTERNAL BALANCES OF DEVELOPING COUNTRIES

(Increment over baseline scenario, in percentage points) [a]

	Scenario [b]							
	A	*B*	*C*	*D*	*E*	*F*	*G*	*H*
All developing countries								
GDP growth	0.2	0.2	0.4	0.0	0.1	0.2	0.0	1.2
Debt/exports	-6.6	-9.5	2.2	2.2	3.1	8.1	-3.9	-8.1
Interest payments/exports	-0.2	-0.5	0.2	0.2	-0.3	0.2	-0.3	-1.0
Current account balance/exports	1.5	2.3	-0.5	-0.5	-0.5	-2.3	0.4	0.8
Latin America								
GDP growth	0.0	0.0	0.7	0.0	0.0	0.1	-0.1	0.8
Debt/exports	-6.6	-8.4	1.0	1.9	0.5	4.4	-20.3	-25.0
Interest payments/exports	-0.4	-0.6	0.0	0.1	-0.7	0.0	-1.8	-2.6
Current account balance/exports	1.2	1.5	-0.2	-0.4	0.0	-1.5	1.8	1.5
Africa								
GDP growth	0.1	0.3	0.5	-0.1	0.2	0.6	0.0	1.8
Debt/exports	-12.5	-16.5	1.2	6.2	1.2	41.5	0.0	11.2
Interest payments/exports	-0.4	-0.8	0.0	0.3	-1.2	0.8	0.0	-1.3
Current account balance/exports	0.7	1.6	-0.1	-0.6	-0.1	-14.3	0.0	-10.7
Asia								
GDP growth	0.3	0.4	0.1	0.0	0.0	0.2	0.0	1.3
Debt/exports	-5.6	-8.8	2.7	2.2	3.9	5.4	0.1	-5.2
Interest payments/exports	-0.3	-0.6	0.1	0.1	-0.2	0.1	0.0	-0.7
Current account balance/exports	1.6	2.6	-0.7	-0.6	-0.7	-1.3	0.0	1.8
Memo item:								
Least developed countries								
GDP growth	0.3	0.2	0.5	0.0	0.0	1.8	0.0	2.7
Debt/exports	-28.4	-33.3	4.6	7.0	2.5	133.9	0.1	64.2
Interest payments/exports	-0.6	-0.8	0.1	0.2	-0.3	3.0	0.0	1.2
Current account balance/exports	3.1	5.5	-0.8	-1.2	-0.4	-47.5	0.0	-34.5

Source: UNCTAD secretariat calculations, based on SIGMA projections.

a Algebraic increments over corresponding values of the baseline scenario (table 23). Figures for GDP growth are average annual rates for 1991-2000, while those for other variables refer to the year 2000.

b Briefly, the various scenarios are as follows: A - higher OECD income growth; B - increased exports of developing countries; C - higher domestic savings rate in developing countries; D - increased exports of Eastern European countries; E - lower LIBOR; F - increased ODA flows; G - write-off of commercial debt for major borrowers in Latin America; H - A to C and E to G combined. See text for a more detailed explanation.

E). Increased ODA flows to developing countries, on the other hand, have a greater impact on the LDCs or Africa than on Latin America (scenario F).

In contrast, the effects of accelerated income growth in OECD countries (scenario A), an increased trade share of developing countries (scenario B), or higher domestic savings rates in most developing countries (scenario C) are more widespread, in terms of both geographical regions and key macroeconomic variables within a region. As may be expected, increased exports from Eastern Europe (scenario D) have a negative impact on developing countries.

The results show quite clearly that, in the absence of appropriate policies to mobilize savings, to stimulate investment or to reverse capital flight, even a substantial reduction in debt cannot be expected to have a significant impact on income growth in the long run. In the context of the baseline scenario, the immediate and direct impact of a debt reduction is to raise the level of import demand in all SITC categories, not all of which are destined for production. With the subsequent increase in income, there is a corresponding increase in consumption, as specified in the consumption functions for both the private and the government sector. The same argument also explains why the results of scenarios E and F are not as significant as might have been expected.

The results when the assumptions in scenarios A to C and E to G are combined into a single simulation run are given by scenario H. For developing countries as a whole, the average annual rate of income growth during the 1990s, with an increase of 1.2 percentage points over the base run, amounts to 4.8 per cent, or 2.4 per cent in per capita terms. Underlying this average, however, are considerable regional discrepancies. For each regional grouping, the gain in income growth is higher than in any individual scenario. For both Africa and the LDCs, there is also a notable increase in the debt to exports ratio over the base run but considerably less than in the case of scenario F. For Latin America, there are significant improvements in terms of the other indicators.

Implicit in scenario H is a positive annual average rate of growth in per capita income in the 1990s for all individual regions (3.6 per cent for Asia, 2.6 per cent for the LDCs, 1.4 per cent for Latin America and 1.0 per cent for Africa).

Apparently, general policy measures which benefit developing countries as a whole bring only limited benefits to the African region in general and to certain particular countries of the region. Besides greater debt relief and official development assistance, these countries require international initiatives specific to their situation, including perhaps measures to strengthen the commodity markets, which are crucial to their national economies.■

Annex to Chapter II

THE LEGACY OF THE 1980s: COEXISTENCE OF DECLINE AND GROWTH

During the past decade many developing countries have been subjected to repeated adverse external shocks, the immediate effects of which were to disrupt the normal functioning of their economies. In addition, consequent falls in investment activity depleted productive capacity and jeopardized longer-run development prospects. The following paragraphs briefly review the development record of the past decade and the changes in the external environment which were so instrumental in its shaping. It is argued that the adverse shocks and resulting disparities in individual countries' economic performance have already contributed to a large extent to shaping the pattern of their development in the years to come.

A. Widening disparities in the economic performance of developing countries

1. *Patterns of per capita income*

Average per capita income in the developed market-economy countries has grown steadily at an annual rate of over 2 per cent over the last two decades. In contrast, it has fallen in the developing countries during most of the 1980s. As a result, the absolute income gap between the two groups of countries increased by over $1,900 (in 1980 prices) during the first eight years of the 1980s (see table A-1).[47] In relative terms, per capita income in developing countries fell from 9.2 per cent of that in developed market-economy countries in 1980 to 7.7 per cent in 1988, the last year for which reasonably complete information exists.

However, while the disparity in per capita incomes became significantly more pronounced in the 1980s, the picture among developing countries themselves is considerably more complex. Indeed, disparities in per capita income among the major developing country regions actually narrowed over the 1980s. With the exception of the poorer countries of Africa, this was the result of large falls in per capita income in regions with relatively high incomes and of significant increases in per capita income in some regions with relatively low initial levels.

In certain regions the declines in per capita income were dramatic. For example, in sub-Saharan Africa during the first eight years of the 1980s the decline amounted to about twice the income gains accumulated during the preceding 10 years. If Nigeria is excluded, the fall was ten times as great. At the same time, in West Asia and North Africa the income gains of the 1970s were more or less wiped out during 1980-1988. The fall in per capita income in Latin America was also substantial, since by 1988 income was more than 8 per cent below the 1980 level. Furthermore, in many cases the reductions in income fell particularly harshly on the poorer sections of the population. In many debtor countries, especially those in Latin America, weak or declining real output growth was compounded by accelerating inflation, which further eroded the purchasing power of wage earners.

[47] This compares with an increase in the gap of more than $1,800 during the decade of the 1970s.

Table A-1

PER CAPITA INCOME IN DEVELOPED MARKET-ECONOMY COUNTRIES AND DEVELOPING COUNTRIES, 1970-1988

(In 1980 dollars)

	1980	*1970-1980*	*1980-1988*
Region	*Level*	*Increment*	
DMECs	10183	2037	1904
Developing countries	937	232	-8
of which.			
Latin America	2245	561	-189
North Africa	1259	133	-141
Other Africa (including Nigeria)	549	52	-96
(excluding Nigeria)	394	-3	-25
West Asia	2893	712	-704
South Asia	232	24	75
East Asia	919	388	351

Source: UNCTAD secretariat calculations, based on national and international sources.

All these losses stood in sharp contrast to the steady and large increases in per capita income in East Asian countries, where the average annual gains during 1980-1988 even exceeded those recorded during the preceding decade. Per capita income in South Asia also rose significantly during the 1980s, though its level still remained below that of other developing regions.

2. *Patterns of growth*

While the fall in per capita income of developing countries over the 1980s was substantial, in addition there is a serious risk that the unequal pattern of income growth among developing countries established in the 1980s could persist in the years to come. In fact, the recent recovery in the world economy concealed the fact that improvements in growth performance were recorded mainly in those countries which had also done well during the recession years; those whose performance was poorest during the recession also by and large were the poorest performers during the recovery.

This point may be illustrated by comparing the growth performance of different countries during recession and during recovery. To this end, the growth in per capita income of a sample of 61 developing countries for which consistent data were available was compiled for two periods, 1980-1983 and 1983-1988. The first period was broadly one of recession, with an uneven recovery in the final year, and the second was one of more sustained recovery. As can be seen from table A-2, very low or negative per capita GDP growth rates predominated during the recession years. For two thirds of the countries in the sample growth was either negative (averaging -3.5 per cent annually) or very low (0.5 per cent). The remaining countries were evenly divided between those with moderate growth rates (averaging 1.9 per cent annually) and those with high rates (5.8 per cent on average).

Significantly, this growth pattern did not change substantially in the subsequent recovery years. Thus, of the 37 countries with negative per capita income growth rates during the recession, 20 continued to register declines during the recovery, while the growth of per capita income in the other 17 remained very modest, averaging less than 1.5 per cent annually. Furthermore, among those countries having either poor or moderate per capita growth in

Table A-2

PER CAPITA GDP GROWTH IN DEVELOPING COUNTRIES, 1980-1988

(Annual percentage change)

		Number of countries	*Average rate* [a]
Countries with negative growth in 1980-1983		37	-3.5
of which in 1983-1988:			
Growth performance:	- unchanged	20	-2.1
	- improved	17	1.4
Countries with poor growth performance in 1980-1983 [b]		3	0.5
of which in 1983-1988;			
Growth performance:	- deteriorated	2	-1.2
	- unchanged	1	0.9
	- improved	-	-
Countries with moderate growth performance in 1980-1983 [c]		11	1.9
of which in 1983-1988:			
Growth performance:	- deteriorated	7	-2.1
	- unchanged	2	1.6
	- improved	2	4.4
Countries with high growth performance in 1980-1983 [d]		10	5.8
of which in 1983-1988:			
Growth performance:	- unchanged	6	5.7
	- deteriorated	4	0.5

Source: UNCTAD secretariat calculations, based on national and international sources.
a Arithmetic average of growth rates for respective country groups.
b Per capita growth between 0 and 1 per cent per year.
c Per capita growth between 1 and 3 per cent per year.
d Per capita growth over 3 per cent per year.

1980-1983, the number of those experiencing deteriorating or unchanged performance outnumbered those showing improvements during 1983-1988. In fact, many countries in this group actually recorded declining per capita income during 1983-1988. Finally, there were also six countries in the sample which consistently recorded high per capita growth rates (over 5.7 per cent on average) during 1980-1988.

3. *The external environment and growth*

It is worth emphasizing that, notwithstanding the above results, at the start of the 1980s the world economy went through one of the most protracted recessions in recent history. World industrial production fell steadily during those years, and the external environment facing developing countries deteriorated generally as well (see table A-3). Economic growth in the developed market-economy countries came to a virtual halt during 1980-1982; the volume of world trade actually declined, after a period of rapid expansion during the second half of the 1970s. Primary commodity prices dropped by about 6 per cent annually on average from 1979 to 1982; the declines were particularly sharp during 1981 and 1982, when prices fell on average 20 per cent in each year. Prices of manufactures exports also fell in dollar terms, but by much less, and thus the terms of trade turned sharply against primary exporters. As

Table A-3

SELECTED GLOBAL ECONOMIC INDICATORS, 1975-1989

(Annual percentage change) [a]

Indicator	*1975-1977*	*1978-1979*	*1980-1982*	*1983-1986*	*1987 1989*	*1980-1989*
World trade	8.1	5.4	-0.7	4.8	6.9	4.1
Real GDP growth in DMECs	4.3	3.9	0.9	3.4	3.8	2.9
LIBOR	6.2	10.5	14.8	9.0	8.2	10.5
Primary commodity prices	3.6	6.6	-6.1	-1.6	6.3	-3.4
			Developing countries			
Terms of trade:						
All developing countries	1.4	2.0	10.1	-9.1	0.5	-3.6
Oil exporters	2.5	4.7	19.5	-17.8	0.0	-6.8
Others	-3.1	-4.3	-2.4	-1.4	-0.4	-1.7
Exports						
Value	16.5	21.1	5.0	-3.9	15.0	1.3
Volume	10.0	2.4	-6.5	4.7	7.5	3.2
Imports						
Volume	9.3	2.3	9.4	-4.1	9.7	3.1

Source: UNCTAD secretariat calculations, based on national and international sources.
a Except for LIBOR (average annual rate).

a consequence, the purchasing power of the exports of the majority of the primary exporters in Latin America and Africa declined steeply during 1980-1982. The deterioration in the terms of trade also contributed to reducing the pace of output growth in many primary exporters during these years (see section B.2 below). For many oil-exporting developing countries the adverse terms of trade of their non-oil exports and the reduced export volumes more than offset the increases in earnings from oil. At the same time, the pervasive high inflationary pressures in the developed market-economy countries gave rise to widespread adoption of deflationary policies in these countries. In particular, the restrictive monetary policy pursued by the United States resulted in sharp increases in interest rates. For example, LIBOR averaged almost 15 per cent during 1980-1982, i.e. more than double the 1975-1977 average (see table A-3).[48] Furthermore, the increases in interest payments on external debt were accompanied by generalized declines in financial flows from both the private banking sector and other sources.

That these developments had a severe negative impact on growth in developing countries could hardly be a surprise. What emerges from the comparison made in the preceding sub-section, however, is that many developing countries seem to have been bogged down in very sluggish growth, a condition which has persisted even during years of economic recovery in the developed market-economy countries. It is true that adverse factors other than the deteriorating external environment were also at work during the decade. In particular, towards the middle of the decade African countries suffered one of the most severe periods of drought in recent history and growth in many countries in the region suffered in consequence. Nevertheless, for developing countries in general domestic conditions did not improve

48 It has been calculated that excess interest payments due to the higher rates prevailing during 1980-1982 accounted for between one third and one half of total interest payments of developing countries in 1982. See *TDR 1985*, Part Two, chap. II, sects. B and C.

and, in some important respects, the external environment even worsened following the onset of economic recovery in the developed market-economy countries.

Cumulatively, the external shocks of the early 1980s were reflected most dramatically in the sudden doubling of the major debtor countries' external payments deficits to $50 billion in 1981.[49] Because of the sharp reduction in external financial flows debtor countries were forced to adjust mainly through heavy compression of their imports, since in the early years of the crisis efforts to expand exports were made difficult by the slow pace of output growth in the developed market-economy countries. While market penetration potential existed for their exports of manufactures to those countries, it was also much reduced because of the high levels of unemployment and the prevailing pressures for protectionism. In the event, debtor countries' imports would have declined even more abruptly had they not continued to be financed by continued debt accumulation in some instances. However, as debt service became heavier and external financing became more scarce, imports had to be reduced, with consequent reductions in the external payments deficits of many countries.[50]

With the onset of the recovery in the developed market-economy countries toward the end of 1982 export performance of the developing countries also improved. However, due to the uneven character of this economic recovery, significant increases in export earnings accrued to only a handful of exporters. Since the boost in aggregate demand occurred mainly in the United States, where the strong recovery gave rise to a large upsurge in import demand for manufactures,[51] demand for primary products remained weak, and in spite of the brief rise in 1983 their prices still stood some 30 per cent lower than the 1980 average. As a result, between 1980 and 1984 the losses in earnings of major primary non-oil commodities exported by the developing countries amounted to as much as $55 billion.[52] The lack of significant response of commodity prices during the recovery owed much to the continued sluggish demand growth in Western Europe, an important market for many primary commodities exported by the developing countries. Furthermore, due to the disparate policy stances pursued by the developed market-economy countries, their unequal demand expansion during the early phase of the recovery led to a noticeable increase in the instability of market growth facing the developing countries during 1983-1984.[53]

Market conditions facing primary exports continued to worsen along with what turned out to be the longest economic expansion in the developed market-economy countries in the post-war period. As inflationary pressures in these countries became less pronounced their real output growth rates also became less divergent, mainly because of the marked deceleration in the United States. In fact, activity in Western Europe remained basically very sluggish well into 1987. However, while interest rates dropped in both 1985 and 1986, the terms of trade of non-oil commodities fell steadily and by 1987 had reached their lowest levels since the Great Depression; those of oil fell below their 1974 levels due to the price collapse in 1986.[54] As a consequence, many oil exporters joined the ranks of those having acute external payments problems and some of them were forced by their worsened external payments positions to reduce drastically domestic activity through restrictive policies.[55] The losses incurred by developing countries on account of these adverse terms of trade tended to offset, in some instances by large margins, the savings on interest payments thanks to the lower rates. Interest rates, however, resumed their climb in 1987 and by the end of the 1980s LIBOR averaged 8.2 per cent, i.e. not much lower than the 1983-1986 average of 9 per cent (see table A-3).

The consequences of the external shocks on real activity, especially in the highly indebted developing countries, have been docu-

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49 For the developing countries taken together the payments surplus of $26 billion in 1980 turned into a deficit of $84 billion in 1982. The deterioration affected all major country groups but reflected in particular the virtual disappearance of the large surplus of West Asia during the latter year.

50 The reduced import demand on the part of developing countries, especially those in Latin America, had significantly postponed the recovery in the United States. It also exacerbated the external payments problem of this country during the 1980s.

51 For details see *TDR 1984*, Part I, chap. II.

52 See *TDR 1986*, table 13, p. 46. It should also be noted that the steady declines in primary commodity prices contributed to ease considerably inflationary pressures in the developed countries during these years.

53 *Ibid.* chap. III, sect. A.

54 The terms of trade of developing countries deteriorated by some 20 per cent in 1986, as both oil and non-oil export prices fell sharply. The losses in income due to these adverse terms of trade amounted to about $80 billion and thus wiped out any gain in GDP growth recorded during the year.

55 As a result, Mexico's real GDP, for example, declined by 4 per cent in 1986.

mented in detail in past issues of the *TDR*. One of the more visible consequences was that real output growth rates started to diverge noticeably in the early 1980s. This divergence in growth performance did not come about because the traditional fast growers had become more dynamic but because the reverses suffered by others were so severe, in particular as activity in many countries was increasingly affected by debt service difficulties. Many debtors which had been obliged to reschedule their debt servicing were also faced with the task of reducing their external payments deficits. With a slow-growing world export market and depressed export prices, the reductions in the external deficits necessarily entailed sharp reductions in imports, which in turn impinged severely on growth performance. Deflationary policies were also adopted in many other developing countries and government outlays, including development spending, were reduced. Output forgone was particularly large in Latin America, in both 1982 and 1983, after a year of stagnation in 1980. Thus, even hitherto fast-growing economies such as Brazil, with its dynamic manufactures export sector, experienced declines in production during these years. In sub-Saharan Africa drought further compounded the difficulties already faced by many debtor countries on account of both reduced export earnings and higher debt service payments. The very unfavourable terms of trade facing primary exports also tended to have a direct impact on activity in many countries in the region, particularly in 1982 (see section B.2 below). Output losses in the region were thus even more pronounced and of more extended duration.

However, even during the worst years of the crisis, economic activity was on the whole well sustained in the larger developing economies, especially those in South Asia. Indeed, because of the size and diversity of their economies they emerged virtually unscathed. As these countries also enjoyed relatively lighter debt burdens, their growth performance remained much more steady than that of most other developing countries, notwithstanding occasional setbacks in the agricultural sector due to bad weather. For different reasons, the exporters of manufactures in East Asia also fared relatively well during these years. These countries had already for some time been transforming their production structure in favour of products with fast growing world demand. With only a short interruption toward the middle of the decade because of stagnation in export market growth, they enjoyed much better growth performance than other developing countries. During the years of weakening foreign sales various countercyclical measures were adopted to bolster aggregate demand, especially during 1986: in the Republic of Korea and Taiwan Province of China government budgets provided for increased public investment, while in other countries interest rates were lowered or tax cuts were effected (as in Singapore). Subsequently, fuelled by accelerating exports, real growth resumed in the region and domestic activity was further sustained by capacity expansion in response to renewed export buoyancy. Since the currencies of many countries in the region were pegged to the dollar, the strengthening of the yen, especially toward the end of 1985, also contributed to improving the competitive positions of exporters of industrial products, in particular the Republic of Korea and Taiwan Province of China, vis-à-vis Japan. Their conspicuous success, however, stimulated a reaction by their trading partners, especially the United States.[56] Subsequent currency appreciations, but also rising domestic costs, sharply eroded their competitive edge, with a consequent weakening of export performance. Meanwhile, industrial output in some traditional primary exporters revived rapidly, as Japanese firms relocated to the region in order to overcome the handicap of an appreciating yen.[57]

All in all, the growth pattern of the developing countries did not undergo any marked change toward the end of the decade. In East Asia output growth appears to have settled to a more sustainable, albeit still relative high, pace following diminishing reliance on the export sector. On the other hand, recent growth performance of some major debtors has suffered seriously from setbacks to their stabilization efforts.[58] As inflation in many of these countries had also accelerated dramatically, the twin targets of containing inflationary pressures and improving the external payments positions continued to be their major preoccupation.

56 Since 1 January 1989, the major exporters of manufactures in East Asia no longer qualify for benefits under the GSP scheme of the United States.

57 Of late, some other major developing exporters of manufactures have also invested substantially in these countries (see section B.3 below).

58 In particular, there was a marked deceleration of real output growth in Brazil and also, to a lesser extent, Argentina in 1987.

Because of the disorder engendered by the acute imbalances in their economies many debtor countries, especially those in Latin America, were unable to translate the recent buoyancy of their external sector into satisfactory domestic expansion.[59] Per capita income continued its decline in many African countries. There is therefore a risk that, on present trends, the unequal growth pattern of the past decade, during which a great many countries saw their living standards decline steadily, while prosperity was the preserve of but a very few, could become entrenched in the years to come. Many factors point to the possiblity of such an outcome. First, available evidence indicates that because investment activity in many developing countries was very low throughout the 1980s, their productive capacity has on the whole become inadequate for accelerating growth. Second, activity in many countries with a high degree of dependence on primary exports, especially those in Africa, has continued to suffer from very depressed export prices. For example, the prices of tropical foodstuffs continued to weaken even during the recent short boom in primary exports. Meanwhile, through the relocation of productive plants and related activity, the buoyancy of activity in the traditional exporters of manufactures in East Asia has been spreading to the neighbouring countries as well, thus setting the stage for continuous dynamic expansion in the region. The following paragraphs take up these issues.

B. The legacy for development: negative systemic reinforcement

1. *The insufficient expansion of productive capacity*

Available data show that there were significant declines in investment in a large number of developing countries during the crisis years. As may be seen from table A-4, in 31 developing countries (of the sample of 61 for which consistent data could be compiled - i.e. those covered by table A-2) the volume of investment during 1981-1983 was on average 14 per cent lower than in 1980. Moreover, in most of these countries it continued to decline even during the recovery years. In fact, in all but five of these countries it remained in 1983-1988 about one third lower than in 1980. Twelve of the highly indebted countries figure prominently in this group (Argentina, Bolivia, Brazil, Chile, Côte d'Ivoire, Ecuador, Mexico, Nigeria, Philippines, Uruguay, Venezuela, and Yugoslavia). In contrast, real investment expanded substantially in a number of the remaining countries of the sample, most notably in the steadily growing economies of South and East Asia, where it rose steadily during both 1981-1983 and 1983-1988.

It was inevitable that investment should have fallen so steadily in the problem countries during the 1980s, since foremost among the factors accounting for their poor economic performance, especially as regards investment, was the extent to which their imports had been compressed because of balance of payments constraints.

A priori, it is to be expected that sharp reductions in imports will seriously affect economic performance in most developing countries. Since imports in these countries largely constitute inputs for production or consist of capital goods for investment, the steady expansion of the economy requires that such imports be in adequate supply. Indeed, the scope for compressing imports without harmful effects on activity was very narrow, since the possibilities of import substitution were very limited in many countries, especially the low-income ones.[60] As a consequence, economic activity suffered most in countries where possibilities for internal adjustment to import reductions were very limited. Growth prospects were particularly jeopardized where the import cuts (most notably in Latin America) affected mainly capital goods in order to sustain imports of inputs for current production. At the onset of the crisis efforts

59 For a discussion of macroeconomic disorder in the developing countries, see *TDR 1989,* Part One, chap. IV.

60 Nevertheless, in many countries efforts were also made to reduce dependence on food and petroleum imports.

Table A-4

REAL INVESTMENT IN DEVELOPING COUNTRIES, 1980-1988

(Index numbers, 1980=100)

		Number of countries	Average index [a]
Countries with declining investment from 1981 to 1983		31	86
of which from 1983 to 1988:			
Investment:	- declined	26	68
	- increased	5	111
Countries with moderate increases in investment from 1981 to 1983 [b]		20	110
of which from 1983 to 1988:			
Investment levels:	- declined	6	90
	- unchanged	4	109
	- increased	10	139
Countries with significant increases in investment from 1981 to 1983 [c]		10	150
of which from 1983 to 1988:			
Investment:	- increased or unchanged	5	205
	- declined	5	113

Source: UNCTAD secretariat calculations, based on national and international sources.
a Arithmetic average for the respective country groups in the relevant period.
b Not exceeding 25 per cent.
c Over 25 per cent.

were made by many countries to maintain imports at required levels, especially through external financing, but they proved to be short-lived in view of the mounting cost of debt service. At the same time, countries sought to increase the volume of their exports in order to finance necessary imports, but in view of the low price elasticity of their primary exports, this often resulted in lower prices. Furthermore, efforts to diversify primary exports towards more profitable items or towards those with potentially faster world demand growth were handicapped by the shortage of foreign exchange for the purchase of the required inputs for these diversification programmes as well as by barriers in the developed market-economy countries to the entry of new products. Consequently, such efforts proved successful only among the larger economies, which already had relatively diversified export sectors.[61] On the other hand, the scope for increasing exports through reductions in domestic expenditure on consumption were limited in countries where the domestic consumption goods were mostly not tradeable in world markets. In any event, even when successful, export expansion did not always ease the investment constraint since the higher export proceeds often had to be devoted to increased debt servicing.

Moreover, the purchasing power of these exports was eroded by the steady deterioration in the terms of trade of primary products during the 1980s. As a consequence, in many countries, especially the highly indebted ones, rapid expansion of export volumes went hand-in-hand with large and increasing outflows of resources. As may be seen from table A-5, in 47 developing countries (of the same sample of 61) export volumes increased on average by 27 per cent between 1980-1983 and 1983-1988, but in 32 out of those countries there was also an increase in the ratio of net transfers abroad to exports, on average as high as 27.6 per cent between these periods.[62] In other words, in many developing countries whatever increase in

61 See *TDR 1986*, chap. III, sect. A .

62 Net transfers are defined as the difference between net capital inflows (including transfers) and net factor service payments and are equivalent to the balance on goods and non-factor services. The concept implies that a country's excess of factor payments (including interest payments on external debt) over net capital inflows must be covered by a corresponding surplus from the trade account.

Table A-5

DEVELOPING COUNTRIES: CHANGE IN EXPORT PERFORMANCE AND NET TRANSFER OF RESOURCES FROM 1980-1983 TO 1983-1988

		Number of countries	Average change (per cent) [a]
Countries with improved export performance		47	27.5 [b]
of which:			
Net transfer:	- increased outflow	32	-27.6 [c]
	- increased inflow	15	15.3 [c]
Countries with deteriorating export performance		14	-14.5 [b]
of which:			
Net transfer:	- increased outflow	6	-11.3 [c]
	- increased inflow	8	61.9 [c]

Source: UNCTAD secretariat calculations, based on national and international sources.
a Arithmetic average for respective country groups.
b Change in export volume.
c Change in the ratio of net transfers to exports.

earnings resulted from attempts to increase the volume of exports was drained away by transfers abroad, a situation typical of debtor countries with significant increases in interest payments. It should also be noted that large positive net transfers (mostly ODA) have benefited a small number of countries, comprising many least developed countries, with particularly weak export performance in the post-recovery period (see table A-5). Especially because of sharply reduced imports in countries with debt service problems the import performance of developing countries varied greatly in the early 1980s. In particular, there were significant reductions in import volumes in Brazil and Argentina, as well as in African countries with debt service difficulties. The poor prospects for oil exports also led to sharp import curtailments in both Venezuela and Mexico. Available data show that this process of import compression continued almost unabated in many debtor countries throughout the 1980s. Elsewhere, on the contrary, although import growth showed some temporary slackening, it remained on the whole relatively strong, especially in East Asia.

The incidence of import compression on real investment during the recovery period (1983-1988) is illustrated in table A-6. Declines in import/GDP ratios between 1980-1983 and 1983-1988 were recorded in 48 developing countries in the sample (of 61 countries). The great majority (37) of these countries also recorded declines in their investment/GDP ratios during these years. On the other hand, investment/GDP ratios rose in 8 of the 13 developing countries in which the ratio of imports to GDP also improved.

The worsening in investment performance in the developing countries took place amid indications of widespread improvements in savings ratios. This came about because of the large net outward transfers of resources, a process already described earlier. In this context it should be noted that since net transfers are made up of flows which are beyond the control of the developing countries themselves, the extent to which domestic savings are actually available for investment is largely governed by exogenous decisions and conditions.[63] The disparity between savings and investment performance is illustrated in table A-7. Among the 39 countries in the sample which recorded an improvement in the savings ratio between

[63] This is because investment is equal to the sum of net transfer and domestic saving; net transfers, on the other hand, are made up of net capital flows and of net factor payments. But except for capital flight, the net capital flows were largely beyond the control of the developing countries in the years following the onset of the debt crisis and net factor payments consisted mainly of interest payments on the external debt. For a detailed analysis see, Edmar L. Bacha, *op.cit.* (see box 3).

Table A-6

IMPORTS AND INVESTMENT IN DEVELOPING COUNTRIES: CHANGE FROM 1980-1983 TO 1983-1988

		Number of countries	Average change (per cent) [a]
Countries with increased import ratios		13	2.7
of which:			
Investment ratio:	- increased	8	2.6
	- decreased	5	-4.1
Countries with decreased import ratios		48	-4.0
of which:			
Investment ratio:	- increased	11	1.7
	- decreased	37	-5.2

Source: UNCTAD secretariat calculations, based on national and international sources.
a Average change for respective country groups (expressed as a percentage of GDP).

1980-1983 and 1983-1988 as many as 26 also experienced a drop in the investment ratios during these years.[64] Many others, however, including six of the highly indebted countries, witnessed a decline, including 6 of the highly indebted countries.[65] Developing countries in Latin America were among those most affected by the long recession in investment activity. Investment has been particularly unstable in the region during recent years and also slowed down considerably in 1988 as net capital inflows almost disappeared during the year and debtor countries in the region continued to rely on their trade surpluses, or international reserves, to meet their debt payments.[66]

2. *Terms of trade and economic activity*

While economic activity in the short run is influenced by many factors, in many developing primary exporters it is also highly vulnerable to bad weather because of the preponderance of the agricultural sector. In particular, the serious drought affecting African countries in the mid-1980s was reflected most indelibly in their growth record during those years. Moreover, primary exports, of both agricultural raw materials and metals, also appear to be vulnerable to large variations in the terms of trade. As changes in these terms affect the real incomes of individuals, the profitability of production and government budgets they also influence expenditures and thus domestic activity.[67] Often, however, the effects of changes in the terms of trade are outweighed by other factors, as happens, for example, when the price changes are small or if foreign trade is small in relation to GNP. None the less, available data suggest that the recent large swings in the terms of trade did affect the pace of output growth in many primary exporting developing countries, especially in Africa. Table A-8 relates movements in the terms of trade, on the one hand, to the change in the rate of growth of real output, on the other, for

64 These include nine highly indebted countries: Brazil, Chile, Colombia, Ecuador, Morocco, Nigeria, Uruguay, Venezuela, Yugoslavia.

65 Argentina, Bolivia, Côte d'Ivoire, Mexico, Peru, Philippines.

66 Because of the fall in investment, productive capacity in Latin America at the end of the 1980s was estimated to have been 15 per cent below pre-crisis trends. See ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1989.*

67 However, increases in profitability (in domestic currency) through currency devaluation can have perverse effects on world markets for commodities with low price elasticities of demand. For example, for 12 commodity country situations in which world prices in dollars fell between 1980 and 1984 but real domestic prices rose by 10 per cent or more, there was an average increase since 1978-1980 of 17 per cent in harvested area while production rose by 12 per cent and the volume of exports by 26 per cent. See *TDR 1986,* chap. III, sect. B.

Table A-7

DOMESTIC SAVING AND INVESTMENT IN DEVELOPING COUNTRIES: CHANGE FROM 1980-1983 TO 1983-1988

		Number of countries	*Average change* [a]
Countries with increasing saving ratios		39	3.8
of which:			
Investment ratio:	- increased	13	2.0
	- decreased	26	-4.2
Countries with decreasing saving ratios		22	-11.5
of which:			
Investment ratio:	- increased	6	2.2
	decreased	16	-5.7

Source: UNCTAD secretariat calculations, based on national and international sources.
a Average change in the respective ratios (expressed as a percentage of GDP).

a sample of primary (non-oil) exporting developing countries during 1980-1988.[68]

The terms of trade worsened for most primary exports during the early 1980s. Among the primary exporters in the sample, in 7 countries in 1981 and 14 in 1982 the decline exceeded 7 per cent. More than two thirds of these countries (5 in 1981 and 10 in 1982) also had a slower growth of output. Export prices, however, did increase for a few products, mainly tropical fruit and some ores, in 1981, and thus improved the terms of trade of some primary exporters. Thus, of 15 such countries in the sample, slightly over half (8), recorded an improvement in growth performance in 1981. In the other 7 countries it seems that conditions were not conducive to faster growth, despite improvements in their terms of trade. In 1987 and 1988 as well, significant terms of trade movements affected the growth performance of a relatively large number of primary exporters. Thus, for 7 countries out of 11 for which the terms of trade worsened in 1987 there was also a slowdown of output growth;[69] likewise, real output growth improved in 8 countries among the 11 which also had improved terms of trade in 1988.[70] Since they still constitute the single most important market for most primary products, demand conditions in the developed market-economy countries remain critical for many primary exporting developing countries. After a brief recovery during 1988-1989, the dollar prices of non-oil commodities started to weaken again as real growth in the developed market-economy countries slackened, and by early 1990 they had fallen to below their 1988 average.[71] In particular, prices of commodities of export interest to African producers fell heavily, as coffee prices more than halved and cocoa prices dropped by more than one-third between January 1989 and January 1990.[72]

68 The present analysis is intentionally restrictive since it is difficult to provide plausible explanations for growth performance in such a partial approach. The presentation is thus confined to changes in terms of trade of more than 7 per cent (both positive and negative) and the primary exporters are those whose primary commodity exports amount to at least 80 per cent of their total exports. The major oil exporters are also excluded because oil prices and oil output often have a tendency to move in opposite directions, thereby resulting in a different relationship than that posited in the analysis.

69 Dollar prices of tropical beverages dropped by over one third in 1987.

70 Dollar prices increased most significantly for minerals, ores and metals, temperate zone food, and vegetable oilseeds and oils, but much more moderately for agricultural raw materials. Tropical beverage prices, however, were more or less stable in 1988.

71 The impact of the recent fall in primary commodity prices has been moderated by declines in the dollar prices of manufactured exports due to the appreciation of the dollar, except for commodities such as tropical beverages, which recorded very sharp declines during recent months.

72 See chap. I, sect. B.4, above.

Table A-8

DEVELOPING COUNTRY EXPORTERS OF PRIMARY PRODUCTS: [a]
ANNUAL CHANGES IN THE TERMS OF TRADE AND GROWTH PERFORMANCE, 1981-1988

(Number of countries) [b]

	1981	1982	1983	1984	1985	1986	1987	1988
Countries with deteriorating terms of trade	7	14	1	3	2	7	11	-
of which:								
- Growth declined	5	10	1	1	1	4	7	-
- Growth improved	2	4	-	2	1	3	4	-
Countries with improving terms of trade	15	1	4	10	-	6	4	11
of which:								
- Growth declined	7	1	2	4	-	2	3	3
- Growth improved	8	-	2	6	-	4	1	8

Source: UNCTAD secretariat calculations, based on national and international sources
a Except oil (see text).
b Includes only countries where the change in terms of trade was at least 7 per cent (see text, footnote 68).

3. *Growth convergence in East Asia*

In spite of recent difficulties associated with the external sector because of currency realigments and labour cost pressures, the traditional developing country exporters of manufactures in East Asia continued to maintain relative high GDP growth rates, though nevertheless lower than in earlier years. Accelerating foreign investment in other developing countries of the region should also pave the way for a period of sustained growth in those countries in the coming years.

Since 1988, the loss of some competitive edge due to currency appreciation and mounting domestic wage costs has led to a slowing down of the pace of economic expansion in the major developing countries exporters of manufactures in East Asia.[73] Firm growth of domestic demand, however, contributed to sustaining activity during the early phase of the transition toward lesser dependence on exports as an engine of growth. Available data suggest that these fast-growing traditional exporters of manufactures have thus settled down to a more sustainable pace of expansion, while remaining some of the fastest-growing economies in world. Their recent performance, however, has been surpassed by some neighbouring developing countries which were the recipients of substantial direct investment, especially since 1988. GDP growth in the major developing exporters of manufactures in East Asia (Hong Kong, Republic of Korea, Singapore, and Taiwan Province of China) is estimated to have slowed down from 9.9 per cent in 1988 to 6.6 per cent in 1989. On the other hand, real output in Indonesia, Malaysia, Philippines and Thailand taken together is estimated to have risen by around 7.5 per cent in both years. Particularly appealing to foreign investors are the abundance and quality of the local low-cost labour and the size of the potential domestic markets. There has thus been increased relocation of labour-intensive production units in these countries, especially from the Republic of Korea and Taiwan Province of China.[74] Fast-growing manufactures exports also contributed to reducing significantly their traditional dependence on exports of primary products.■

73 In fact, the contribution of net exports to growth has been negative in Taiwan Province of China since 1987.

74 Foreign investment in Thailand rose from $1.9 to $6.2 billion and in Indonesia from $1.5 to $4.4 billion from 1987 to 1988. Although less substantial, FDI has grown very fast in Malaysia and also the Philippines. Partial data indicate a continued rapid growth of FDI in these countries in 1989. See Nomura Research Institute, *Quarterly Economic Review*, February 1990, table 2, p. 30.

Chapter III

SELECTED ISSUES IN INTERNATIONAL TRADE

The recent past has been rich in changes in economic structures and policy orientations in the developed market economies and in Eastern Europe. Three issues are singled out for consideration in this chapter. In Europe, the decision to complete the single EEC market by 1992 has already given rise to extensive comment, including that contained in *TDR 1989.* This programme must now be seen in a broader context, which includes closer co-operation between EEC and EFTA and the movement by some countries in Eastern Europe to establish preferential trade links with the Western European trade groupings. The opportunities and dangers for developing countries inherent in these developments are the first topic discussed below.

The second issue refers to trade policies in the United States. In that country, tendencies toward unilateralism and bilateralism in trade policy have become increasingly evident in the past few years. The recent strengthening of trade laws which mandate negotiations under the threat of retaliation with trading partners perceived to be engaging in "unfair" trading practices is a cause for concern for developing countries. There has also been a move by the United States to enter into bilateral trade arrangements, the most important of which to have been concluded to date being the United States-Canada Free Trade Agreement. In its negotiations with individual trading partners, the United States has sought to expand the notion of what constitutes trade policy, the most recent instances of which have been attempts to draw into trade negotiations norms on intellectual property rights, trade in services, foreign direct investment and even domestic regulations and ways of doing business (as witnessed by the so-called "Structural Impediments Initiative" with Japan). Some of the implications for developing countries and for the world economy are explored.

The third issue revolves around Japan's import boom. In spite of its low tariffs and few non-tariff barriers, Japan has often been accused of being an economy closed to imports. However, since 1985, imports have grown considerably faster than in other developed economies. The value of imports of manufactures almost tripled between 1985 and 1989. The growth of intra-Asian trade centred around Japan has been particularly rapid. Eight developing economies of the Pacific Rim have been in the forefront as exporters to Japan; they have also been important recipients of Japanese foreign direct investment. This has led some observers to speculate that an investment-led trading bloc centred around Japan may be emerging. The extent to which this is so would have important implications for different groups of developing countries.

A. The formation of a wider European Economic Space: Implications for exports from developing countries

Political and economic changes and progressing economic integration and co-operation in Europe are likely to assume a new dimension and may lead eventually to the formation of a wider "European Economic Space". EEC has been enlarged by its new southern member countries and a single market will be formed by 1992. In parallel, EEC and EFTA will be moving closer to each other. And the momentous changes in Eastern Europe may

entail the gradual reintegration of these economies into the mainstream of European economic development. There are bound to be implications for the export opportunities of developing countries. On the one hand, if economic growth were to accelerate significantly, as is likely, greater European economic integration could boost the demand for developing country exports. On the other hand, given the diversity of economic conditions and development levels in Europe, in their pursuit of a "Common European House" Governments may be tempted to resort to trade policies towards third countries which could result in significant trade diversion. Pressures in this direction need to be resisted.

1. The completion of the Single European Market

(a) Implications for developing countries

With the introduction of the Single European Act in 1987, approved by each national legislature of the Community, the EEC member States committed themselves to the formation of a single European market without internal frontiers by the end of 1992. The completion of the single market is expected to improve productivity and competitiveness, and hence economic growth and welfare, within the Community. The implications of the integrated market for the Community's trade with non-member countries, in particular the developing countries, have increasingly become a topic of discussion. The potential impact of such trade is difficult to assess at the present stage, as reforms within EEC have not taken final shape and multilateral trade negotiations are proceeding in parallel in the Uruguay Round, which continues until the end of 1990. Potentially, trading partners may benefit from the creation of new trade, particularly if the process of European integration is accompanied by the strengthening of the multilateral system. If this is not the case, trading partners could suffer important setbacks as a result of trade diversion.

Even in the absence of new barriers against non-members, the Community is likely to increase output at the expense of some previously imported goods, owing to the reduction in cost and prices arising from the removal of trade barriers and customs control procedures within the Community and to longer-run dynamic effects such as economies of scale in production and distribution, the stimulus from stronger competitive pressures, and the larger inflow of foreign investment into import-competing sectors. The extent of trade creation, on the other hand, will depend on the extent to which economic growth in the Community accelerates and the responsiveness of imports to such acceleration.

Some estimates indicate that the completion of the single market could reduce imports into EEC from developing countries by 10 per cent, and even by as much as 15 per cent, on the assumption that the long-run dynamic gains of the single market are fully realized. On the other hand, according to the same estimates, as a result of higher incomes, imports from developing countries into the Community could increase by about 15 per cent, provided income in EEC increases by at least 5 per cent, which corresponds roughly to the impact of the 1992 programme on Community income estimated by the Commission of the European Communities. Hence, at an aggregate level, the net impact on developing countries could be small.[75]

The net effects of the 1992 programme will, of course, vary widely among developing countries, depending on the product composition of their exports to the EEC market. In the case of commodities not produced in the Community, trade creation is generally expected to be more dominant than for manufactured products. The main beneficiaries of trade creation could be exporters of fuel, who are expected to capture some 80 per cent of the potential gains, due to the high income elasticity of demand for fuel compared to most other primary products.[76] Both trade-creating and trade-reducing effects are, on the other hand, likely to be marginal for commodities and manufactured products with relatively low income elasticities of demand and for industries which have already reached a more advanced stage of integration within EEC. Thus, it is expected that the impact of the single market will be negligible on the textile and clothing industries (see box 9).

Trade creation, whether for commodities or manufactures, would of course be more sig-

[75] See M. Davenport and S. Page, "Regional Trading Agreements: The Impact of the Implementation of the Single European Market on Developing Countries", report prepared for the UNCTAD secretariat, October 1989, pp. 25-27.

[76] Alan Matthews and Dermot McAleese, "LDC Primary Exports to the EC: Prospects Post 1992", paper for the Netherlands Ministry of Foreign Affairs, The Hague, October 1989.

Box 9

IMPACT OF THE THE SINGLE EUROPEAN MARKET ON THE TEXTILE AND CLOTHING INDUSTRY

The impact of the Single European Market on the textiles and clothing (T-C) sector will be marginal, because of the advanced state of integration already achieved in this sector. EEC's T-C industry has already undergone significant structural changes, starting from the early 1970s. Structural changes, and notably technical improvements in the industry, were partly a response to increased intra-EEC competition resulting from the first enlargement of the Community following the accession of the United Kingdom, Ireland and Denmark in the early 1970s. More importantly, the T-C industry has faced significant and increasing competitive pressure from lower-wage non-EEC countries, notably some developing countries of Asia. As a result, there have been substantial technical improvements in the EEC industry, both in production (e.g. rationalization and use of automated machines) and in management and sales.

T-C producers in the Community have vigorously pursued a variety of new marketing and production strategies, including a shift away from mass production of standardized products and towards smaller runs and more high-fashion products to serve niche markets. This has been particularly the case in the Federal Republic of Germany and in Italy. In the latter country, the development of a flexible organization of the industry was achieved through the "putting out" of production to many small firms and through rapid responses to changes in consumer tastes by means of computerized information systems linking sales outlets and design operations. Flexibility and efficiency have also been obtained by sub-contracting either labour-intensive production processes or the manufacture of final products to production units in developing and Eastern European countries. The Federal Republic of Germany has used this strategy extensively in the last decade.

Since a high level of market integration and specialization has already been achieved, the scope for price reductions due to the completion of the Single Market would be insignificant. Furthermore, the low income elasticity of demand for the products of this industry in general implies that the income effects of a more rapid growth of consumption after 1992 are likely to be small. By implication, the scope for trade creation is limited, particularly if current trade barriers against imports from developing countries are not removed. Therefore, the major factor which will reshape the T-C sector in the Community in the years to come is not internal market integration, but acute competition from lower-wage countries. The full absorption of the Iberian countries into the Community and possible trade agreements with some Eastern European countries will undoubtedly increase competition in the European market for textiles and clothing, since these two groups of countries are significant producers of these goods.

Source: Kurt Hoffman, *Technological and Organizational Change in the Global Textile-Clothing Industry: Implications for Industrial Policy in Developing Countries*, Technology case study No. 2, UNIDO, Vienna, April 1989; M. Breitenacher, S. Paba and G. Rossini, "The Cost of 'Non-Europe' in the Textile-Clothing Industry", in *Research on the "Cost of Non-Europe"*, vol. I - *Basic Studies: Executive Summaries* (Brussels: Commission of the European Communities, 1987).

nificant should incomes in the Community increase by more than 5 per cent as a result of the 1992 programme. Faster growth may occur, for example, as a result of larger-than-expected flows of foreign direct investment to the Community.[77] Moreover, the completion of the Single European Market is now taking place in the context of profound changes in Europe as a whole, which are likely to lead to a significant increase in investment and to a boost in growth rates beyond what would have resulted from implementation of the 1992 programme alone. For one thing, growth forecasts for the Federal Republic of Germany in the near future have already been raised to take into account the impact on demand of German monetary and economic union. Conversely, trade creation could be dampened if the adjustment costs arising for the Community from the completion of the single market turn out to be more substantial than estimated by the Commission and if, as a consequence, trade restrictions on non-

77 Foreign direct investment has two potential effects: on the one hand, it could raise the production of import-competing goods; on the other, it raises incomes and, therefore, leads to higher imports generally.

members are raised. If this were to be the case, trade diversion away from non-members and towards the Community could well arise.

(b) EEC trade policy vis-à-vis developing countries

EEC has a complex system of trade preferences and import restrictions in its trade with developing countries. Under successive Lomé Conventions, 68 African, Caribbean and Pacific (ACP) countries have been accorded duty-free access for their exports of manufactures and for most agricultural products not covered by the Common Agricultural Policy (CAP).[78] Twelve developing countries in the Mediterranean basin have free access to the EEC market for most manufactures and semi-manufactures, with restrictions notably on imports of textiles and clothing. Agricultural products not covered by CAP benefit from tariff reductions. By contrast, the developing countries in Asia and Latin America have a lower preferential status in the EEC market than the ACP and the Mediterranean developing economies. These countries benefit from tariff preferences under the Community's GSP scheme. These preferences have been eroded over the years by reductions in MFN rates through consecutive rounds of GATT negotiations and by increasing limits placed on access to preferential rates. Moreover, MFA quotas and other non-tariff measures affect mostly countries in this latter group. Some of these measures are applied at the Community level, but a significant number of them, including MFA and other textiles and clothing quotas, are still distributed among member States on a national basis.[79]

While the EEC market is of far greater importance for the ACP countries and the Mediterranean developing countries than for the developing economies of Asia and Latin America, the ACP countries have lost market shares in EEC, despite their preferential status, due in part to limited supply capabilities, but also as a result of a fall in commodity prices and financial stringencies caused by debt problems. On the other hand, the Asian developing countries, in particular the large exporters of manufactures, have gained (see chart 4).

Over the last two decades, EEC trade policy has been characterized by increasing recourse to a wide array of non-tariff measures. These include quantitative restrictions such as voluntary export restraints (VERs), orderly marketing arrangements and basic price systems imposed by the Community, individual member States or by both, particularly on manufactured imports from developing countries. VERs imposed at the Community level are concentrated on agricultural goods, textiles and steel products, whereas those of member countries focus mainly on electronics products, automobiles and shoes.[80] Another symptomatic feature is the increasing use of countervailing and anti-dumping measures mainly for protectionist purposes. Furthermore, anti-dumping measures, at first applied mainly to constrain imports of chemical products, are now used to impede market access for a wide range of heterogenous products, most notably electronic consumer goods. Besides Japan, the main "target" countries are the Republic of Korea, Taiwan Province of China, Hong Kong, Brazil and Mexico.

With the approaching completion of the single market, the key issue is whether the trade policy stance of EEC will evolve in a liberal or non-liberal direction. The critical aspect is the disparities in the application of non-tariff barriers among EEC member countries. As bilateral import restrictions depend for their effectiveness on internal border controls, such restrictions cannot possibly be maintained within the framework of a single European market. Rather, a unified market will require fully unified import rules toward third countries. Hence, the completion of the single market will necessitate the removal of the differences in the import regimes of member countries resulting from national quantitative import restrictions.

The removal of differences in the import regimes can be achieved by an elimination of all non-tariff barriers or by substituting new EEC-wide restrictions for the existing national barriers. While the first solution would be desirable in the interest of an open international trading system, it might not be politically feasible. Concern has accordingly been expressed by the Community's trading partners that member States may exert pressure to extend their own restrictive regimes to third-country exports to the Community as a whole. If compromises are struck at the lowest common denominator, such pressures would, indeed,

78 Two countries (Haiti and Dominican Republic) signed the Convention for the first time in 1989, bringing the number of ACP countries from 66 under Lomé III to 68 under Lomé IV.

79 The impact of national restrictions on the Asian textile and clothing industry is elaborated in R.J. Langhammer, "EEC Trade Policies towards Asian Developing Countries", *Asian Development Review*, vol. 4, No. 2, 1986.

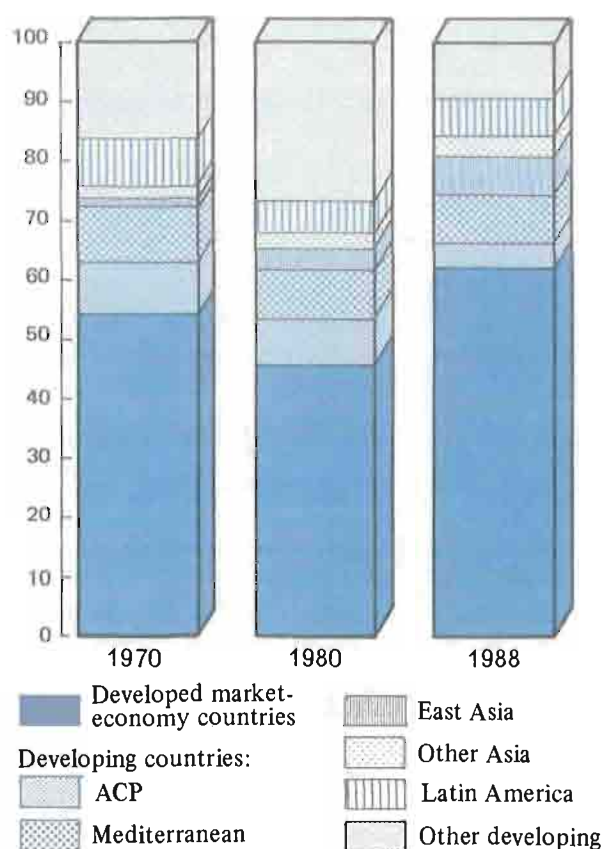
80 GATT, *Review of Developments in the Trading System, September 1988-February 1989*, Geneva, 1989; and G. Koopman and H.-E. Scharrer, "EC Trade Policy Beyond 1992", *Intereconomics*, September October 1989.

lead to the adoption of the position of the most restrictive Government by the entire Community. While such extension of protectionism may be intended to be temporary, experience shows that protection, whatever its nature, has a strong tendency to become permanent.

Chart 4

SHARE OF DEVELOPING COUNTRY GROUPS IN IMPORTS INTO EEC

(Percentage)



Source: Eurostat, *External Trade. Statistical Yearbook, 1989*, Brussels-Luxembourg, 1990.

Member countries with a relatively high level of quantitative restrictions are, in fact, demanding that Community-wide restrictions should replace their national protective measures in "sensitive" areas. Some member countries are also seeking compensation for the loss of national non-tariff barriers which they now apply.[81] Such compensation could be in the form of tariff equivalents of abolished quantitative restrictions or of import quotas set at the Community level. Furthermore, there is growing anxiety that EEC will make access to its single external market dependent on the fulfilment of reciprocal demands, urging trading partners to make concessions on their part and liberalize trade on a bilateral basis. Hence, access to the enlarged Community market could become the result of *quid pro quo* agreements.

The developing countries will gain from trade creation only if liberal tendencies dominate in the trade policy stance of EEC after 1992, though some redistribution of gains among the developing economies may occur in view of the highly differentiated trade policy of the Community towards different groups of countries. Thus, liberalization could affect unfavourably ACP exporters of some manufactures such as clothing and exporters of certain tropical products, notably bananas, which at present enjoy guaranteed access to the EEC market. At least three EEC member States limit at present banana imports from non-ACP suppliers through the imposition of quantitative restrictions (see box 10). The removal of these restrictions could adversely affect ACP suppliers, who may prove to be less competitive than exporters in Latin America. The ACP countries are also concerned about the possible erosion of their preferences due to reductions of MFN tariff rates, particularly in the case of tropical products, currently under negotiation in the Uruguay Round.

(c) Impact of the southward enlargement of EEC

The access of Spain and Portugal to the markets of the other EEC members will improve considerably once the two countries are fully integrated into the Community. At present, they are still in a transitional period, which extends for industrial products up to January 1992 and for agricultural products up to January 1996.

Spain is the larger and more industrialized of the two, with significant supply capabilities in both industry and agriculture. Spain's agricultural output is substantial, amounting to about 17 per cent of the Community total. The agricultural produce of both Spain and Portugal competes in the EEC market with a broad range of products from Mediterranean developing countries such as fresh and processed vegetables and fruit (particularly citrus fruit), olive oil, fish products and wine. For Morocco, Tunisia, Israel and Cyprus, these products account for some 70-95

[81] For an interesting discussion, see D. Spinanger. "Is the EC Foreshadowing a Fortress Europe in 1992? Examining Implications of 1992 and Current EC Trade Restrictions for PACRIM countries", Pacific Rim Institute of Comparative Economic Studies, Kiel, July 1989.

Box 10

THE SINGLE EUROPEAN MARKET AND BANANA EXPORTS OF DEVELOPING COUNTRIES

Presently half of the Community's consumption of bananas is supplied by ACP countries and the French overseas departments of Guadeloupe and Martinique, while the other half consists of "dollar" bananas, mostly from Latin America. The latter are imported primarily by member States which do not have quantitative restrictions favouring specific ACP countries. At present, three EEC member States limit banana imports through quantitative restrictions specifying the origin of the product. The United Kingdom has been providing a guaranteed market for unlimited quantities of bananas from the English-speaking Caribbean and Suriname. France provides similar guarantees for the French overseas departments, Cameroon and Côte d'Ivoire, and Italy reserves a share of its market for Somalia. For a number of these developing countries, bananas constitute a substantial share of total merchandise exports - 50 per cent in Guadeloupe and Martinique, 40 per cent in Saint Vincent and the Grenadines, and 20 per cent in Somalia - with the Community accounting for 90-100 per cent of their banana exports.

Although these producers enjoy a 20 per cent tariff preference over producers of dollar bananas in all EEC countries except the Federal Republic of Germany, it is unlikely that they could compete without a guaranteed market. Latin American producers already dominate the markets of countries other than France, Italy and the United Kingdom. Most of the ACP producers are small-scale and relatively inefficient, and their costs are considerably higher than those of the large plantations of Central America, Colombia and Ecuador. The banana trade in Latin America is dominated by large United States corporations with efficient marketing and distribution facilities.

Under the Lomé IV Convention the Commission has repeated commitments to maintain preferential access for traditional suppliers, but with the removal of national quantitative restrictions after 1992, the current preference margin is unlikely to be adequate to sustain their exports. One solution to the dilemma would be helping the ACP producers to raise productive efficiency and improve infrastructural facilities. Other solutions include direct compensation, an EEC subsidy to ACP producers, or assistance to diversify out of bananas, perhaps accompanied by a gradual unwinding of protection.

Source: M. Davenport and S. Page, *op. cit.*, pp. 25-27; and "The Lomé IV Convention", *The Courier* (Brussels), No. 120, March-April 1990.

per cent of their total agricultural exports to EEC.

Prior to the most recent enlargement of the Community, the Mediterranean developing countries enjoyed more privileged access to the EEC market than the Iberian countries. When the process of enlargement of the Community is completed, the Iberian countries will be able to compete with the Mediterranean countries on an equal footing, and this may affect adversely the exports of the latter to EEC.[82]

Furthermore, the new members and many developing countries are direct competitors in the EEC market with regard to a number of manufactured products such as textiles and clothing, footwear, leather, pulp and paper, wood products, cork, iron and steel and machinery. Free access by Spain and Portugal to the market of the Community will substantially increase the competition for suppliers from developing economies.

The Iberian enlargement of the Community could also affect Latin American exports of agricultural products to Spain and Portugal.[83] Both countries had special trade agreements with countries in Latin America, offering import duties below the common external tariff of the Community for a number of commodities (including coffee, millet, maize, soya, unprocessed tobacco and beef). Having terminated these preferential agreements, they are likely to import agricultural products such

82 P. Gray, "The Economic Effects of the EEC Second Enlargement", United Nations Department of International Economic and Social Affairs, New York, 1989 (mimeo), pp. 16-25.

83 *Ibid.*, pp. 22-24.

as cereals, livestock and dairy products increasingly from other EEC member countries rather than from Latin America. The exports of several countries in Latin America, including Argentina, Uruguay, Suriname and Brazil, will in consequence be adversely affected.

There is a certain danger that the absorption by the Community of labour-intensive manufactures or agricultural products from the new member countries rather than from developing countries may be viewed as one way of reducing the social cost of integration, and the southward enlargement of the Community could therefore increase internal protectionist pressures. The developing countries have generally a competitive advantage on account of lower labour costs, and this advantage may become more pronounced as and when labour costs in the new member countries rise as a consequence of a greater convergence of wages in an integrated Community market. Hence, any attempts to restrict further the access of developing countries to the EEC market need to be resisted.

2. *The strengthening of EEC-EFTA relations*

EEC and EFTA are currently engaged in preliminary discussions for the extension of the existing bilateral free-trade arrangements to all essential features of the Single European Market. Negotiations between the two groups are to be concluded in time for an agreement on a European Economic Space (EES) to enter into effect by January 1993.

Such an arrangement will result in a substantial extension of present preferential EFTA-EEC relations to cover areas such as agricultural trade, government procurement, services, investment, and others. EFTA-EEC trade has been substantially free for some time, and recent multilateral agreements have removed technical barriers to trade, reduced the cost of customs documentation, and opened EFTA participation in EEC research and technology programmes.

EES, if realized, will also affect third countries, both European and other. In the first place, some Central and Eastern European countries have already sought to establish special association arrangements with EFTA; if these materialize, they will carry over into an eventual EES. It is even possible that EES may develop its own dynamics, eventually encompassing most European countries. The motives of EFTA member States for seeking association with EEC are just as valid for other European countries: the removal of barriers to intra-European trade and the encouragement of greater competition will reduce costs and boost investment. The establishment of a EES would, therefore, lead to a further concentration of the trade of European countries within Europe. Likewise, Europe is likely to absorb a substantially larger share of the world's foreign direct investment than in the past.

3. *The possible effects of economic and political change in Eastern Europe*[84]

Political and economic reforms in Eastern Europe are going ahead at a rapid pace. The reforms could entail a significant impact on exports from developing countries, and concern has been voiced by many of them about potential ramifications which could affect their exports adversely. Increased purchases by Western European countries in Eastern Europe, at the expense of imports from the developing countries, could be one corollary of the changes under way. Other configurations are conceivable and some could imply favourable export prospects for developing countries, such as new opportunities in Eastern Europe where the reforms are taking place.

Over the short term, it appears unlikely that the patterns of production and exports of countries in Eastern Europe will change significantly. Nor will the volume of their exports increase dramatically. Export expansion is limited by insufficient supply capability and, to some extent, by the inability to meet the quality requirements of Western markets.

In the medium term, structural change is possible, and investment by both domestic and foreign firms may lead to a substantial enhancement in productive capacities in goods which could compete with those exported by developing countries. The factor endowment of the countries of Eastern Europe is likely to give them a good competitive position for ex-

[84] The discussion in this section refers mostly to the changes that have occurred, or can be envisaged at this point, in Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland and Romania. The situation in the Soviet Union is still too fluid and uncertain for an observer to be able to discern trends or to build credible alternative scenarios.

ports of goods within the lower and middle segments of Western markets, i.e. the type of goods exported by several developing countries. In particular, if trade and investment relations with Western European countries are strengthened, goods from Eastern Europe could displace exports from developing countries in Western European markets. Investments by Western European firms for export back to their home countries could go increasingly to Eastern Europe rather than to developing countries.[85] Such investment-led trade links would reinforce those created by preferential trading arrangements.

Economic policies will play a pivotal role in shaping future trade relations. The process of reforms in Eastern Europe and the structural changes in the direction of more open and market-oriented economies are likely to lead to greater economic integration with Western Europe and, possibly, other developed market-economy countries. The unification of Germany will result in the automatic incorporation of one of the countries of the region into the Community. The conclusion of trade and co-operation agreements by EEC with a number of other countries of Eastern Europe and readiness to consider concluding association agreements at a later stage reflect the strong political determination to establish closer economic links. It can reasonably be expected that such rapprochement will involve easier access to the markets of Western Europe and other developed market-economy countries for exports from the economies of Eastern Europe. Preferential market access with relatively wide product coverage would significantly extend the scope of preferences which some of these economies have already been accorded in the past, such as benefits under the GSP and outward-processing arrangements. Greater ease of market access could favour imports from countries of Eastern Europe at the expense of imports from developing countries. The potential for trade diversion could be significant if Eastern European countries receive preferential treatment which is as favourable as or more favourable than the treatment granted to imports from developing economies.

The future course of trade and other economic policies in the countries of Eastern Europe will also strongly influence the export prospects of the developing countries in these markets, though the direction of the impact is as yet unclear. If economic liberalization and the shift towards greater outward orientation continues in the countries of Eastern Europe, it can reasonably be assumed that these countries will increasingly meet their needs from external sources of supply whenever foreign suppliers are more competitive than their own producers. Thus, the propensity to import would generally increase over the medium term, benefiting all trading partners with competitive supply capabilities.

Another possibility is that Eastern European countries decide to protect their industrial and other economic sectors over a transitional period during which the productive base is modernized and restructured in line with competitive positions, while deregulation and the progressive introduction of market-oriented mechanisms continue in the domestic economies. In such a case, imports would evidently be adversely affected, and the barriers to market access could turn out to be higher for imports from developing countries than for those from Western European ones.

The speculative nature of all this is evident, and the longer the time horizon of the analysis, the more speculative will be the essence of the findings. The dynamic character of current developments in Eastern Europe and their interaction with economic developments and structural changes in other countries, both developing and developed, make the analysis of the potential implications for exports of developing countries extremely complex.

4. International policy issues

Undoubtedly, the new political and economic realities in Europe hold out great promise for an acceleration of the region's economic growth. This in itself would be highly positive for the evolution of world trade. However, the process of European economic integration in Western Europe and the systemic changes taking place in Eastern Europe are likely to be difficult and fraught with short-term adjustment problems. In this context, it is important that Governments do not succumb to protectionist options and that the structural changes that are taking place go hand in hand with a commitment to open markets. Otherwise, the outlook for a sustained expansion of world trade could prove to be dim. The developing countries could be the main ones to lose, while the gains of other countries, including those in Europe, would be less than they could be in the presence of an open international trading environment.

[85] See Henry S. Gill, "Los Cambios en Europa Oriental y sus Implicaciones para América Latina y el Caribe", SELA Seminar on International Economics, Caracas, 12-15 February 1990, p. 17.

A hesitant approach by the countries of Eastern Europe towards opening their markets to the competitive pressures of international trade and the formation of a single market by EEC without a significant reduction in protection, or, still worse, coupled with heightened protectionism, could be particularly damaging to the export prospects of developing countries. Trade diversion effects at their expense could become even more intense if, in this context, European integration assumes a new and wider dimension. While closer economic links of Western Europe with countries of Eastern Europe would be a welcome development, the danger that the formation of a "Common European House" could entail new discrimination against imports from developing countries has to be kept at bay. In this connection, the strengthening of the multilateral trading system through the successful conclusion of the Uruguay Round assumes a critical importance.

B. Aspects of trade policy in the United States

1. General trends

Changes in trade policy in the United States are particularly important for the international trading system, not only because the United States is the single largest trading nation but also because its commitment since World War II to an open trading system has given a major impetus to trade liberalization under the aegis of GATT.[86] Recent actions and legislation would seem to indicate that the United States' traditional support for an open trading system and for multilateral norms governing the conduct of international trade has tended to weaken.

The drift away from GATT disciplines and the increasing resort to non-tariff measures, not only by the United States but also by practically all major trading countries, has already been commented upon extensively.[87] As regards the United States, a recent expression of this trend was the extension in 1989 for a period of two and one-half years of the voluntary export restraints (VERs) limiting steel imports. Under the Steel Import Program, which began in 1984, VERs had been negotiated with 19 countries and EEC and were valid up to 30 September 1989. The new agreements will allow steel imports to increase overall by one percentage point per year. The annual increases will be allocated preferentially to countries that reduce or eliminate subsidies to steel producers and/or offer United States producers greater access to their markets. At the same time, the United States announced that it will seek an international consensus with regard to free trade in steel, including disciplines over subsidies, tariffs and non-tariff barriers. It is unclear, however, whether the United States would seek to extend the VERs in 1992 if it were unable to negotiate a consensus acceptable to it.

In recent years, there have been additional striking departures in United States trade policy from its previous commitments to open markets and multilateralism. One of them has been the increasing willingness to practise or threaten unilateral retaliation against trading partners perceived to be engaging in unfair trade policies. Another has been the attempt to expand the scope of trade policy discussions and to demand that trading partners change domestic laws, regulations and business practices when they are perceived by the United States Government to have adverse effects on United States exports. In particular, the United States has sought unilaterally to impose on trading partners norms regarding trade in services, intellectual property and foreign direct investment, areas in which there are no accepted international norms and disciplines and in which negotiations are taking place in the Uruguay Round.[88]

Yet another trend that could have adverse implications for the multilateral system,

86 This commitment has always been qualified. From the very beginning, it excluded agriculture; the United States has also supported the exclusion of textiles and, more recently, steel, from full GATT disciplines.

87 See *TDR 1989*, Part One, chap. III, sect. B, and the annual reports of the UNCTAD secretariat to the Trade and Development Board, "Protectionism and Structural Adjustment".

88 See William A. Niskanen, "The Bully of World Trade", *Orbis - A Journal of World Affairs*, Fall 1989; and Jagdish

if the protectionist drift of recent years is not reversed, is the move by the United States to enter into bilateral free trade agreements and other special bilateral arrangements with specific groups of countries. The United States-Canada Free Trade Agreement has now entered into force, and comparable arrangements with Mexico are under discussion. Coupled with preferential agreements with Central American and Caribbean countries under the Caribbean Basin Initiative, these arrangements could come to constitute a large North American trading group. Such an outcome need not necessarily give rise to concern. If barriers to trade with countries not participating in the arrangements are kept low, the trade-creating effects of the formation of such a group could tend to be larger than their trade-diverting ones. However, in the current atmosphere, with frequent and increasing resort to non-tariff trade barriers and grey area measures such as VERs, the trade interests of countries not participating in the arrangements could be adversely affected. In particular, the developing countries, because of their weak bargaining power and inability to retaliate effectively, could be especially vulnerable to the imposition of VERs and other non-tariff barriers.

2. *The new unilateralism*

The intent to use unilateral means to make trading partners change policies - be they in the trade or other areas - perceived as "unfair" or "unreasonable" has gained ground in recent years. Since mid-1985, the United States Government has been engaging in a policy of pursuing "reciprocity" negotiations under the threat of retaliation with selected trading partners, many of which are developing countries. These negotiations - which have been conducted under the mandate of section 301 of the Trade Act of 1984, as amended (see box 11) - have covered practices ranging from partners' import barriers and export subsidies to alleged violations of United States intellectual property rights. Since the adoption of this new policy, the USTR has initiated a total of 32 cases under section 301, most of which are still unresolved, and developing countries have accounted for more than half of them.

The Trade Act of 1988 went further in giving the USTR discretionary powers in investigating and taking retaliatory action against unfair practices by trading partners. Under the so-called "Super 301" provision, the USTR was required to identify specific unfair traders in 1989 and 1990 and to enter into negotiations with them for the removal of the offending practices. Another provision ("Special 301") referred specifically to the identification of countries denying adequate protection to intellectual property rights of United States companies or citizens.

The first three countries to be placed on the priority list in 1989 under the Super 301 provision were Japan, Brazil and India. Japan was cited for restrictions on foreign purchases of space satellites by governmental entities, procurement of Japanese-made supercomputers by government agencies and public universities at deep discounts that make foreign supercomputers uncompetitive, restrictions on imports of certain wood products from the United States, and building codes and product standards that make United States wood products uncompetitive. Restrictive import licensing procedures were identified as the major cause for placing Brazil on the list. In the case of India, it was restrictive policies with respect to insurance imports and foreign direct investment. As regards the Special 301 provision, a number of countries and territories were put on watch lists, although none of them was named as a "priority" target.[89]

These actions were generally viewed by trading partners as a threat to multilateralism. India refused to negotiate with the United States. While denouncing the procedure, Japan did engage in intense negotiations and was able to arrive at compromises considered satisfactory by the United States. Negotiations with Brazil have not yet concluded, but there are indications that the recent import liberalization programme announced by Brazil may lead the United States to drop its proceedings against that country. In April 1990, the second priority list was announced under the Super 301 provision, and it included only India, for the same reasons as in the preceding year. However, in June the United States decided not to impose sanctions on India stemming from its refusal to negotiate on the 1989 charges. The argument used by the USTR was that sanctions would

Bhagwati, "The International Trading System", Keynote Speech, Symposium for the 25th Anniversary of UNCTAD, Geneva, 18-19 September 1989, reprinted in *IDS Bulletin*, vol. 21, No. 1 (January 1990), p. 9.

[89] As a result of bilateral negotiations, the countries on these lists have tended to change since they were first announced in May 1989. As of May 1990, four countries were still on the "priority watch list" (Brazil, India, China and Thailand), and 19 were on the "watch list" (Argentina, Canada, Chile, Colombia, Egypt, Greece, Indonesia, Italy, Japan, Malaysia, Pakistan, Philippines, Republic of Korea, Saudi Arabia, Spain, Taiwan Province of China, Turkey, Venezuela and Yugoslavia).

Box 11

SECTION 301 OF THE UNITED STATES TRADE ACT

Section 301 of the Trade Act of 1984 is designed to enforce United States rights under trade agreements and to provide for responses to what are perceived to be unfair foreign trading practices. The law covers foreign practices regarding goods, services, investment and the protection of intellectual property rights. Section 301 allows the United States Trade Representative (USTR) to take all appropriate action, including retaliation, to obtain removal of any act, policy, or practice of a foreign Government which is found to violate an international trade agreement or which is found to be unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce. "Unjustifiable" practices are those which are inconsistent with international legal rights; "unreasonable" practices are defined as unfair or inequitable practices, although they may not be inconsistent with international legal rights; by "discriminatory" is meant practices which deny MFN treatment to United States goods, services, or investment. In the Trade Act of 1988, Congress further expanded the notion of "unreasonable" to include the denial of the fair and equitable provision of adequate and effective protection of intellectual property rights; the denial of fair and equitable market opportunities, including toleration for private anticompetitive schemes; export targeting; and the persistent denial of workers' rights.

The perceived general lack of success in eliminating foreign unfair practices, either through bilateral consultations or through the GATT dispute settlement process, led Congress in 1988 to strengthen section 301 considerably. It now mandates retaliation in cases involving unjustifiable acts and provides for retaliation, at the USTR's discretion, for cases involving unreasonable or discriminatory foreign practices. More specifically, retaliation is required if the USTR determines that the foreign practice denies United States rights under a trade agreement; violates or denies benefits to the United States under a trade agreement; or is unjustifiable and burdens or restricts United States commerce. Mandatory retaliation has certain exceptions. The USTR need not retaliate when the United States receives an unfavourable determination, report or ruling under GATT or other dispute settlement provisions; when the foreign country is taking certain specified measures to alleviate or eliminate the problem or to compensate the United States for it; when action would adversely harm the United States economy; or when it would seriously harm national security interests.

The Trade Act of 1988 also amended section 301 to add a provision that has come to be known as "Super 301". This provision required the USTR to identify in 1989 and 1990 priority unfair practices and priority countries and negotiate with these countries over a three-year period to eliminate, reduce, or compensate for these practices. If any country does not comply with the agreements negotiated, the USTR must initiate an unfair trade investigation and take action under United States trade laws. Furthermore, the Trade Act of 1988 requires the USTR to identify foreign countries which deny adequate and effective protection of intellectual property rights or deny market access to United States entities that rely on intellectual property protection. These countries are considered to be priority countries under the so-called "Special 301" provisions.

Source: UNCTAD, *Handbook on Major United States Trade Laws* (UNCTAD Technical Assistance Programme on the Generalized System of Preferences and Other Trade Laws and Regulations Directly Affecting the Exports of Developing Countries), Geneva, 1989.

be inappropriate at this time, while negotiations on services and investment were under way in the Uruguay Round. The more restrained use of Super 301 and the failure to name any country as a priority under Special 301 for the second consecutive year have given rise to hopes that in the future the United States will rely on multilateral mechanisms, rather than on unilateral actions, to resolve its trade conflicts.

If unilateralism and forced negotiations under the threat of retaliation were to become the established norm in United States trade policy, this would have very adverse consequences for developing countries, which do not have sufficient leverage to dissuade a powerful trading partner from such practices. Moreover, the rule of law in international trade would be unavoidably weakened, and the results that may emerge from the Uruguay Round would be inevitably compromised.

3. The Structural Impediments Initiative

Evidence of the attempt by the United States to widen the scope of what is understood by trade policy is the discussions it launched in 1989 with Japan on ways of reducing the bilateral trade imbalance between the two countries, known as the "Structural Impediments Initiative" (SII). Since Japan has generally low tariffs and relatively few non-tariff barriers, it is claimed that its barriers to trade are embedded in domestic laws and business norms which discriminate against imports. The removal of such barriers, in this view, would result in improved market access for United States exports and would reduce the United States bilateral deficit with Japan. The following structural characteristics of the Japanese economy are alleged to contribute to keeping United States exports out of Japan: government procurement practices; the unique brand of co-operation between Government and business found in Japan (as contrasted to the laissez-faire approach to business of the United States); complex licensing, testing and certification requirements which are found to be onerous by foreign companies; a complex distribution system which favours small family-run stores, which do not tend to stock imports; the "keiretsu" system of business conglomerates, which discriminates against non-group (including foreign) suppliers; and low levels of public consumption - and, consequently, high savings rates.[90]

During the negotiations, Japan countered with some observations on the structural characteristics of the United States economy which, in its view, contributed to the United States deficit with Japan. Among the more important of these were: the low United States savings rate, due mainly to the large and persistent budget deficit; the short-term view of United States corporations, which concentrate on quarterly changes in balance sheets rather than long-term investments that strengthen international competitiveness; excessive corporate take-over activity; the poor quality of United States education, particularly in science and mathematics; and low and declining research and development expenditures.

After arduous negotiations, the two sides issued an interim report in early April 1990. Japan agreed to reduce the waiting period needed to set up supermarkets and other large retail stores, to enforce the anti-monopoly law more strictly by imposing tougher fines, and to increase investment in housing, parks, sewers, airports, and other areas of infrastructure. Japan also agreed to open its distribution system further by expanding customs facilities at airports and seaports; to issue guidelines to private businesses aimed at making their activities and decision-making more transparent; and to treat price-fixing as a criminal act. For its part, the United States promised to continue efforts to reduce the budget deficit, to work to expand eligibility for individual retirement accounts, to lower the capital gains tax with a view to stimulating investment, to lift some export controls, and to recommend to Congress the partial lifting of the ban on Californian heavy crude oil exports.[91]

Perhaps the most remarkable aspect of the SII talks is that they represent a widening of the scope of what Governments consider to be within the purview of trade negotiations. Certainly, many domestic regulations, norms and ways of doing business can and do have an impact on trade. However, if taken to an extreme, such an approach would give licence to a Government to examine the policies, laws and regulations of other countries and seek changes in them when they are considered to cause injury to their export interests. Since such pressures can be exerted only by those with strong bargaining power, the economically strong would have an additional weapon to impose their will on the weak. Development policies have a direct and indirect impact on the structure and rate of increase of a country's exports and imports. Therefore, these policies are bound to affect the interests of its trading partners, in some cases positively and in others negatively. If generalized, the approach implicit in the SII talks could open the door to unwarranted intrusions by special interests, with the support of their Governments, into the development policies of developing countries.

A widely held perception among United States policy makers, particularly in Congress, is that the large United States trade deficit can be reduced through trade policy action aimed at correcting what are perceived as the unfair trade practices of others. In this view, such

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90 These arguments are discussed in C. Fred Bergsten and William R. Cline, *The United States-Japan Economic Problem,* Policy Analyses in International Economics No. 13 (Washington, D.C., Institute for International Economics, January 1987), pp. 4-11 and 63-72. See also Robert Z. Lawrence, "How Open is Japan?" (New York, National Bureau of Economic Research), October 1989 (mimeo).

91 *International Trade Reporter* (Washington, D.C., The Bureau of National Affairs, Inc.), 11 April 1990. In late June, as this report was being prepared, the two countries agreed on a final report.

action should take the form of limiting imports into the United States from countries perceived to be engaging in unfair trade practices or whose policies have an adverse impact on United States trade interests. As already argued in *TDR 1989*, such trade policy action is unlikely to lead to a significant change in the trade deficit. Pressuring other countries to open their markets or to change specific policies may not result in larger exports: third countries or domestic companies may well be the beneficiaries. Policy changes such as most of those agreed to in the interim SII report still have to go through complex domestic approval procedures; their impact on trade flows is likely to be tenuous and, at best, of a long-term nature. In the short and medium term, trade balances respond to fundamental macroeconomic variables, not trade policies. Even if trade policy changes were to induce a correction of the bilateral trade deficit of the United States with Japan, this would be no guarantee that the overall United States trade deficit would decrease.

In the long term, the competitive decline of United States firms relative to those of its major trading partners, particularly Japan, could be partially responsible for the obdurate nature of the United States trade deficit. This could be the result of the dollar not having depreciated enough to compensate for productivity growth differentials between the United States and its major competitors. The persistence of the trade deficit and the fall in the dollar that has taken place since 1985 have given rise to concerns regarding the decline in the per capita income of the United States relative to other developed countries. To the extent that there is some truth in this argument, the correction of the long-term factors noted by the Japanese side in the SII talks as responsible for the United States trade deficit may have a positive effect in reducing the trade deficit and reinvigorating growth in real incomes. However, action along these lines cannot be expected to have a positive effect on the deficit in the near future.

Perhaps the only policy changes identified in the SII talks which have a fair chance of influencing the United States trade deficit in the medium term are, primarily, the reduction in the United States budget deficit and, secondarily, the more expansionary fiscal stance implicit in Japan's promise to increase public investment. Such actions are squarely in the macroeconomic field and have little to do with the direct and indirect market access issues with which United States trade policy has been preoccupied. In order to preserve growth and employment in the United States and elsewhere in the world economy, budget deficit reductions would have to be accompanied by an easing of monetary conditions and appropriately expansionary policies in other major countries, to which the greater Japanese spending would undoubtedly contribute. Greater fiscal and monetary ease in Japan, together with the more expansionary policies associated with German unification, may provide the opportunity for policymakers in the United States to reduce the fiscal deficit while avoiding recession. The current relaxation in East-West tensions would appear to be a particularly favourable moment for reducing military spending in the United States.

Thus a shift in the mix of fiscal and monetary policies in the United States and a more appropriate balance in the overall stances of policy as between the United States and its major trading partners could bring about a swift reduction in the United States trade deficit (as well as in the surpluses of other major OECD countries). This would make the single greatest contribution to an easing of protectionist pressures and to the preservation and strengthening of the multilateral open trading system.

C. The Japanese import surge

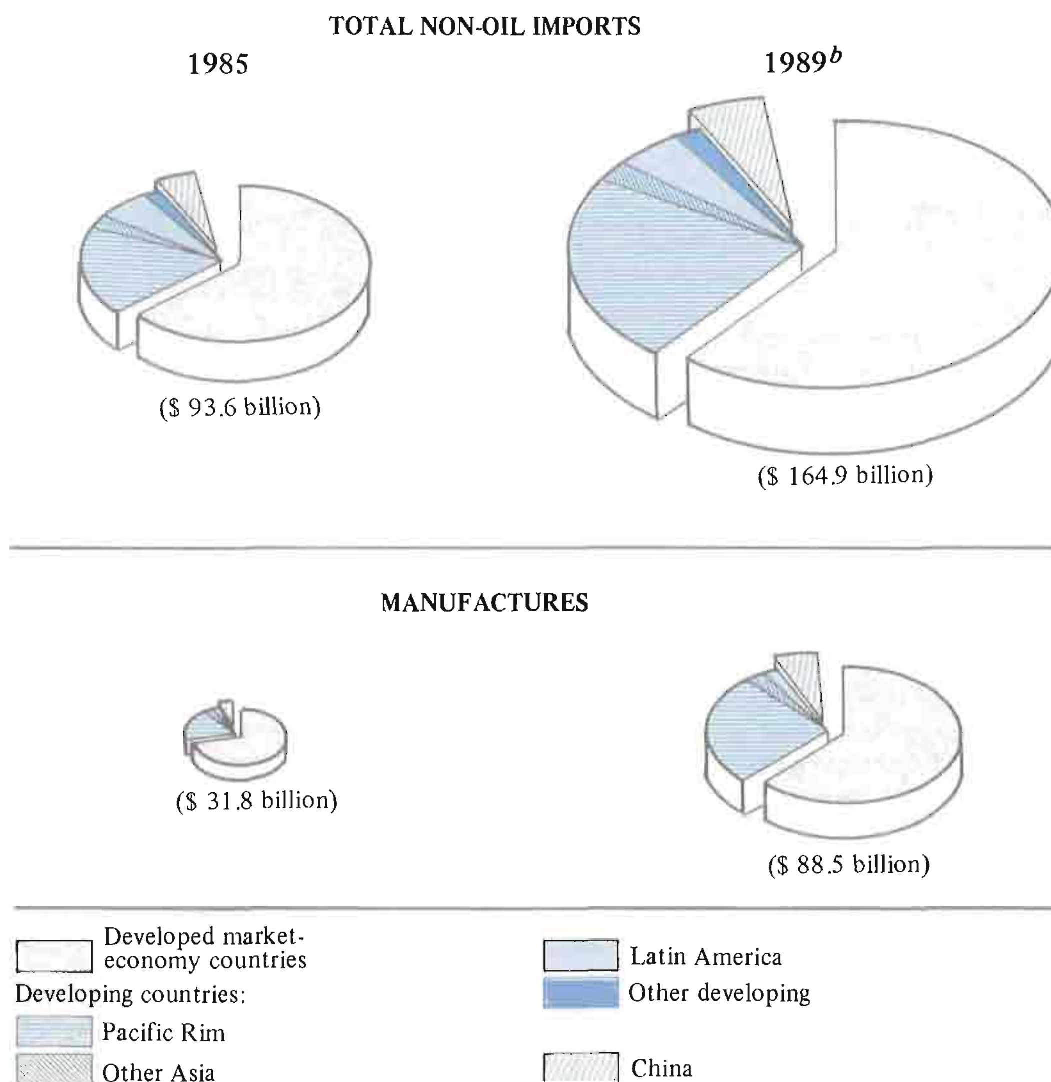
1. *Japanese import performance and developing countries*

The Japanese economy has undergone major changes since 1985. One of the most striking has been the emergence of an import boom as the economy has shifted from growth led by exports to growth led by domestic demand. Total Japanese merchandise imports grew from $132.3 billion in 1985 to $210.8 billion in 1989. The growth in the value of manufactured imports has been even more

Chart 5

NON-OIL IMPORTS AND IMPORTS OF MANUFACTURES [a] INTO JAPAN: SHARES OF DEVELOPING COUNTRY GROUPS, 1985 AND 1989

(Percentage)



Source: United Nations Statistical Office.
a SITC 5-8 less 68.
b Preliminary.

rapid - from $31.8 billion to $88.5 billion.[92] These gains in dollar value were not simply due to the depreciation of the dollar: between 1985 and the first quarter of 1989, the volume of manufactured imports into Japan doubled. The prospects are that Japan will continue to be the most rapidly growing developed country market.

The recent surge in Japanese imports is a most welcome development, and its continuation should make an important contribution to world economic growth and to the exports of developing countries. However, in some quarters there is a growing concern that the benefits from Japanese import growth will not be widely

92 Manufactures are here defined as SITC groups 5-8 less 68. The figure for 1989 is an estimate based on data for the first three quarters.

enjoyed because an Asian network is developing into an informal trading group centred around Japan and propelled by Japanese foreign investment. It is feared that the benefits of Japan's trade growth will be largely confined to a select group of Asian developing economies on the Pacific Rim (PACRIM) - Hong Kong, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan Province of China and Thailand - and that countries, both developed and developing, which are not part of this network could be relatively disadvantaged when competing in the Japanese market.

Japanese non-oil imports are primarily from developed economies (64 per cent in 1985, against under 30 per cent from developing countries, of which more than half was from the eight PACRIM developing economies). Since 1985, growth in imports from developing countries, and particularly from the PACRIM economies, has been very rapid. The latter group now accounts for 23 per cent of Japanese non-oil imports and for 26 cent of manufactured imports (see chart 5).

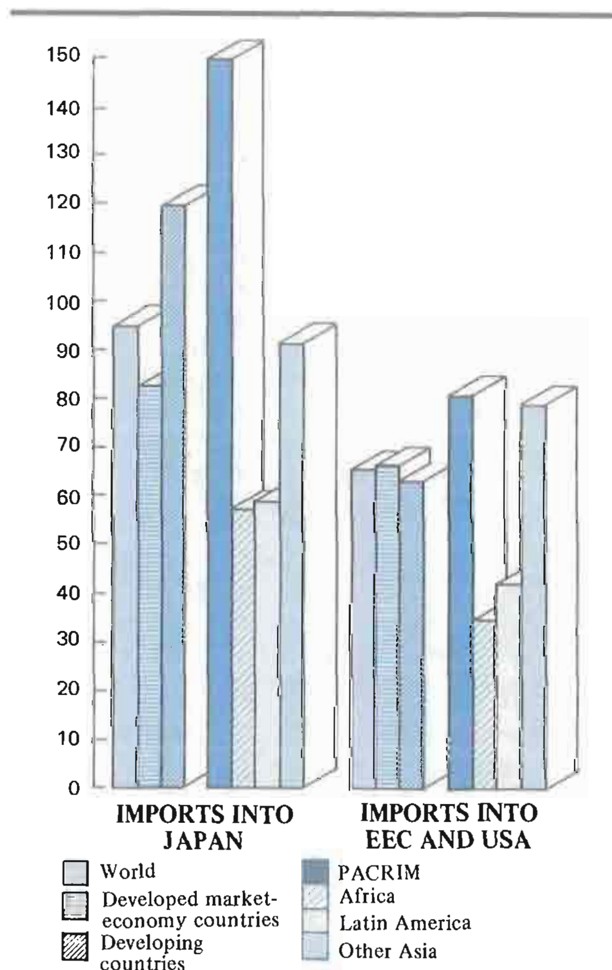
While Japanese imports from the PACRIM economies expanded rapidly after 1985, two points should be stressed. First, even after this rapid surge in growth, by 1988 Japan had only regained its relative importance as a market for the PACRIM economies, compared with the combined markets of EEC and the United States, that it had held in 1981.[93] Second, by 1988 Japanese imports from the PACRIM economies were still only 28 per cent of the combined imports of EEC and the United States from those economies. Thus far, therefore, the degree to which the Japanese and the PACRIM economies are in the process of constituting a self-contained grouping should not be exaggerated.

The growth in Japanese non-oil imports from other developing countries over the period was also rapid - but it was slower than the growth of total imports and much slower than the growth in non-oil imports from the PACRIM economies. In particular, although Japan represented a rapidly growing market for developing countries in America and Africa, the growth in imports from these regions was considerably less than that of total non-oil imports. The result was a significant decline in the shares of developing countries other than the PACRIM economies in non-oil Japanese imports. Although they lost in terms of market share, by the end of the 1980s, this group of developing countries was exporting considerably more to Japan than at the beginning of the decade because of the rapid growth of Japanese overall imports.

Chart 6

INCREASE FROM 1985 TO 1988 IN THE VALUE OF IMPORTS FROM DEVELOPING COUNTRIES INTO JAPAN AND OTHER MAJOR DEVELOPED COUNTRY MARKETS

(Percentage)



Source: United Nations Statistical Office.

There could be alternative explanations for the geographical concentration of the increase in Japanese imports. In the first place, the PACRIM economies benefit from physical proximity to Japan, and high transport costs may be a strong competitive disadvantage for many other developing countries, particularly those in Africa and America. Second, these recent geographical growth patterns could, in principle, simply reflect the commodity composition of Japanese imports, with its concentration on certain manufactured goods. The

93 Schott notes that intra-regional trade in East Asia declined as a share of total East Asian trade from 34 per cent in 1980 to 28 per cent in 1986 and back to 33 per cent in 1988. See Jeffrey J. Schott, "Is the World Devolving into Regional Trading Blocs?" (Washington D.C., Institute for International Economics), December 1989 (mimeo), p. 20.

relatively slower growth in imports from other developing countries might be due to the fact that these countries tend to be less specialized in manufactured goods. Conversely, the strong growth in the exports of the PACRIM economies to Japan could be the result of the mix of commodities in which they have specialized.[94] A third explanation could lie on the supply rather than the demand side. The performance of the PACRIM economies in the Japanese market could simply reflect the increased attractiveness of their products in world markets, rather than a growing Asian bias in Japanese imports. Conversely, other developing countries could be losing competitiveness.

The commodity mix and competitiveness factors have played an important role in explaining the geographical composition of Japanese import growth since 1985.[95] Indeed, as can be seen from chart 6, judging simply by the changes in the shares of the PACRIM economies in the combined markets of EEC and the United States, the relative performance of those economies appears to have been quite similar in all major developed country markets, suggesting that the competitiveness factor may have been an important one.

None the less, the data do suggest that foreign direct investment and intra-firm trade account for a growing, albeit small, share of Japanese imports from the PACRIM economies. In some sectors, such imports have been predominant. The next sub-section tackles this issue.

2. The role of foreign direct investment

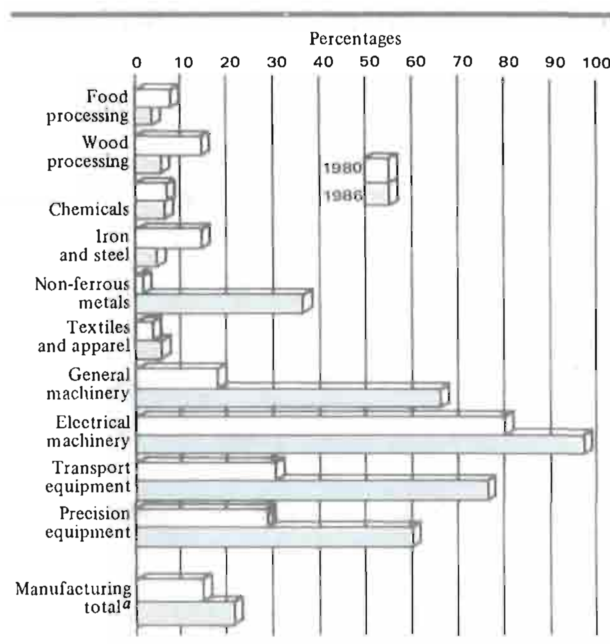
Foreign companies have often found the Japanese economy extremely hard to penetrate. As noted above, they frequently complain of hidden barriers which inhibit them from making sales in Japan. Japanese firms with established distribution systems do not suffer from these barriers in Japan. If these perceptions have a basis in reality, it might be expected that countries which are successful in attracting Japanese foreign direct investment would have an edge in selling in Japan.

Since the mid-1980s, in fact, growth in Japanese manufacturing FDI has accelerated, but the rise has been confined to the developed economies and Asia. The non-Asian developing countries have not benefited - in fact, real flows of FDI to developing countries other than PACRIM economies have actually declined.[96] Between 1985 and 1988, Asia accounted for 80 per cent of all manufacturing FDI flows to developing countries. The most important host economies in Asia are Thailand, Indonesia, the Republic of Korea, Singapore and Taiwan Province of China. In real terms, corresponding flows to Latin America, the Middle East and Africa fell dramatically in this period.

Chart 7

SHARE OF IMPORTS FROM AFFILIATES IN JAPAN'S IMPORTS OF MANUFACTURES FROM ASIA, BY SECTOR, 1980 AND 1986

(Percentage)



Source: K. Takeuchi, *op. cit.*
a SITC 5-9.

How important are imports from Japanese foreign affiliates in Japanese trade with developing countries? As can be seen from chart 7, while the share of FDI-related imports from Asia for the manufacturing sector as a whole is still relatively low, it has been growing. The role of foreign investors, however, varies considerably as between sectors.

[94] Of course, the coincidence between the commodity composition of Japanese import growth and PACRIM export expansion could be due to some extent to investments of Japanese corporations in the PACRIM economies for export back to Japan.

[95] The technical analysis can be found in the annex to this chapter.

[96] Kenji Takeuchi, "Japanese Direct Foreign Investment: A Promoter of Japanese Imports from Developing Countries?" (Washington, D.C., The World Bank), May 1990 (mimeo).

Table 25

IMPORTS INTO JAPAN OF FDI-INTENSIVE PRODUCTS, [a] 1985 AND 1988

	Value ($ million)		*Share of non-oil imports (Per cent)*	
Origin	*1985*	*1988*	*1985*	*1988*
World	11,856.9	25,587.5	14.5	18.1
PACRIM economies	1.225.8	4,394 0	8.8	12.7
Hong Kong	47.2	234.4	5.3	10.8
Indonesia	0.8	8 3	0.1	0.3
Malaysia	62.9	141.1	3.2	4.6
Philippines	21.0	63.3	1.9	3.2
Republic of Korea	438.6	1,658.5	12.4	14.4
Singapore	172.5	469 9	33.4	36.8
Taiwan Province of China	424.9	1,840.3	12.6	18.7
Thailand	58.1	180.4	5.7	6.6

Source: United Nations Statistical Office.
a SITC 7 (machinery and transport equipment) and 87 (instruments).

While in most industries affiliates play a minor role, in non-ferrous metals they are significant (about a third of all imports), and in four sectors (general machinery, electrical machinery, transportation machinery and precision equipment) their share in Japanese imports is overwhelming. Typically, around three quarters of Japanese imports from Asia in these commodities are shipped by Japanese foreign affiliates. Moreover, in 1986 exports from just these four sectors accounted for 74 per cent of all imports from manufacturing affiliates in Asia, and the electrical machinery and electronics sector alone accounted for 50 per cent.

The high degree of industrial concentration of imports from these affiliates makes it appropriate to calculate an FDI-intensive aggregate which comprises machinery and transportation equipment (SITC 7) and precision instruments (SITC 87). As reported in table 25, in the 1985-1988 period Japanese imports of FDI-intensive products increased by 116 per cent, compared with the rise of 91 per cent for other non-oil imports. Therefore, countries which are hosts to affiliates of Japanese corporations producing for the Japanese market did have an advantage over countries which do not have an important presence of Japanese corporations. However, the quantitative importance of FDI-related imports was insufficient to account fully for the performance of the PACRIM economies. While the share of FDI-intensive imports from PACRIM economies increased rapidly (from 8.8 per cent to 12.7 per cent) over this period, FDI-intensive trade accounted for just 15 per cent of the growth in non-oil imports from this group. Thus, while they constituted a rapidly growing part of Japanese imports from the PACRIM economies, the FDI-intensive sectors continued to account for a relatively small part of the overall rise in imports.

Examining individual country performance suggests a similar conclusion. FDI-intensive sectors were important in the growth in non-oil imports from Singapore, in which they accounted for 39.1 per cent of overall growth. They were less important for other economies such as Taiwan Province of China (22.5 per cent), Republic of Korea (15.3 per cent) and Hong Kong (14.2 per cent), and less so in the other countries in the group.

3. *Some tentative conclusions*

The analysis suggests that their ability to attract Japanese FDI played a role in the rapid growth of the PACRIM economies' exports to Japan. The presence of affiliates of Japanese corporations allowed them to outperform the growth in their markets as determined both by their commodity mix and by their general competitive performance. The influence of affiliates of Japanese corporations in the strong

export performance of the PACRIM economies in the Japanese market was particularly strong in Singapore and, to a lesser extent, in Taiwan Province of China, Republic of Korea and Hong Kong.

In sum, the evidence indicates that, in the machinery and precision instruments industries, Japanese FDI plays a critical role in Japanese imports from Asian developing countries. In this sense, there is support for the view that a trade network centred around the activities of Japanese corporations abroad has been developing in the PACRIM economies. However, the overall contribution of this network to Japanese non-oil imports should not be exaggerated. While FDI-intensive imports grew extremely rapidly, they accounted for only 15 per cent of the overall growth in Japanese non-oil imports from the PACRIM economies. Generally, developing countries seeking rapid growth in exports to the Japanese market in sectors other than machinery and instruments will have to rely on possession of the appropriate commodity mix and competitiveness. This means that the emphasis will have to be on policies which promote the efficient development of supply capabilities in goods which are, and will be, in strong demand in this growing market. These policies will also be essential for success in the markets of the United States and Europe, which are likely to remain the major markets for developing country exports of manufactures for some time to come. On the other hand, developing countries seeking to penetrate the Japanese market for machinery and instruments will probably have to attract investment by Japanese corporations.■

Annex to Chapter III

THE ROLES OF COMMODITY COMPOSITION AND COMPETITIVENESS IN THE JAPANESE IMPORT SURGE

What role did the patterns of specialization play in performance in the Japanese market? One reasonable benchmark is to estimate what Japanese imports from a trading partner would have been had that partner been able to maintain its share in the import growth of each of the commodities it sold to Japan. A comparison of this constant-share performance with the actual growth in total Japanese non-oil imports would indicate the role played by commodity composition in changing the partner's market share.

The constant market share growth index (relative to base year 1985) can be expressed as:

$$CJ_j = \sum_i W_{ij} \times GJ_i$$

where GJ_i = index of Japanese imports of commodity i at the two-digit SITC level in 1988;

W_{ij} = share of commodity i in country j's exports to Japan in 1985.

The ratio of this index to the growth of total Japanese non-oil imports is an estimate of the role of commodity mix in the change in market share of the trading partner. Expressed in index form:

$$(CJ_j \; / \; GJ) \times 100$$

where GJ = index of total Japanese non-oil imports in 1988.

Commodity composition does play a major role in explaining the favourable performance of the PACRIM economies. The constant share market for the non-oil products of the PACRIM economies grew by 128.6 per cent between 1985 and 1988 (the last year for which complete data are available), compared with the 94.5 per cent growth in non-oil imports overall. Thus of the 28 per cent growth in the share of the PACRIM economies in non-oil Japanese imports, fully 18 percentage points could be ascribed to the commodity composition of trade (see table A-9).

By the same token, the commodity composition of imports from developing America also helps explain some of the slower growth of Japanese imports from these countries. Had these countries been able to maintain their shares in each commodity they exported, the share of developing America would have declined 8 per cent. This still leaves 10 percentage points, or about half, of the decline in the share of developing America unexplained. Commodity composition sheds less light on the African performance, accounting for only 3 percentage points of the decline in the market share of these countries.

The influence of commodity mix reflects Japanese demand patterns. In addition, however, the supply-side performance of exporters to Japan could play an important role. Products from the PACRIM economies could have become more competitive in world markets generally, because of either improved quality or lower prices. Conversely, products from other developing countries may have lost competitiveness. One way to estimate and quantify these changes is to examine performance in non-Japanese markets. The measure of competitiveness on the supply side that is used is the change in the market share of each trading partner in the combined market of EEC and the United States that is *not* attributable to commodity-mix effects. Each trading partner's constant-share market growth is estimated on the assumption that it was able to hold its 1985 share of each commodity in the combined EEC/US market over the period 1985-1988. In order to obtain a measure that will be relevant for use in the Japanese market, the 1985 shares of each commodity in non-oil exports *to Japan* are used.

Table A-9

ANALYSIS OF JAPAN'S IMPORT GROWTH FROM 1985 TO 1988

(Percentage)

	Change in:		*Change in share attributable to:*		
Imports from	*Imports*	*Share of Japan's imports*	*Market growth*	*Competitiveness*	*Residual*
World	94.5	.	.	.	.
Developed countries	82.3	-6	-4	-	-2
Developing countries	119.6	13	9	-2	6
PACRIM	149.9	28	18	11	-
Other	68.8	-13	-5	-6	-2
Africa	57.3	-19	-3	-2	-15
Latin America	58.9	-18	-8	-11	1
Other Asia	91.1	-2	-	19	-21
PACRIM economies:					
Exporters of manufactures					
Hong Kong	148.8	28	30	-2	-
Republic of Korea	225.2	67	35	17	16
Singapore	147.4	27	1	7	19
Taiwan Province of China	180.7	34	27	-8	15
ASEAN four					
Indonesia	139.7	23	4	25	-6
Malaysia	55.6	-20	-4	-2	-14
Philippines	56.3	-20	-2	-17	-1
Thailand	168.1	38	7	68	-37

Source: UNCTAD secretariat calculations, based on data of the United Nations Statistical Office.

In this case, the constant market share growth index of a country in the combined EEC/US market (1985 = 100) can be expressed as:

$$CEUS_j = \sum_i W_{ij} \times GEUS_i$$

where $GEUS_i$ = index of EEC + US imports of commodity i (at the two-digit SITC level) in 1988;

W_{ij} = share of commodity i in country j's exports to Japan.

In order to derive the competitiveness index of a particular country in the Japanese market, $CEUS_j$ is compared to an index of actual performance in the combined EEC/US market using Japanese market weights:

$$AEUS_j = \sum_i W_{ij} \times GEUS_{ij}$$

where $GEUS_{ij}$ = index of EEC + US imports of commodity i from country j in 1988.

The desired competitiveness index for country j is equal to:

$$\left(1 - \frac{CEUS_j}{AEUS_j}\right) \times 100$$

To be sure, performance in the combined EEC/US market might not be a perfect benchmark for appraising competitiveness. First, some countries could be subject to more stringent import barriers in EEC or the United States than in Japan, thus biasing the measures of competitiveness downward. Second, the analysis could be sensitive to the level of disaggregation and the choice of 1985 as a base year. Third, the measures are affected by the fact that they are based on *import* shares rather than on shares which include consumption of domestic products. None the less, the results obtained are an interesting first approximation to the measurement sought.

The competitiveness residuals that were obtained accord with expectations: the PACRIM economies have relatively large in-

Table A-10

PACIFIC RIM ECONOMIES: PERFORMANCE IN FDI-INTENSIVE AND NON-FDI-INTENSIVE EXPORTS TO JAPAN, 1985-1988

(Percentage) [a]

	Change in:		Change in share attributable to:		
Imports from	*Imports*	*Share of Japan's imports*	*Market growth*	*Competitiveness*	*Residual*
FDI-intensive sectors [b]	258.5	66	10	16	40
Non-FDI-intensive sectors	139.5	25	19	10	-4

Source: UNCTAD secretariat calculations, based on data of the United Nations Statistical Office.
a Or percentage points, as appropriate.
b SITC 7 (machinery and transport equipment) and 87 (instruments).

creases in competitiveness, and most groups of other developing countries (with the exception of other Asian countries) exhibit declines (see table A-9).

At the level of broad country aggregates, the statistical analysis does not point to a major role for a special Japanese residual which could be ascribed to unique institutional developments in the Japanese economy. Instead, performance in the Japanese market over the period seems to be well explained by the commodity mix of trading partners and changes in national competitiveness. The spectacular growth in the share of the PACRIM economies in Japanese imports (28 per cent) is almost fully accounted for by the contributions of favourable commodity mix (18 percentage points) and improvements in competitiveness (11 percentage points). Similarly, the 13 per cent decline in the share of other developing countries is largely explained by a 5 per cent decline due to commodity composition and a 6 per cent decline due to competitiveness. At less aggregated levels, large positive residuals do remain for the Republic of Korea, Singapore and Taiwan Province of China. If there is an unusual bias towards the PACRIM economies that is not explained by commodity composition or competitiveness, it would appear to be confined to these three economies, rather than being widely spread across the Asian Pacific economies in general.

On the other hand, among other regional developing country groups, countries in developing America have done as well as their potential markets and competitiveness would lead one to expect. Other Asian countries and African countries have not performed as well as might have been expected according to the commodity mix of their exports and their competitiveness.

In sum, the analysis does not point to a pervasive bias in Japanese trading patterns in favour of the PACRIM economies and against other developing countries. On the one hand, five of eight PACRIM countries performed no better than (or worse than) might have been expected on the basis of commodity mix and competitiveness. On the other hand, while African and other Asian economies did record negative residuals, developing countries in America performed as well as could have been expected.

It is also illuminating to perform the constant market share analysis undertaken above on the PACRIM economies, splitting the sample into FDI-intensive and non-FDI-intensive industries. The former are composed of imports of machinery (SITC 7) and precision instruments (SITC 87). The latter are all other imports. This allows one to obtain an idea of the role of the FDI-intensive sectors in the favourable commodity mix and competitive ratios estimated above. The results are reported in table A-10. Overall, one can fully explain the 25 per cent share improvement in Japanese non-FDI-intensive imports from the PACRIM economies on the basis of commodity composition (19 percentage points) and improvements in competitiveness (10 percentage points). However, the 66 percentage points rise in the PACRIM economies' share in FDI-intensive products is less fully explained. Only 10 points are due to market growth and 16 to an improvement in competitiveness. The 40 percentage point positive residual suggests a considerable role for the direct effect of Japanese investments in this performance.■

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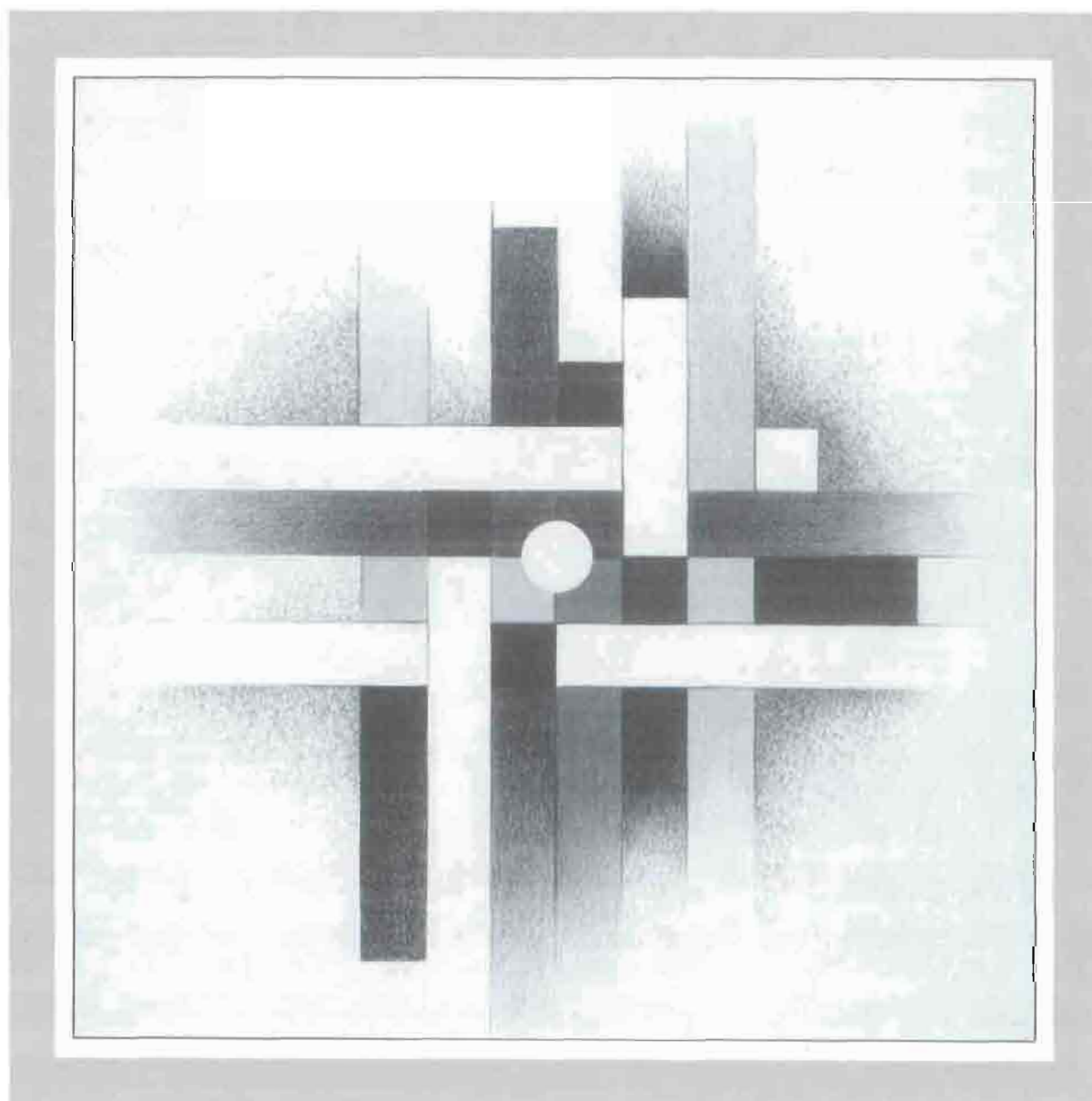
Part Two

THE INTERNATIONALIZATION OF FINANCE



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Introduction

One of the principal characteristics of the world economy in recent years has been the rapid pace at which financial activity has grown and become international in character. As restrictions on their movement have been relaxed, funds have increasingly flowed back and forth across national boundaries; and as capital has learned to operate globally, restrictions on its behaviour have progressively lost their force. At the same time, trade in financial services and assets of varying maturities has grown by leaps and bounds, both nationally and internationally, far exceeding the expansion of production and trade in goods.

This dual process - the tightening of the financial linkages among countries and the apparent delinking of finance from production - has asserted itself in various ways. In the first place, the money markets in many countries, including all the developed market economies, have become closely interrelated. So, too, have bond markets, both via the linkage of money markets and directly; equity markets have displayed a similar tendency. Secondly, since currency transactions are required for cross-border movements of funds, foreign exchange markets have become more important transmission belts for monetary and financial fluctuations. Consequently, trade - and hence production, investment and employment - have become more directly exposed to changes in the financial environment. Equally, national money and capital markets have become highly vulnerable to conditions in currency markets, and uncertainties from this source, by augmenting wealth-holders' preference for liquidity, have added to upward pressures on interest rates.

Banks have played a key role in the internationalization of finance, both on behalf of their customers and on their own account. Thus, their deposits and loans have become increasingly - and for many large banks, highly - diversified in their country composition, and cross-border fee-earning activities have become increasingly important sources of profit and growth. The expansion and diversification of international banking has in part been due to the growth of other transnational corporations whose overseas branches, subsidiaries and affiliates have drawn in the banks which served them in their home base, both to provide international banking services and to deal with the residents of the host countries. But at the same time, financial innovation and deregulation have blurred the distinction between banks and non-bank financial institutions, most notably in a number of major financial centres: banks have increasingly entered into lines of business from which they were previously barred, while various other types of institutions have taken on banking activities of various kinds. Financial services have as a result become more easily "unbundled" and traded, domestically and globally.

The process of internationalization, though rapid, remains incomplete - in particular as regards the developing countries and the actors involved. Most developing countries maintain restrictions on capital movements (though in some these are inoperative owing to the opportunities for leakage provided by flows of trade and services of other kinds, opportunities which in some countries have interacted with acute economic stress to generate "dollarization" and large-scale capital flight). Moreover, notwithstanding the growth of cross-border transactions and the establishment by banks of a presence inside other countries, the bulk of purely domestic transactions generally remains in the hands of domestically owned institutions. Restrictions on the right of establishment and differential treatment of foreign and domestic institutions have been critically important factors in preventing banks from increasing their presence and participation in financial markets abroad to the full extent of their wishes. For developing countries, however, the question of foreign access to domestic financial markets remains closely connected to the issue of financial openness generally, including the ability to control capital movements and conduct autonomous monetary and financial policies directed at their own development.

Much controversy has been generated by the internationalization of finance. On one view, it has brought major benefits to the world economy by improving the allocation of resources internationally. It is argued that dismantling restrictions has allowed capital to flow freely to countries in response to opportunities for real investment, while increased financial openness has made it possible for individual countries to save more than they invest or to invest more than they save, thereby raising the global levels of production, investment and savings. Similarly, restrictions on market access in the provision of banking ser-

vices have effects similar to quotas and tariffs on international trade in goods. Thus, for example, restrictions on establishment can lead via lower levels of competition to reduced innovativeness and microeconomic efficiency or to excess profits (or to both) among banks already in the market. Operating restrictions can lead, via the increased costs imposed on banks affected, to higher interest rates and other charges and to lower levels of lending. It is thus argued that the liberalization of restrictions on the establishment and operations of foreign banks will improve the performance of financial sectors as regards both the opportunities it makes available to depositors and investors for the placement of their funds and as regards the amount and allocation of financing for borrowers.

On another view, however, the internationalization of finance has been harmful. For one thing, so it is said, increased financial openness has made each country more susceptible to changes in the international financial environment and has greatly reduced policy autonomy. Equally important, it has weakened the impact of domestic monetary and financial policy instruments, and hence the ability of the Government to manage the macroeconomy. Moreover, Governments have become highly vulnerable to shifts in the degree of confidence they command in the international financial community, over which they have far less leverage than over purely domestic financial institutions. According to this view, the increased power of international finance to discipline Governments has not been accompanied by a lessening of the financial markets' penchant for speculative excesses and overreactions. Indeed, international financial integration has resulted in stronger and swifter propagation of financial instability across different countries and markets. The increased fragility of the international monetary and financial system, and the resulting risks and dangers for the "real" sectors, reflect in part the failure of the official sector to respond adequately to the new realities.

Similarly, it is argued that a liberalized regime for international trade in banking services - one of the most important issues under negotiation at the Uruguay Round - poses dangers, particularly to developing countries. Commitments to liberalize cross-border transactions in banking services may entail abandoning exchange controls essential to macroeconomic management and to limiting capital flight. Moreover, unless subject to appropriate controls, the presence of foreign banks will complicate the conduct of autonomous national monetary policies owing to the character of the banking operations which this presence facilitates, and to the lower degree of "moral suasion" to which such banks tend to be susceptible: since economic development often requires direction of the allocation of credit, the liberal, market-driven banking systems of the type currently prevailing in many OECD countries are not the right model to follow. Besides, much of the protection of banking in developing countries is of an infant industry nature. It is argued that the avoidance of financial dependence and the establishment of indigenous banking systems are an integral part of economic development, and generally require protection and support to national institutions which would otherwise risk being swamped by the superior competitive strength of banks from the OECD area.

The issues underlying this debate constitute the subject matter of Part Two of this report. Chapter I examines the extent of financial integration among countries, its causes and effects. It first examines the extent of the internationalization of finance; assesses its relationship to output, trade and investment; and examines the role of financial deregulation and liberalization in increased financial integration and openness. It goes on to discuss its effects on financial stability, emphasizing the links between currency and financial markets and the role of policies, drawing on the experience of the 1980s. It concludes with a discussion of ways to improve the functioning of the international monetary and financial system.

Chapter II begins with a discussion of the definition of the banking sector and the measurement of the services it provides. These topics show the relation between the key concept of market access and the existence of different banking sub-markets and give an idea of the scale of international banking transactions. Subsequent sections discuss the nature of competition in banking and its connection to the costs and benefits of liberalization for the sector, some aspects of financial dependence, relations between credit allocation and the promotion of economic development, and problems which liberalizing trade in banking services may pose for monetary policy. There is also a review of some of the comparative evidence concerning the actual incidence of restrictions on the market access and operations of foreign banks in developing countries. The final part of the chapter takes up the question of applying to banking various concepts and principles on which discussions at the multilateral trade negotiations have centred, and which may eventually become key constituents of an agreed framework for international trade in banking services.■

Chapter I

INSTABILITY, UNCERTAINTY AND INTERNATIONAL FINANCE

Recent years have witnessed many sharp and unpredictable shifts in the major monetary and financial variables, including the prices of financial assets, interest rates and exchange rates, and flows of capital, both across borders and across markets for financial assets denominated in different currencies. There have also been periods in which these variables have persistently stayed at levels not compatible with their fundamental determinants; instability has thus been latent even when it has not actually occurred. As a result, serious strains have been put on international debtor-creditor relations, the banking system, capital markets and the international payments and exchange arrangements. Many observers, analysing these developments from the standpoint of both the world economy and individual countries, have concluded that actions to make the monetary and financial system more stable and less susceptible to disruptions and crises should have high priority.

Monetary and financial disorder is not a new phenomenon. The international monetary and financial system has exhibited disorderly and sometimes even chaotic behaviour since the early 1970s - although the latter has fortunately been relatively short-lived. Until the early 1980s this behaviour could plausibly be explained by shocks and abrupt changes in the environment in which the international monetary and financial system operated. First, the early 1970s saw progressive disintegration and the eventual breakdown of the Bretton Woods system; currency market turbulance and exchange rate instability could thus be expected to persist until floating was generalized and the markets learned and established new rules of the game. Second, the inflationary experience following the oil-price rises of the 1970s had destabilizing influences for the international monetary and financial system. On the one hand, not only did foreign exchange markets have to operate under conditions of price instability, but also relative price levels of major countries underwent drastic changes because of significant inter-country differences in rates of inflation. On the other hand, the trade imbalances that emerged as a result of oil price increases and terms-of-trade changes, together with policies designed to avoid contraction in economic activity, resulted in substantial increases in international liquidity and debt-financing of current account deficits which proved a major problem subsequently. Finally, the disinflationary process of the late 1970s and early 1980s entailed substantial instability in financial and currency markets because the mix and stance of policies in the major countries gave rise to large swings in key financial prices. The pace of disinflation also differed among the major countries, implying substantial changes in relative price levels.

However, such conjunctural and transitory factors are much less capable of explaining the continued instability in international money and finance over the last six to eight years. This period has seen neither especially high inflation nor serious supply shocks, and the major market economies have increasingly converged in their growth performance and displayed increased willingness to undertake joint interventions to manage exchange rates. Even so, the international monetary and financial system has remained unstable, as witnessed by the sharp swings in stock prices, exchange and interest rates, continued failures of banks and other financial institutions, and persistence of strains in international debtor/creditor relations. As pointed out by the President of the Federal Reserve Bank of New York: "The past fifteen years have witnessed a greater number of financial disruptions with potential systemic implications than was the case over the post-war period prior to 1974. And if we divide the 1974-1989 period roughly in half, the latter half of that interval has seen more disruption than the former."[97]

[97] *Federal Reserve Bank of New York Quarterly Review*, Winter 1989-1990, p. 9.

These considerations suggest that deficiencies in the structure of international financial and monetary system and in the philosophy underlying policies are more important factors in the observed behaviour of financial and currency markets. Disruptions and disorder in such markets have so far been contained in that they have not led to crises with serious and widespread damage for the real economy.[98] However, crisis management has been costly. For instance, an international banking crisis has been staved off at the expense of living standards, stability and development in debtor developing countries while exchange rate management has tended to raise world interest rates. More important, so long as the international monetary and financial system remains structurally vulnerable, the potential for an extremely costly crisis will remain. Again, in the words of the President of the Federal Reserve Bank of New York, "if a crisis were to develop ... its capacity to generate major damage to the real economy may be greater today than it was in the past. The fundamental reason for this is the nature, speed and complexity of the operational, liquidity and credit interdependences that bind together all major financial institutions and markets in the world."[99]

There are three basic deficiencies:

(a) The main activity of financial markets has become not so much to intermediate between ultimate savers and investors, allocate resources on the basis of asset valuations reflecting long-term risk and profits, and facilitate transactions and payments needed for investment, trade and production, but rather to create short-term opportunities for speculation in volatile and misaligned asset valuations. Speculation is not of course a new phenomenon; but the increased internationalization of finance has enhanced the scope for propagation of disturbances from one market to another within as well as across borders;

(b) The policy approach prevailing in the major countries has also tended to contribute to instability. Since the beginning of the decade many countries have effectively ceased to use the government budget and prices and incomes policies for macroeconomic management, thereby overloading monetary policy and making different policy objectives more difficult to reconcile. Moreover, the conduct of monetary policy has changed significantly: not only have interest rates been deregulated, but, except at times of crisis, monetary policy has been directed at certain monetary aggregates rather than the management of financial asset prices and interest rates. Consequently, monetary and real shocks to financial markets have tended to generate sharp swings in financial asset prices and interest rates. Moreover, interest rate deregulation has not always been accompanied by increased prudential regulations; excessive risk-taking in the financial system has played a major role in financial failures in some major countries. Meanwhile the dismantling of quantitative and tax restrictions on movements of capital across countries, markets and currencies has accorded markets greater scope to generate and/or propagate speculative disturbances;

(c) Effective multilateral constraints and obligations on policy making in the major countries have been absent. Although existing institutional arrangements have been outmoded by the increased financial integration and internationalization of finance that has taken place, there has been no reform designed to ensure effective multilateral surveillance over the policies of countries which have a large impact on the world economy.

This chapter analyzes these shortcomings, and points to possible ways of dealing with them. Section A discusses the extent and causes of the internationalization of finance, and the relationship between international financial "deepening" and output, capital formation, international trade and foreign direct investment. It then discusses the role of financial deregulation and liberalization in increasing financial integration and openness.

Section B examines some important consequences of the internationalization of finance. It discusses its contribution to efficiency in the allocation of savings internationally, and to investment and trade, and assesses the extent to which it has increased the scope for speculative activities and financial instability. It examines the interactions between currency and financial

98 Concepts such as financial crisis, disruption and disturbance do not have unique definitions, and can mean different things to different people. Here financial crisis is reserved to describe a situation characterized by falling asset prices, widespread insolvency among debtors and financial intermediaries which seriously undermine the capacity of the markets to allocate capital and exert a visible and significant damage to the real economy. However, it should also be remembered that "the line between 'disruption' and 'crisis' can be fine indeed, since it is not at all difficult to imagine circumstances in which specific 'disruptions' of the past ten or fifteen years could have tripped into the category of 'crisis'." (*Ibid.*, p. 8.)

99 *Ibid.*, p. 9.

markets and identifies the channels through which disturbances are propagated, contained or attenuated, and the effect of financial openness on the ability of national authorities to pursue autonomous policies.

Section C examines the behaviour of financial and currency markets in the 1980s, especially destabilizing interactions among three key prices - interest rates, exchange rates and equity prices. It discusses the role of financial and monetary policies in the major OECD countries and market behaviour in generating these movements.

Section D opens with a brief discussion of the effects of financial and monetary instability, in particular the adverse consequences for countries, especially developing countries, unable to take protective action; these raise the costs and risks of integrating more fully into the world economy. The section then discusses the need for reform in exchange rate arrangements, the treatment of speculative capital flows and institutional arrangements for multilateral surveillance and policy co-ordination.

A. International financial integration

1. *The nature and volume of international finance*

The primary function of a financial system is to transfer funds from savers to investors by reconciling the desire of the former to remain liquid with the need of the latter to acquire indivisible, illiquid physical assets. Financial intermediaries (such as banks) can help achieve the required maturity transformation by holding assets that are less liquid than their liabilities. They thus carry a liquidity risk for which they expect to earn profits. Alternatively, savers can have direct claims on investors, for instance in the form of bonds; the possibility of selling such claims in secondary markets provides the necessary liquidity, but there is a risk of capital loss.

Strictly speaking, the term *domestic finance* covers only financial transactions among residents denominated in the country's own currency (the "home currency"). By contrast, *international finance* involves either a non-resident or assets denominated in a foreign currency, or both - i.e. financial transactions across borders or across currencies. *International banking* thus involves claims and liabilities vis-à-vis residents denominated in foreign currencies, as well as claims and liabilities vis-à-vis non-residents denominated in either home or foreign currencies.

This definition of international finance is wider than Eurocurrency or offshore banking, which excludes international bank loans to and deposits of non-residents denominated in the home currency. It also includes bond and equity issues in Eurobond and Euroequity markets - i.e. in a currency not that of the country in which the bond or the equity is issued; issues in the so-called foreign bond markets - i.e. bonds issued by non-residents in a country in the currency of that country; and non-resident holdings of securities issued by residents in the home currency (i.e. issued in the so-called national stock market).

However, domestic and international transactions are not segmented into separate markets. When the financial market of a country is opened to non-resident investors and/or borrowers, or when residents are allowed to deal in foreign currency assets and liabilities, these markets become internationalized. As national and international financial transactions develop relations of substitutability and complementarity, financial transactions with purely domestic characteristics become subject to strong external influences.

The share of transactions with international characteristics can, in principle, provide a good indicator of the exposure to such influences.[100] Table 26 puts together some data on international banking, covering major financial markets and offshore centres. Almost one-third of total bank assets in this group of countries taken together qualifies as international. The share is very large in some countries - two-thirds in London and more than three-quarters in offshore centres - but relatively low in the Federal Republic of Germany. About two-thirds of international assets are interbank transactions. In general, claims on non-

[100] There are serious practical difficulties in estimating financial transactions with international characteristics and integrating national and international aspects of finance since such data are not readily available for most countries. Thus, the estimates in this section need to be used with caution.

Table 26

TOTAL AND INTERNATIONAL ASSETS OF BANKING OFFICES IN SELECTED INDUSTRIAL COUNTRIES AND OFFSHORE BANKING CENTRES, 1982 AND 1988

					Assets with international characteristics (as a percentage of total assets)					
	Total assets [a] ($ billion)		International assets as a percentage of total assets		Claims on non-residents in foreign currencies		Claims on non-residents in home currency		Claims on residents in foreign currencies	
Country/centre	*1982*	*1988*	*1982*	*1988*	*1982*	*1988*	*1982*	*1988*	*1982*	*1988*
8 European countries [b]	3811	7427	31.9	30.7	19.9	19 7	4.5	4.8	7 4	6 3
of which:										
United Kingdom	893	1841	72 3	62 4	48 9	43.8	2 9	4.2	20.5	14 4
Federal Republic of Germany	1140	2529	7.5	8.3	1.7	2.4	5.6	5.7	0.2	0.2
France	654	1271	28.8	27.3	19 0	18 4	3.7	3.3	6.1	5.6
United States	2109	3048	17.2	18.4	0.4	2.3	16.8	16.1	-	-
Japan	1157	4625	15.4	25.0	5.7	8.4	2.2	7.4	7.5	9.1
11 industrial reporting countries [c]	7313	15504	24.9	26.2	12.4	12.7	7.6	7.7	5.4	5.9
Eight offshore centres [d]	660	..	87.4	..	75.6	..	1.3	..	10.5	..

Source: 1982 data (except for Japan) from Ralph C. Bryant, *International Financial Intermediation*, Washington, D.C., 1987, table 3.1; 1988 data from BIS, *International Banking and Financial Market Developments*, and national sources. All data are end-year.
a Gross size of banks' balance sheets.
b Belgium, Federal Republic of Germany, France, Ireland, Italy, Netherlands, Switzerland and the United Kingdom.
c The eight European countries plus Canada, Japan and the United States.
d Bahamas, Bahrain, Cayman Islands, Hong Kong, Lebanon, Netherland Antilles, Panama and Singapore.

residents in foreign currencies account for a substantial portion of international assets, but banks in the United States and the Federal Republic of Germany appear to have a stronger preference for the home currency in international lending.

Data for 1982 and 1988 are not directly comparable, particularly in the Federal Republic of Germany and Japan; between these dates the deutsche mark appreciated against the dollar by nearly 40 per cent and the yen by more than 90 per cent, raising considerably the dollar value of total bank assets in these countries. Nevertheless, they reveal a number of tendencies regarding changes in the importance of international banking. First, there has been a significant increase in the share of international banking in Japan despite the yen appreciation. Second, there has been a decline in the share of offshore centres in international banking (from about 25 per cent in 1982 to 20 per cent in 1988), and in the share of international banking in some traditional financial centres such as London.[101] This probably reflects competition - financial deregulation and liberalization by other centres.

[101] It has to be pointed out that sterling depreciated between 1982 and 1988, i.e. figures in table 26 underestimate the relative decline in international banking in the United Kingdom.

Table 27

SIZE AND STRUCTURE OF WORLD FINANCIAL MARKETS IN 1982 AND 1988

	1982		1988	
	Value of assets ($ billion)	*Per cent of total assets*	*Value of assets ($ billion)*	*Per cent of total assets*
Bank assets [a]	8,887	64.1	17,005	46.6
Domestic	6,218	44.8	11,500	31.5
International	2,669	19.3	5,505	15.1
Capital markets	4,977	35.9	19,507	53.4
Euroequity	-	-	40	0.1
International bond markets [b]	259	1.9	1,085	3.0
Stock markets	1,591	11.5	9,563	26.2
Bond markets	3,127	22.5	8,819	24.1
Total	13,864	100.0	36,512	100.0

Source: See table 26; capital market information has been supplied by Salomon Brothers International. All data are end-year.

a Gross size of banks' balance sheets.

b Eurobonds and foreign bonds.

The combined size of world financial markets can be estimated at over $36,000 billion (table 27), half of which is accounted for by commercial banks.[102] Assets which are strictly international (i.e. international bank assets, Euroequities, Eurobonds and foreign bonds) account for 18 per cent of total world markets; but including those "national" capital markets which have become more open to non-resident investors raises substantially the share of world financial markets having an international character.

The 1980s have seen a major shift in international financial intermediation from banking to security markets ("securitization"). International bank lending slowed down, reflecting the cutback of lending to developing countries and the increased recourse of international borrowers to direct security issues while Eurobond markets became important; Euroequity markets also emerged. While securitization has reduced the share of international banking in world financial markets, it has increased the involvement of banks in security transactions, greatly widening the grey area between banking and security market transactions, often in the form of off-balance-sheet business. Securitization has gone hand-in-hand with the introduction of a variety of new financial instruments (e.g. rate-issuance facilities, swaps, options and forward rate agreements) designed to reduce investors' exposure to credit, liquidity and exchange rate risk.

The internationalization of finance has also meant financial deepening at a global level. Growth in world output, trade and investment naturally tends to cause the volume of financial transactions to grow. However, over the last two to three decades the pace of growth of international financial transactions has been far in excess of that of the real variables. This is demonstrated in table 28, which compares two measures of international banking (the only time series available on a continuous basis) with indicators of "real" world economic activity - production, trade and investment. These figures tend to underestimate the deepening since, as noted above, securities transactions have grown even faster than international banking.

Since the early 1970s, international banking has grown at more than 20 per cent per annum, i.e. about twice as fast as international trade (12 per cent) and world output (10 per cent). Between 1972 and 1987 world trade increased by about $2,500 billion whereas international banking expanded by $4,000 billion.

102 These figures include total gross assets of commercial banks and stock and bond markets in major financial centres, and Eurosecurity issues. It should be noted that table 27 gives the gross size of world markets not only because bank assets include interbank claims but also because they include direct securities.

Table 28

INTERNATIONAL FINANCIAL DEEPENING: INTERNATIONAL BANKING IN RELATION TO WORLD OUTPUT, TRADE AND INVESTMENT, SELECTED YEARS

	1964	*1972*	*1980*	*1983*	*1985*	*1987*
			As a percentage of world output [a]			
Net international bank loans [b]	0.7	3.7	8.0	12.0	13.2	14.8
Gross size of international banking market [c]	1.2	6.3	15.5	21.8	25.3	27.9
			As a percentage of world trade [a]			
Net international bank loans [b]	6.4	25.7	35.2	57.3	63.9	72.9
Gross size of international banking market [c]	10.6	43.8	67.8	104.0	122.2	137.2
			As a percentage of world gross fixed investment [a]			
Net international bank loans [b]	4.0	18.0	39.2	66.3	72.4	78.2
Gross size of international banking market [c]	6.7	30.6	75.4	120.5	138.7	147.3

Source: UNCTAD secretariat estimates based on Bryant, *op. cit.*; BIS, *Annual Report* (various issues) and Morgan Guaranty, *World Financial Markets* (various issues).

Note: The table relates the stock of bank loans outstanding at the end of the year to world output, trade and gross fixed investment in current dollars during the year.

a Excluding Eastern European countries.

b Claims of banks in the BIS reporting area, excluding inter-bank redepositing.

c Claims of banks in nearly all European countries, the Bahamas, Bahrain, Canada, Cayman Islands, Hong Kong, Japan, Netherlands Antilles, Panama, Singapore and the United States, including inter-bank redepositing.

In 1987 the stock of international bank assets exceeded world trade by around 40 per cent.

A comparison of finance with capital accumulation would provide an even better measure of financial deepening in view of the role of finance in converting savings into investment. Between 1982 and 1988 the annual increment in the stock of world financial assets was, on average, about $3,800 billion, whereas the annual average level of world fixed capital formation was around $2,300 billion. The ratio of the size of the international banking market to total global fixed investment doubled in less than a decade (table 28).

2. *Deregulation and internationalization of finance*

The strong tendency for the pace of the internationalization of finance to outstrip the growth of real activity has been facilitated (and itself accelerated) by developments in communication and transportation technology, particularly in electronics. These have allowed information to be acquired, processed and disseminated much more rapidly and at very low costs, and to greatly improve the payments transmission mechanisms across countries. As a result, opportunities for cross-border arbitrage have increased, the costs of international financial transactions have been reduced and national markets have been brought closer together.

The progressive dismantling of policy barriers to capital movements has also played a cardinal role. Financial deregulation and liberalization quickened after the collapse of the Bretton Woods system, and has further accelerated in the 1980s. As a result, the financial system prevailing in the major countries now has the following broad characteristics: cross-border and foreign exchange credits are virtually unrestricted in all the countries concerned; cross-border and forex deposits are allowed in all major financial centres, and are being liberalized in others (e.g. some member countries of EEC); and security transactions now enjoy a high degree of freedom (see box 12).

Box 12

FINANCIAL DEREGULATION IN INDUSTRIAL COUNTRIES

Industrial countries loosened substantially capital controls following the second devaluation of the dollar in 1974; the deregulation drive accelerated at the end of the 1970s and the early 1980s. By the mid-1980s six of the major industrial countries (Canada, Federal Republic of Germany, Netherlands, Switzerland, United Kingdom and United States) had become fully open to capital movements. In Japan, the 1980 revision of the foreign exchange law constituted a landmark in the process of integrating Japanese markets with world financial centres, and the mid-1984 agreement with the United States has further opened up its financial markets to non-residents, and widened the range of yen-denominated assets for international transactions. In many countries restrictions on outward credits had been virtually removed, while in a few others (Denmark, France and Italy) flexibility was being introduced on the procedures of control. Restrictions on inward credits as well as on deposits abroad by non-bank, non-financial institutions had already been removed in the Federal Republic of Germany, the United Kingdom and the United States. International portfolio operations in securities had already benefited from significant liberalization; in five developed market-economy countries (Canada, Federal Republic of Germany, Japan, United Kingdom, United States) the flow of securities was virtually free from limitations. Although restrictions were still widespread, particularly on outward portfolio operations, other countries were already making moves towards liberalization. For instance, in 1985 France reopened the Euro-French franc bond market, allowing non-residents to issue Euro-French franc bonds and French residents to purchase them freely; in 1986, the system of the *devise-titre*, used to monitor outward portfolio investment, was abolished. Most major developed market-economy countries also allowed operations on a wider range of new financial instruments, including floating rate notes (FRNs), forward, futures and options contracts, certificates of deposit, swap-driven bond issues, zero-coupon bond issues and money market instruments. For instance, in 1985 the Bundesbank expanded the range of deutsche mark bonds to include FRNs, zero-coupon bonds, double-coupon bonds and bonds linked to interest rate and currency swaps, to be available to residents and non-residents. The Netherlands took similar decisions in 1985.

In the second half of the decade the move toward liberalization received further impetus, particularly in EEC, where most restrictions on capital movements are to be eliminated by the end of 1992. The project to complete the single internal EEC market by 1992 began with a Commission white paper in 1985 calling for the liberalization of capital movements in the Community and creation of an integrated financial market. All restrictions have already been eliminated in Denmark, the Federal Republic of Germany, the Netherlands and the United Kingdom. Some other countries (i.e. Belgium, France and Italy) took important steps in 1988 and 1989 with a view to eliminating controls by mid-1990. In France, for instance, restrictions on borrowing abroad in foreign currency or French francs have been eliminated, as well as certain restrictions on foreign currency accounts in France or abroad in foreign exchange or French francs. In Italy, the foreign exchange law of 1988 permits all foreign exchange transactions unless expressly prohibited, and guarantees free repatriation of capital and factor incomes. Most restrictions on security operations (e.g. prior approval of security issues by non-residents on the Italian capital markets) have been lifted. Initiatives have also been taken outside EEC to reduce exchange and capital controls. In Switzerland, for instance, most restrictions on capital outflows by banks and quasi-bank institutions have been removed; Japan has completed the liberalization of Euroyen lending; and in the United States banks have been allowed to accept foreign currency deposits from non-bank residents. Furthermore, a number of actions have been taken to encourage international trading of securities. In the United States exchanges have been allowed since 1987 to trade futures contracts in government securities of some developed market-economy countries (for instance, Canada, Japan and the United Kingdom). Since 1987, too, sales of foreign currency options have also been allowed by the United States Commodity Futures Commission. In the United Kingdom, rules have been relaxed for the listing of foreign companies. The introduction of certain new instruments (in particular on some options and futures exchanges) is also a sign of the increasing financial integration. For instance, the London International Financial Futures Exchange (LIFFE) introduced in September 1988 the first futures contract in DM on a ten-year government bond of the Federal Republic of Germany; and a similar contract was later introduced on the *marché à terme des instruments financiers* (MATIF) in France.

The 1980s have also been marked by easing of restrictions on the entry of foreign banks and financial institutions to domestic markets. The most important developments in this area took place in EEC. The Second Banking Co-ordination Directive, adopted in June 1989, allows banks to do business anywhere in the Community under home country rules. Some non-EEC countries have also taken steps to increase participation of foreign financial institutions in their markets.

Box 12 (concluded)

Japan, for instance, has committed itself to permit foreign banks to engage in trust business in Japan, to allow them to deal in government securities and to study ways of extending membership of the Tokyo Stock Exchange to foreign firms; various measures have also been taken to that end since 1985. Canada, which had maintained a total ban on entry of foreign institutions on its markets, has been progressively liberalizing access. Switzerland also recently opened the closed membership of its permanent syndicate for Swiss franc foreign bond issues to the Swiss subsidiaries of the major banks of the Federal Republic of Germany.

A more liberal tax treatment of international financial transactions and incomes is another reason for increased internationalization of finance. An important factor in the development of the Eurobond market is that Eurobonds are bearer bonds (unregistered assets) free from any country's direct supervision and from withholding tax. In 1984, the United States removed withholding taxes on interest paid to non-residents on government and corporate bonds, and was followed shortly by France, the Federal Republic of Germany and the United Kingdom. In late 1987, however, the Federal Republic of Germany reintroduced a 10 per cent withholding tax on interest income. This led to massive capital outflows, putting pressure on the deutsche mark and forcing the authorities to abolish the tax.

Since the early 1970s, freedom of capital movements has been increasingly viewed as an important policy objective. This trend is in stark contrast to government attitudes in the post-war years: the Bretton Woods era was based on a consensus that capital flows unrelated to foreign direct investment or trade should be discouraged (or even prevented).

By contrast, in the field of trade, restrictions of various kinds have proliferated. The tendency for financial policies to become less restrictive cannot be explained by considerations of efficiency; the efficiency argument has greater validity in respect of trade liberalization. A more plausible reason is that costs of financial openness (loss of policy autonomy, increased financial instability, etc.) being collective are anonymous in their incidence, whereas the benefits accrue to particular economic agents (especially international financial and non-financial enterprises, and rentiers). Political pressures by the latter for financial opening therefore does not meet significant resistance. By contrast, in the field of trade, it is the costs of restrictiveness that are borne collectively, and the benefits accrue to particular groups.

The failure of controls imposed under the Bretton Woods system to check capital movements also played an important role in changing official attitudes towards financial deregulation. Most controls and regulations were adopted *ad hoc* for macroeconomic reasons, and did not slow down the growth of unregulated offshore markets and relocation of financial activities. This in turn entailed a more liberal treatment of financial operations in order to avoid a loss of competitiveness for domestic financial institutions.

Similarly, competition among national financial markets has also been an important factor in the proliferation of deregulation and the reduction or abolition of taxes. Examples include competitive abolition of withholding tax on securities held by non-residents; widespread decisions concerning non-resident issues in national capital markets; authorization given to foreign banks to lead-manage bond issues; and removal of restrictions on trading in certain financial instruments. When many major financial centres deregulate, the rest have little choice but to follow suit. The process tends to be circular and cumulative also because markets themselves generate pressures for further freedom; for deregulation generates fluctuations and turnover for many financial operators on which their profits depend.

Moreover, there has been a tendency for national financial regulations to become subject to international negotiations and agreements. These include the move towards a unified single market within EEC; the Canada-United States Free Trade Agreement of 1989, which provides for the removal of restrictions on United States financial institutions operating in Canada and equal treatment of Canadian banks in the United States; and the 1984 United States-Japan agreement (which contributed to a massive increase in the Japanese portfolio and foreign direct investment in the United States instead of increasing the penetration of Japanese financial markets by United States

institutions). So far such agreements have been at the regional or bilateral level; but financial services are on the agenda of the current multilateral trade negotiations (see chapter II below).

3. *Financial openness in developing countries*

In developing countries the degree of financial openness (i.e. the ease with which residents can acquire assets and liabilities in foreign exchange, and non-residents operate in national financial markets) is not accurately reflected by the restrictiveness of regulations ostensibly in force. The administrative capacity to implement rules and regulations effectively is often lacking, and the under-development of financial intermediaries and the importance of informal financial ("curb") markets make it relatively easy to circumvent regulations.

The degree of financial opennesss also depends on specific national factors. For instance, a high level of earnings from tourism and workers' remittances facilitates the formation of a curb market in foreign currency. Similarly, the presence of transnational corporations (whether in financial or non-financial sectors) makes it easier to transfer funds in and out, as does physical proximity to hard-currency countries and financial havens. For example, in Uruguay, where banks are free to accept forex deposits and banking secrecy prevails, about one-half of forex deposits (which account for about 80 per cent of total bank deposits) belong to Argentinians.

Other examples can also be cited of how liberal treatment of financial inflows abroad can impede a country from limiting its degree of financial openness. The United States, for instance, exempts foreign depositors from taxation. Until the recent tax reform in Mexico this, in combination with the tax deductibility of interest payments in that country, gave enterprises an incentive to shift their funds abroad, and recycle them back as loans to themselves or to enterprises under their control, thereby avoiding taxes on interest income received in the United States while deducting interest payments on loans from their taxable income in Mexico.

Nevertheless, a country's own policies and regulations also play a major role in determining the degree of financial openness. Since the early 1970s there has been in general an easing of restrictions on the access of residents to loans from international markets; on portfolio investment of residents in foreign currency assets at home and abroad; and on the access of non-residents to domestic capital markets. Although some countries have subsequently reimposed restrictions because of the adverse consequences for external indebtedness, capital outflow and balance of payments, developing countries generally have become much more integrated into world financial markets.

The first wave of liberalization in developing countries generally took the form of allowing the private sector to borrow abroad. This happened not only in the Southern Cone countries in Latin America (i.e. Argentina, Chile and Uruguay) after the mid-1970s in the context of broader programmes of financial deregulation, but also in a number of countries where domestic financial markets continued to be highly regulated (e.g. Turkey, Yugoslavia, Philippines). Domestic banks were often involved as intermediaries between international capital markets and domestic borrowers, often raising funds in the former to extend to the latter in the domestic currency. In many cases, particularly in the Southern Cone countries, the need for government approval and guarantee was lifted, the reasoning being that private firms would assess the costs and benefits of domestic and foreign debt equally carefully since their survival depended on it.

The freedom to borrow triggered a massive build-up of foreign exchange liabilities in the private financial and non-financial sectors, particularly in countries where borrowers continued to enjoy exchange rate guarantees or where domestic interest rates rose sharply (which they often did as a result of deregulation). The consequent over-borrowing by the private sector contributed significantly to the subsequent debt servicing difficulties and the debt crisis. In many such countries Governments found it necessary to subsidize private debt servicing through special exchange rates, or assume the liabilities of insolvent financial institutions. Controls over foreign borrowing by the private sector were subsequently reinstated in many such countries. Resident banks are now generally allowed to hold short-term foreign exchange liabilities vis-à-vis international capital markets provided they are for financing trade, and covered by short-term foreign exchange claims on exporters.

The liberalization episode in the 1970s, particularly in Latin America, also included relaxation of restrictions on convertibility and capital movements. In some cases this went even further than in some major industrialized countries. This, in combination with inappropriate exchange and interest rate policies, gave

rise to a substantial outflow of capital. Restrictions had to be reimposed but capital flight continued, particularly in the early years of the debt crisis. The cumulative outflow of capital from Latin America during 1977-1983 has been estimated at over $100 billion. There can be little doubt that an important part of it was channelled to financial markets and institutions in the major industrial countries, and particularly the United States, and constituted part of the category of "assets with international characteristics" described above; in 1988 the total liabilities of the banks in the United States to non-bank foreigners amounted to $87 billion. There was also a close correlation between its country breakdown and capital flight, with the residents of countries such as Argentina, and particularly Mexico, holding greater amounts of deposits in United States banks than, say, Brazil, where capital controls were much tighter.

While a large majority of developing countries have restrictions on capital outflows, there has been an increased tendency to permit and encourage holding of foreign exchange deposits with resident banks. Previously many developing countries where remittances from workers abroad were sizeable had already offered such deposits to non-resident nationals at attractive terms in order to divert foreign exchange from curb markets. However, during the 1980s many countries also allowed residents to hold foreign exchange deposits in resident banks. Usually, interest rates offered on such deposits have been kept above world levels in order to be attractive. These deposits are very liquid, and accessible even to the moderately wealthy. They have often enjoyed full government guarantees and, in some countries, deposit holders have also been allowed to transfer limited sums abroad to cover certain types of spending (e.g. tourism). On the other hand, many countries have also permitted exporters to retain part of their export receipts in the form of foreign currency deposits, and to use them to finance imports without being subject to foreign exchange restrictions.

Whereas in most major developed countries bank liabilities to non-bank residents denominated in foreign currency have barely exceeded 10 per cent of total bank liabilities, in several developing countries the share of forex deposits in total deposits has grown rapidly to reach very high levels, even exceeding the share of deposits in the home currency (e.g. about 20 per cent of the total in Chile, and between 40 per cent and 60 per cent in Bolivia, Costa Rica, Philippines, Turkey and Yugoslavia). This substantial increase in banks' liabilities having international characteristics represents an ongoing process of currency substitution that undermines autonomy in monetary policy (see section B.3 below), and has been brought about by increased resort to currency depreciations, heightened macroeconomic instability, and increased risks and uncertainty regarding returns on domestic currency assets.

Recent years have also witnessed increased access of non-residents to financial markets in developing countries. Deregulation of domestic financial markets has often been accompanied by relaxing restrictions on the entry of foreign banks. Of equal or even greater importance is the substantially increased access of non-residents to national equity markets. Some countries have encouraged this, often within the context of privatization programmes, in order both to acquire foreign currency and to generate private demand for public assets; such demand is often small relative to the size of the enterprises to be sold off. In some cases the development of the domestic capital markets has also been a goal.

The debt crisis has also increased the internationalization of finance through resort to various debt conversion facilities, which have significantly raised the amount of equities and domestic currency debt-assets held by non-residents.[103] In some countries residents have also been allowed to buy foreign currency in the curb market to repurchase debt in secondary markets; since the purpose is also to bring back flight capital, such schemes have often also included tax and other forms of amnesty. Similarly, relending and onlending facilities have served to reallocate the external liabilities of the country among various sectors, often from the public to the private sector, establishing direct links between the latter and external creditors. The "market-based menu" has raised the degree of financial openness by opening up new prospects for international arbitrage and speculation for both residents and non-residents in debtor countries.

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103 For a more detailed account of these schemes and their effects see *TDR 1989*, Part One, chap. IV.

B. Some consequences of the internationalization of finance

1. *Capital mobility, speculation and rates of return*

The main argument put forward in favour of financial openness and internationalization of finance is the same as that for trade liberalization, namely, that it would improve the allocation of resources internationally. The reasoning is that, if allowed to move freely, capital would flow to countries in response to opportunities for real investment, thereby equalizing rates of return on investment everywhere, and allow individual countries either to save more than they invest, or to invest more than they save, according to market disciplines.

Whether openness and internationalization in practice have had these results can, in principle, be assessed in three ways: by comparing rates of returns on physical capital; by comparing returns on similar financial assets; and by examining the links between national savings and investment rates.

Comparison of rates of return on capital investment among the Group of Seven countries shows that, on average, inter-country differences in rates of return (as measured by the coefficient of variation) during the 1980s have been as large as they were during the 1960s and early 1970s.[104]

Lowering of national barriers to financial flows has undoubtedly reduced substantially the degree of segmentation of financial markets and, hence, international dispersion of prices for financial assets denominated in the same currency but issued in different countries. Rapid dissemination of information, increased ease of market access and greatly reduced transaction costs have indeed helped equalize yields on assets denominated in the same currency and with identical default risk and term to maturity in various parts of integrated financial markets (e.g. dollar CDs issued by London and New York banks).

But a similar tendency is not discernible for financial assets with identical risk and maturity characteristics but different currency denominations (e.g. United States Treasury bills in dollars and United Kingdom Treasury bills in sterling), even though certain financial intermediaries, institutional investors and large corporations accounting for an important part of the market find them close substitutes (see box 13). The interest rate differential between two such assets should indicate that the currency in which the asset offering a higher rate of interest is denominated will depreciate against the other currency, over the same time interval as the maturity of the assets, so as to equalize the rates of return on the two assets, expressed in a common currency. But this has not been the case, especially in the 1980s; for example, during the first half of the 1980s the dollar offered higher interest rates and sold at a discount in the forward markets against most other currencies, and yet dollar depreciation failed to materialize within the time frame of the contracts entered into; again, some European currencies have persistently offered higher interest rates *and* appreciated against the others during the same interval of time (e.g. the French franc against the Swiss franc during recent years).

This, together with the fact that nominal exchange rates do not move in line with the purchasing power parity of the two currencies, means that real interest rates have not tended to be equalized across countries. Disparities in real interest rates among major countries are also reflected in differences in the cost of capital. Firms in the United States and the United Kingdom suffer from a decided disadvantage in this respect compared to those in the Federal Republic of Germany and Japan, and need a higher rate of return on their investment in order to cover financing costs.[105]

This last observation suggests a relatively strong link between national savings and investment. Indeed, direct evidence on this link is in line with the evidence on relative rates of return and interest rates. They suggest that even among the OECD countries where capital has become increasingly mobile, the strength

[104] The figures are given by the OECD for the business sector; see, e.g. *OECD Economic Outlook*, No. 45, June 1989. It should be noted that there are serious conceptual and practical problems in the measurement of rates of return, and they cannot always be compared among countries because of country-specific factors (e.g. taxation of earnings on capital assets). Thus, available estimates need to be interpreted with caution.

[105] See *Federal Reserve Bank of New York Quarterly Review*, Summer 1989, vol. 14, No. 12, pp. 7-28.

Box 13

EXCHANGE RATES AND RATES OF RETURN ON FINANCIAL ASSETS

Rates of return on assets denominated in different currencies can only be compared by using exchange rates. Convergence of rates of return implies a tendency for interest rate differentials to equal the expected change in the exchange rate of the currencies in which they are denominated. When assets are close substitutes, the forward rate reflects the expected future rate, and the forward premium (i.e. the proportionate differential between the forward and spot exchange rates) the expected rate of currency depreciation. The evidence shows that the premium tends to be equalized with the interest rate differential over the same time interval, i.e. "covered interest parity" holds, but that forward exchange rates have failed to predict the future spot rates (i.e. "uncovered interest parity" does not hold). The deviations are too large to be explained by the risk premium, which implies that rates of return on assets denominated in different currencies are not equalized.

This strongly suggests that markets systematically leave unexploited opportunities for abnormal profits, i.e. they are inefficient in the sense that they fail to incorporate relevant information in the determination of exchange rates. Indeed, divergence between forward rates and future spot rates has taken place in a manner that is far from random; rather, it can be related in a systematic way to the information available at the time the forward rates are established. For instance, it has been found that inflation and interest rate differentials give better predictions of future spot rates than have forward rates. This evidence, in combination with bandwagon type exchange rate movements, strongly suggests that speculation has been predominant in the determination of exchange rates, and that it has been destabilizing.[1]

When nominal interest rate differentials do not cover exchange rate changes, there is no reason to expect real rates of interest to be equalized across countries. Such a process requires not only that exchange rates move in line with the relative purchasing power parity of the two currencies, but also that exchange rate changes are fully covered by interest differentials; i.e. that differences between nominal interest rates are equal to changes in the exchange rate between the two currencies and that these are equal to changes in the relative price levels. The evidence shows clearly that neither the uncovered interest parity nor *ex ante* purchasing power parity have been attained. This tallies with the observation that there is no tendency for real interest rates to be equalized across countries; admittedly they tend to move together, but this synchronization is as likely to be the result of convergence in economic performance and in monetary policies as of capital mobility.

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1 For a more detailed account of the speculative nature of foreign exchange markets see the paper by the UNCTAD secretariat on "The Exchange Rate System", in *Compendium of Selected Studies on International Monetary and Financial Issues for the Developing Countries* (UNCTAD/ST/MFD/4), United Nations publication, Sales No. E.87.II.D.3, particularly pp. 101-103 and 107-112.

of the correlation between national savings and investment rates has not diminished, and a very large share of new domestic savings remains at home.

The evidence does not necessarily mean that financial markets are not integrated, or that capital is not very mobile: to gauge the degree of financial integration and capital mobility in terms of the extent to which rates of return are equalized reflects *a priori* assumptions about the role of international finance which may not necessarily tally with reality. Massive flows of capital are not always motivated by opportunities for real investment. Indeed, a very large proportion of international financial transactions today is unrelated to trade and investment. The daily volume of foreign exchange trading in major currency markets has reached almost the average monthly volume of world trade. International capital flows reflect portfolio decisions rather than business decisions, e.g. to establish a production base in a foreign country. The annual increase in the size of the international banking market alone now amounts to almost nine times total foreign direct investment made across all borders (table 29). Since a large proportion (about three-quarters, see table 26) of transactions in the international banking market represents cross-border transactions (i.e. claims on non-residents), this evidence alone implies that capital flows across countries have little to do with investment. Besides,

Table 29

THE GROWTH OF INTERNATIONAL BANKING RELATIVE TO FOREIGN DIRECT INVESTMENT AND NET CAPITAL FLOWS ACROSS COUNTRIES

	1972-1979	*1980-1984*	*1985-1987*
	As a percentage of foreign direct investment		
Net international bank loans	331	217	487
Gross size of international banking market	650	391	889
	As a percentage of net capital flows across countries [a]		
Net international bank loans	161	115	224
Gross size of international banking market	316	219	407

Source: As for table 28. See also that table for definitions.
Note: The figures relate the annual average increase of international bank loans in each period to the average annual FDI or net capital flows across countries during the period.
a Net capital flows are measured as the absolute sum of current-account balances divided by 2.

annual increases in cross-border banking transactions are several times greater than the annual net capital flows across countries (table 29).

These transactions have increasingly come to be governed by perceptions of prospects of short-term capital gains and losses rather than long-term yields, and are capable of generating gyrations in exchange rates and security prices (see section C). These, in turn, increase profit opportunities and, hence, the speculative component of the market. It is thus far from clear that the process of international financial deepening is contributing to efficiency in the allocation of resources internationally. The extent of predominance of speculation over enterprise, which Keynes long ago foresaw to increase as the organization of financial markets improved, tends to suggest that the degree of financial deepening has gone beyond the point needed for trade and investment (see box 14).

2. *Links between currency and financial markets*

The internationalization of finance and integration of financial markets have considerably increased the importance of securing an exchange rate system conducive to financial stability. For one thing, the increased denomination of assets and liabilities of financial intermediaries, debtors and investors in foreign currencies mean that the value of assets and liabilities is directly influenced by exchange rate changes. For another, events in exchange markets can exert a strong influence on asset (e.g. bond and equity) prices because exchange rate expectations can induce funds to be shifted among securities denominated in different currencies, and/or because policy measures taken to manage exchange rates or to deal with the inflationary or deflationary influences of exchange rate changes alter interest rates and security prices. Exchange rate instability can therefore increase the level of risk in the financial system. For instance, banks can incur substantial losses when there is a serious mismatch between currency denomination of their assets and liabilities, and many Governments in major countries have introduced regulations restricting open positions. However, perfect matching (e.g. by taking forward cover) is very difficult and costly, particularly since bank liabilities are much shorter in maturity, and their currency composition can undergo sharp changes. Thus, regulations do not generally require perfect matching since this would imply serious restrictions on banks' ability to accept forex deposits and, hence, loss of international business.

The impact of unexpected changes, and hence uncertainty, cannot be fully removed unless there are forward markets for all goods

Box 14

KEYNES ON SPECULATION AND ENTERPRISE

"It happens ... (that the) ... professional investor and speculator ... are, in fact, largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public. They are concerned, not with what an investment is really worth to a man who buys it "for keeps", but with what the market will value it at, under the influnce of mass psychology, three months or a year hence...

This battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years, does not even require gulls amongst the public to feed the maws of the professional; - it can be played by professionals amongst themselves. Nor is it necessary that anyone should keep his simple faith in the conventional basis of valuation having any genuine long-term validity. For it is, so to speak, a game of Snap, of Old Maid, of Musical Chairs - a pastime in which he is victor who says *Snap* neither too soon nor too late, who passes the Old Maid to his neighbour before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players will find themselves unseated.

Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitiors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitior has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.

These considerations should not lie beyond the purview of the economist. But they must be relegated to their right perspective. If I may be allowed to appropriate the term *speculation* for the activity of forecasting the psychology of the market, and the term *enterprise* for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organization of investment markets improves, the risk of the predominance of speculation does, however, increase... Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism - which is not surpising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object."

- John Maynard Keynes, *The General Theory of Employment, Interest and Money*, chap. 12.

and assets for which there are current markets, and they reach far into the future. Since there are not, the financial system is subject to a systemic risk. Existing forward and futures markets and instruments simply transfer risk to those who are willing to take it at a price, rather than eliminate risk by providing guidance as to the future course of prices; these instruments are used as much for gambling as for hedging. Risk transfer may be possible for each operator taken individually, but not collectively, because the quality of assets held by financial intermediaries or savers investing in direct securities will remain vulnerable to unexpected changes in exchange rates since their debtors cannot be fully covered. Exchange rate

uncertainty thus tends to raise the credit risks assumed by the financial system. As put by the General Manager of BIS, "you may argue that when risk-averse market participants shift risks associated with unexpected interest and exchange rate developments onto willing risk takers, everybody is going to be better off. This may well be the case, but increased collective happiness does not necessarily mean greater systemic stability."[106]

The effects of monetary policy and interest rates on exchange rates are familiar: changes in interest rate differentials (current and/or expected) can lead to massive shifts of portfolios among financial assets denominated in different currencies, exerting a significant influence on exchange rates. What is less appreciated is the influence of changes in expected exchange rates on prices of securities denominated in different currencies, and, hence, on interest rates. These effects occur because, as noted above, the demand for securities denominated in different currencies depends, *inter alia*, on expected changes in exchange rates. Changes in expectations can thus shift portfolios between bonds and equities denominated in different currencies, even causing sharp changes in their prices (as well as in current exchange rates). Such shifts can generate disparate movements in the prices of securities in different countries, as was witnessed between New York and Tokyo in the early months of 1990 (see section C below).

It is to be stressed that the shifts in question are in the *stock* of financial wealth, not merely in the *flow* of external savings as measured by current account deficits, which are very small in comparison (possibly less than 1 per cent in the United States) and do not have a significant influence on domestic interest rates. Moreover, portfolio shifts from, say, yen-denominated to dollar-denominated securities can occur and alter the exchange rates and their relative prices significantly quite independently of current account balances and the flow of external savings between the two countries concerned.

Similarly, policy responses to developments in currency markets can generate changes in security prices. Management of exchange rates under conditions of extreme volatility tends to generate considerable swings in interest rates (and hence financial asset prices), particularly when domestic monetary policy is targeting certain reserve aggregates and exchange market intervention needs to be sterilized through domestic open market operations; such sterilization could have a significant effect on bond prices, particularly when the market pressure on the exchange rate is strong. Alternatively, when sterilization is too difficult, action may be needed on interest rates (e.g. discount and interbank rates) to check liquidity expansion. When pressures on the currency markets are due to serious inconsistencies in the mix and stance of policies in major countries, attempts to manage exchange rates through monetary policy and currency market intervention can prove highly destabilizing for the financial system, as exemplified by the events leading to the October 1987 crash (see section C).

Exchange rate management and/or trade adjustment can introduce a bias towards higher interest rates. If the burden of responsibility for policy action is put entirely on deficit countries and monetary policy is the only tool, defending the exchange rate and/or reducing demand will require interest rates to be raised, possibly to extremely high levels.

Currency markets themselves intensify the instability of interest rates arising from the way monetary policy is conducted, and hence enlarge the interest rate risk for banks due to maturity mismatching of their assets and liabilities, particularly in international business. Variable-interest loans allow banks to pass through changes in funding costs to borrowers. However, these do not eliminate the risk but simply transform it into credit risk, as has been witnessed during the debt crisis.[107] Moreover, such loans represent only a portion of total bank assets. The difficulty of matching perfectly the maturity structure of liabilities with the length of rollover periods (which are, in general, fixed at certain intervals) increases the interest rate risk when interest rates are very volatile, especially since the maturity of liabilities tends to be shorter the more volatile are interest rates.

This shortening results naturally from the increased uncertainty created by the volatility of the financial environment and the increased liquidity preference of market participants. Financial instability tends to increase uncertainty and reduce the degree of confidence in the expectations held with respect to the future course of interest and exchange rates and security prices. Since uncertainty is the essence of liquidity preference, as uncertainty grows, liquidity preference increases. Not only are maturities shortened as the demand for

[106] A. Lamfalussy, "The Changing Environment of Central Bank Policy", *American Economic Review. Papers and Proceedings*, May 1985, p. 411.

[107] See *TDR 1985* and *TDR 1988*.

capital-uncertain assets is reduced, but also interest rates, especially long-term rates, are pushed up to cover increased riskiness of interest-bearing financial assets.

There is evidence that this has indeed been happening. In the 1970s, as instability and uncertainty increased significantly alongside inflation, markets started to innovate to meet the increased demand for interest-bearing short-term assets (such as the negotiable order of withdrawal (NOW) and the automatic transfer service (ATS) accounts in the United States to by-pass regulations regarding interest rates on savings and demand deposits). Innovations have continued to burgeon, particularly in short-term liquid paper, in more recent years even though inflation has been kept relatively low and stable. On the other hand, as will be seen below, interest rates have stayed persistently high in the 1980s, particularly in the United States (and on dollar assets), where financial instability has been more pronounced than in other major countries. The increase in long-term interest rates in most countries has been greater, and these rates have been less sensitive to fluctuations in short-term rates compared to past decades.

Thus, the high interest rates experienced in recent years are due not only to the stance of monetary policy in major countries (which has, on average, been tighter in the 1980s than in the past - see section C), but also to a number of systemic factors stemming from the asymmetry in international adjustment and exchange rate management, and from the instability of the financial environment and of key financial prices.

3. *Financial openness and policy autonomy*

Increased financial openness and dismantling of barriers to capital flows have considerably strengthened the links among the financial markets of national economies. This has had significant implications for national policy autonomy and domestic and global effects of national economic policy. The degree of policy autonomy has declined everywhere, but most of all in smaller and/or less developed countries having a high degree of financial openness. On the other hand, the global effects of the policies pursued by the major countries have increased considerably, even though their policy autonomy too has diminished.

Policy autonomy refers to the ability of national policy makers to control national policy goals by using the policy instruments at their disposal. The ultimate goals of policy include the volume of output, the level of employment and the rate of inflation. Policy instruments are those variables that can be precisely controlled by policy makers. These include not only the parameters that can be directly set by policy makers (e.g. tax rates, the discount rate and reserve requirements), but also a number of variables that are otherwise influenced by market behaviour but that can be precisely or very closely controlled by policy makers through intervention if they choose to do so (e.g. interbank rates or total reserves of banks, which can be closely controlled through open market operations). Most economic variables are, however, intermediate between ultimate goals and instruments of policy (e.g. long-term interest rates, money supply, fiscal balances and external balances). These intermediate variables influence the ultimate goals, and are influenced by the latter as well as by policy instruments. They are not pursued as final goals of policy; nor can they be precisely controlled by policy makers.

The degree of policy autonomy or the effectiveness of national policy instruments in controlling ultimate goals of policy depends on the *strength* of the influence of these instruments (directly or indirectly, through intermediate variables) on goals. It also depends on the *stability* of the link between instruments and goals and, hence, the predictability of the influence of the former on the latter. Financial openness reduces the degree of autonomy because it weakens the national policy influence on national goals while it raises the external influence. It also renders the link between national instruments and targets less stable and reliable, making the relationship dependent on the behaviour of policy makers and markets elsewhere.

The more open an economy, the smaller is the impact of national policy instruments on national policy goals, because the effects of policy action tend to spill abroad. Thus, increased openness raises the impact of national policy instruments on variables in other countries relative to their influence on national variables. More important, foreign policy action and economic shocks originating abroad exert significant constraints on the conduct of national policy, and on its ability to attain policy goals.

Such cross-country influences, including those of policy instruments, are not usually known with a reasonable degree of accuracy. Knowledge about structural and behavioural

relations that link the national economy to the rest of the world is extremely inadequate; available empirical models linking major countries differ not only as regards the magnitude but even the direction of cross-country policy influences. Moreover, access to information abroad is more difficult and costly, and developments in other countries are difficult to assess. An equally and perhaps more important source of uncertainty is the game-theoretic nature of decision making by policy authorities in an interdependent world. What constitutes an appropriate policy action of a home Government depends on what is assumed of the behaviour of foreign policy makers; but the latter, in turn, depends on assumptions about the policy course in the home economy. This not only creates problems in policy making, but can also lead to serious conflicts when countries have incompatible objectives for the same and common variables such as exchange rates and trade balances. These difficulties arise from a variety of sources, among the more important of which is the fact that internationalization of finance and financial opennesss raise the degree of substitutability of assets denominated in home and foreign currencies, and issued by residents and non-residents. They also create increased possibilities for the private sector to circumvent various restrictions imposed by monetary authorities, such as credit ceilings and reserve requirements.

Indeed, in a financially open economy domestic monetary and credit aggregates become extremely difficult to define in a meaningful and useful way, i.e. so as to provide reliable guidance to the conduct of monetary policy. For instance, there is no satisfactory and generally agreed way of dealing with the assets and liabilities of Eurobanks. Should a dollar deposit held in a London bank by a Colombian resident in Switzerland be included in the money supply of Colombia, the United States, the United Kingdom or Switzerland? The same question arises also with respect to credits from Eurobanks. Here the difficulty is not a practical but a conceptual one - that of identifying the influence of such deposits and credits on spending decisions in the various countries involved, and thus interpreting movements in such aggregates in taking monetary policy action. These difficulties become particularly serious when monetary policy is targeting certain monetary and credit aggregates.

That increased financial interdependence leads to loss of policy effectiveness and autonomy for national Governments does not imply that influences due to financial openness always undermine the achievement of policy objectives. That depends on the objectives pursued, and actions taken at home and abroad. For instance, in a financially open economy fiscal stimulus tends to leak abroad because the consequent rise in interest rates encourages capital inflow, thereby appreciating the domestic currency and reducing net exports. By contrast, monetary tightening can lead to currency appreciation, which can reinforce the disinflationary impact of the monetary policy. Again, the ability to attract capital through financial policies can help avoid taking deflationary action at times of serious external payments difficulties. However, in both cases there is a great deal of uncertainty as to the final outcome, not only because of unpredictability of the response of international financial markets to such policy actions, but also because of their international repercussions and the policy response of foreign Governments. This uncertainty and the associated costs of loss of control over national economies can only be reduced by collective action, involving management of international money and finance and of interdependence (see section D).

For a developing country complete financial openness would bring an even greater loss of policy autonomy. For one thing, the country would be unable to delink its real interest rates from those abroad. Indeed, domestic real interest rates would be pushed well above the levels prevailing in world markets, particularly where there is macroeconomic instability and a persistent external debt problem.

Moreover, the link between exchange and interest rates can be much more destabilizing in developing countries. A major industrial country may be able to influence its exchange rate by monetary policy actions regardless of the state of its external balances. In developing countries, however, exchange rates are influenced to a much greater extent by external payments. This means that payments disturbances tend to feed into domestic interest rates; for competition with foreign assets requires that domestic interest rates should cover interest rates on foreign assets plus the expected rate of depreciation of the currency. When the currency is expected to depreciate in real terms, domestic real interest rates would be raised further. This link can pose serious problems for fiscal and monetary management, particularly where the public sector needs to borrow in domestic markets in order to service its external debt, as has been observed in many countries in recent years.[108]

[108] See *TDR 1989*, Part One, chap. IV.

Table 30

SHORT-TERM INTEREST VARIABILITY [a] IN THE MAJOR RESERVE CURRENCY COUNTRIES, 1960-1990

(Index numbers, 1960-1969 = 100)

	United States		Japan		Federal Republic of Germany		United Kingdom		France	
Period	A	B	A	B	A	B	A	B	A	B
1973-1979	191	209	223	211	139	117	296	276	231	269
1980-1982	573	752	192	186	135	109	263	259	310	340
1983-1989 [b]	155	170	123	134	52	50	179	172	96	105

Source: UNCTAD secretariat calculations, based on OECD, *Main Economic Indicators*, various issues; IMF, *International Financial Statistics*, various issues.

Note: Data are for the following interest rates: *United States* - 3-month Treasury bills; *Japan* - money market rate; *Federal Republic of Germany* - 3-month interbank loans; *United Kingdom* - 91-day Treasury bills; *France* - money market rate.

a Average annual range of monthly interest rates (measure A) and average annual standard deviation of monthly interest rates (measure B).

b Including also the first quarter of 1990.

C. Financial and currency markets in the 1980s

Following the period of serious problems of adjustment between 1973 and 1980, real economic activity in the major developed market economies in the 1980s has shown a considerable degree of stability. This was helped by an increased acceptance of relatively high rates of unemployment in a number of countries which, together with weak commodity prices, served to reduce inflation substantially. Both were largely the results of the prolonged recession at the beginning of the decade, which was followed by modest but sustained growth. By contrast, financial and currency markets have been more unstable than in the 1970s, due to various types of destabilizing interactions among monetary policy, interest rates, securities prices and exchange rates described in the previous section.

1. Monetary policy and interest rates

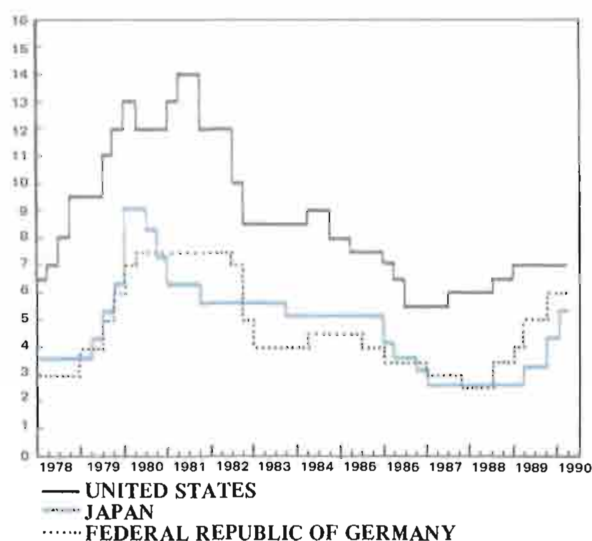
During the past decade, interest rates in the major reserve currency countries have been both extremely high by historical standards and highly unstable. Table 30 provides some indicators of short-term interest rate instability, which suggest that in the 1980s instability has been no lower than in the 1970s and markedly higher than in the 13 years before the advent of floating exchange rates. Interest rate variability increased substantially in all the major currency countries during the period of disinflation in the early 1980s; compared to the 1960s it had doubled in Japan, the United Kingdom and France and increased more than five times in the United States. Since 1982 interest rate instability has been lower than in the 1960s in the Federal Republic of Germany, but it has remained particularly high in the United States and the United Kingdom.

The uncertainty ruling financial markets also becomes evident when account is taken of the fact that alterations in the direction of movements in interest rates have been more frequent than at any other time since the war, including in Japan and the Federal Republic of Germany. In addition to increased short-term (weekly or monthly) instability, there were two periods in the 1980s during which interest rates

underwent substantial swings in all the major currency countries: in the early 1980s, when monetary policy was geared to disinflation; and during 1987-1989, when the focus of monetary policy shifted back and forth between currency and financial markets, and, particularly in the United States, between fears of recession and inflation (see chart 8). The latter period also witnessed substantial swings in share prices, to an extent unprecedented in the post-war period.

Chart 8

CENTRAL BANK DISCOUNT RATES IN THE UNITED STATES, JAPAN AND FEDERAL REPUBLIC OF GERMANY, 1978-1990



Source: IMF, *International Financial Statistics*, various issues.

Interest rates in the major reserve currency countries, in particular in the United States and the United Kingdom, have also been higher in the past decade than previously (see tables 31 and 32). Short-term nominal rates were, on average, also high in the 1970s, but so was inflation: in real terms, with the exception of the Federal Republic of Germany, they were negative. After 1981, as inflation eased, nominal rates began to fall from their peak of 1980-1981. But, generally they did not fall significantly below the average level of the 1970s, although inflation declined considerably. Consequently, real interest rates increased strongly compared to the previous decade, and also exceeded those of the more stable 1960s by between one-half (Federal Republic of Germany) and more than four times (United Kingdom).

This generalized increase in interest rates is primarily due to the fact that monetary policy has been, on average, tighter. However, as already noted, increased instability and uncertainty have also influenced the level and term structure of interest rates. It is noteworthy that, comparing the 1980s with the 1960s, in the United States long-term interest rates have increased much more than short-term rates. This steepening of the yield curve cannot be explained by expectations of an acceleration of inflation; inflation has not only been falling sharply since the early 1980s, but it has been lower, on average, than in the 1960s. These factors could have been expected to push future short-term interest rates below the current rates. The steepening of the yield curve in the 1980s, together with the proliferation of holdings of liquid short-term assets, suggests that the increased instability of interest rates and the exchange rate of the dollar has been an important factor in the increase in interest rates, one which can also help explain the evidence that the ability of the term structure of interest rates to forecast future inflation is very much limited.

Three basic factors account for the increased financial instability of the 1980s. First, a fundamental change took place in the conduct of monetary policy, away from targeting interest rates. Second, financial deregulation allowed markets greater scope to innovate and generate disturbances, thereby reducing the capacity of central banks to achieve their objectives. Third, as will be seen in sub-section 2 below, monetary policy became overloaded as Governments tried to manage exchange rates without co-ordinating their macroeconomic and particularly fiscal policies. The pressures in exchange markets tended to be propagated to equity markets through their effects on monetary policy and interest rates; but when equity prices fell precipitously, monetary policy had to be redirected once again.

In the 1960s and the 1970s monetary management was mostly concerned with keeping interest rates low and stable with a view to providing a favourable financial environment for productive investment. This was helped in many countries by the widespread practice of direct regulation of interest rates. Monetary policy was discretionary and shared the task of short-term demand management with fiscal and, to some extent, prices and incomes policies. In the late 1970s and early 1980s many central banks switched to quantitative targets for certain monetary aggregates and embarked upon a strict disinflationary policy stance. During this phase both the level and the instability of nominal interest rates reached new peaks, particularly in the United States. This happened not only because interest rates are inevitably more unstable under the operating procedure chosen, but also because the assumptions underlying this monetarist approach proved wrong, resulting not only in a substan-

Table 31

SHORT-TERM INTEREST RATES IN THE MAJOR RESERVE CURRENCY COUNTRIES, 1960-1990

(Per cent per annum)

Period	Nominal interest rates					
	United States	Japan	Federal Republic of Germany	United Kingdom	France	LIBOR
1960-1969	4.0	7.8	4.6	5.5	4.9	5.8 [a]
1973-1979	6.9	7.6	6.6	10.2	9.6	8.6
1980-1982	12.1	8.4	10.2	13.2	14.0	14.8
1983-1989 [b]	7.5	5.1	5.3	10.6	9.5	8.6

Period	Real interest rates				
	United States	Japan	Federal Republic of Germany	United Kingdom	France
1960-1969	1.6	2.4	2.2	2.0	1.1
1970-1979	-0.9	-2.7	1.6	-4.6	-1.0
1980-1982	3.3	3.3	4.5	-0.3	1.1
1983-1989 [b]	4.0	3.7	3.3	5.2	4.5

Source: OECD, *Main Economic Indicators*, various issues; IMF, *International Financial Statistics*, various issues.

Note: Data are for the interest rates specified in table 30; LIBOR is the rate for 3-month Eurodollar deposits. Real interest rates are derived by adjusting the annual average of nominal monthly rates by the rate of change in the consumer price index in the same year.

a 1963-1969.

b Including also the first quarter of 1990.

tially increased instability in the financial system, but also in a deflationary overkill (see box 15).

Strict monetarism in the conduct of monetary policy was abandoned in the United States at the end of 1982, when it was recognized that financial deregulation and innovation had significantly reduced the control of the Federal Reserve over certain monetary aggregates, and that inflation was not as closely governed by monetary aggregates as had been assumed. Money supply targeting has continued, though with broader definitions of money, wide target ranges, and the use of a number of indicators, including interest rates, in the conduct of monetary policy. The new operating regime has tended to result in less pronounced short-term fluctuations in interest rates than strict monetarism, but greater instability than a regime of interest rate targeting.

2. *Exchange rates and financial markets*

The exchange rates of the major currencies in the 1980s have been much more unstable than their interest rates (see tables 33 and 34); short-term instability intensified at the beginning of the 1980s, when monetary policy began to be targeted at monetary aggregates rather than interest rates, and has shown no tendency to diminish in subsequent years. Bilateral exchange rates among the United States dollar,

Table 32

LONG-TERM INTEREST RATES AND YIELD GAP IN MAJOR RESERVE CURRENCY COUNTRIES, 1960-1990

	Long-term interest rate [a] (per cent per annum)			*Yield gap [b] (percentage points)*		
Period	*United States*	*Japan*	*Federal Republic of Germany*	*United States*	*Japan*	*Federal Republic of Germany*
1960-1969	4.6	7.0 [c]	6.6	0.6	- [c]	2.0
1973-1978	7.9	8.0	8.0	1.6	0.1	1.4
1979-1981	11.5	8.5	8.8	-0.4	0.5	-0.7
1982-1989 [d]	10.0	5.9	7.1	2.2	0.6	1.3

Source: IMF, *International Financial Statistics*, various issues

a Interest rates are for the United States long-term government bond yield, for Japan government bond yield, and for the Federal Republic of Germany public authorities bond yield.

b Difference between long-term interest rates and short-term rates as specified in the note to table 30.

c 1966-1969.

d Including also the first quarter of 1990.

Japanese yen and the deutsche mark have been particularly volatile. By contrast, since the inception of the European Monetary System, bilateral exchange rates among member currencies have, on average, fluctuated much less; this is reflected in the substantially lower figures in table 33 for the exchange rate instability of the Federal Republic of Germany and France. As noted above, in these countries the interest rate instability has also been lower than in the other major OECD countries (see table 30).

More important, key exchange rates in the 1980s have shown persistent deviations from the levels consistent with sustainable current account balances and the underlying capital flows. The real effective exchange rate of the dollar rose by more than 40 per cent between 1980 and mid-1984, remained there for about a year, and then fell back below the level of 1980 within a matter of about two years. The Japanese yen, in turn, moved up in real terms by more than 35 per cent between early 1985 and November 1988, but fell by around 20 per cent between that date and March 1990.

The behaviour of exchange rates in the 1980s cannot be systematically explained by the variables generally cited as their determinants, i.e. interest rates, price levels, and trade and current account balances; empirical models seeking to do so have failed.[109] These variables, and the macroeconomic policies that exert a strong influence on them, do influence the demand for foreign exchange, but their impact on exchange rates is not systematic or predictable. Because of the speculative nature of currency markets, the influence of the variables cited depends on whether or not they have been anticipated, and on how they affect expectations regarding the future course of exchange rates. Moreover, for the same reason, expectations regarding the future course of exchange rates can change and alter the current pattern of exchange rates independently of macroeconomic policy; in other words, speculative bubbles occur, whereby a currency appreciates simply because investors believe that it will go even higher in the future.

In some periods exchange rates have moved in line with current account developments because the latter were expected to trigger monetary policy actions that would influence the future course of exchange rates. For instance, in 1987 and early 1988 announcements of United States monthly trade figures caused strong reactions on foreign exchange markets. But the widening of trade imbalances among the major OECD countries in the first half of the 1980s did not influence the dollar until 1985, when they had grown so big as to give rise to expectations that policy

109 For various influences on exchange rates see UNCTAD, "The Exchange Rate System", *op. cit.*

Box 15

THE CONDUCT OF MONETARY POLICY IN THE UNITED STATES

A major difficulty in the conduct of monetary policy is that central banks can only influence their final goals in a very indirect way; for the relationship between policy instruments and goals is highly complex, involving a number of intermediate variables. Moreover, monetary authorities cannot control both short-term interest rates and reserves - if one is chosen as the control variable, the other becomes a shock-absorber, changing freely with market conditions.

Monetary policy may be conducted by targeting an intermediate variable (e.g. money supply), but the success of such strategy depends on two assumptions; namely, that such intermediate targets can be closely controlled, and that they are reliably linked to ultimate goals. This approach can be very troublesome when these assumptions prove wrong. Alternatively, monetary policy may concentrate directly on the behaviour of its ultimate goals. Such a one-stage strategy can cause serious swings in the real economy if reserve growth is tied rigidly to inflation, and when the link between money and prices is weak and unstable. Flexibility may be introduced into both regimes by using various intermediate variables as indicators of the need for policy action as well as of the effects of actions taken. This procedure allows more discretion but can encounter problems when indicators give conflicting signs. These difficulties explain why different central banks use different operating regimes and revise them from time to time.

Some of these points can be exemplified from the experience of the United States. In the 1970s the Federal Funds Rate (FFR) targeting was the operating regime of monetary policy. It was closely controlled through open market operations, and assumed to reflect changes in the liquidity of the banking system and to have a systematic relationship with other short-term interest rates. Bank reserves were adjusted whenever the FFR tended to move out of a relatively narrow target range, except when the consequent monetary expansion was considered excessive. Consequently, this operating procedure resulted in relatively large fluctuations in reserves, whereas interest rates remained fairly stable.

In the course of the 1970s this operating regime came under strain as it implied accommodation of the inflationary pressures; besides, stabilizing interest rates became very difficult because of volatility of inflation. In October 1979 the Federal Reserve Board changed its operating procedure in order to control monetary expansion and inflation; it started adopting targets for money supply (M1 and M2), using non-borrowed reserves as its main instrument, thus allowing interest rates to float freely. This operating regime turned out to be ill-founded: deregulation resulted in the introduction of various types of interest-bearing transaction accounts which reduced the control of the Federal Reserve Board over M1. Targets were missed most of the time, and the velocity of circulation of money fell sharply, causing an excessive liquidity squeeze. Thus, deregulation and monetarism made disinflation extremely costly, generating the longest and deepest recession since the Great Depression. During 1980-1982 the instability of short-term interest rates (as measured by deviations from the mean change) rose by four times compared to the 1970s.

This operating procedure was abandoned in early 1983. Money supply targeting has continued but the Federal Reserve Board moved gradually to broader aggregates. First, M1 was de-emphasized and later (in 1986) dropped altogether as a target of policy; M2 and M3 have been targeted with wide ranges (i.e. 3-7 per cent annual growth). More important, the Federal Reserve Board started to use borrowed reserves (BR) as its control variable, introducing discretion in monetary policy: a target is set for BR consistent with intermediate monetary targets and final goals. Since any subsequent change in the demand for reserves is accommodated by open market operations, the FFR tends to be more stable than under the strictly monetarist regime, but somewhat less stable than under the FFR regime. Moreover, since there is no direct link between BR and monetary growth, a number of the intermediate indicators can be used to determine the need to revise BR; these have so far included strength of economic expansion, inflation, interest rates, exchange rates and financial market conditions. This lack of automatic control over money growth and redirection of monetary policy according to various intermediate indicators have resulted in significant variations in total reserves and monetary growth, but inflation has been low and stable. The short-term interest rate volatility fell sharply compared to 1980-1982, but remained relatively high compared to the 1960s.

Table 33

AVERAGE MONTHLY CHANGES IN NOMINAL EFFECTIVE EXCHANGE RATES [a] OF THE MAJOR RESERVE CURRENCIES, 1961-1990

Period	*United States*	*Japan*	*Federal Republic of Germany*	*United Kingdom*	*France*
1961-1972	0.18	0.24	0.31	0.32	0.28
1974-1979	1.06	1.64	1.04	1.23	1.01
1980-1989 [b]	1.76	1.73	0.89	1.45	0.89

Source: IMF, *International Financial Statistics*, various issues
a Average percentage change, ignoring sign, in the monthly average nominal effective exchange rate index
b Including also the first quarter of 1990.

actions would be taken to avert the resulting tensions in the trading system.

In certain periods the dollar's exchange rates against other major reserve currencies moved in line with current short-term interest differentials: for instance, during the period of dollar appreciation in the early 1980s; during 1986, when the dollar declined; and in the early phase of yen depreciation at the beginning of 1989. But, there have also been a number of episodes when the relationship was inversed: for example, during 1983-1984 the dollar continued to appreciate although there was no clear trend for interest rates in the United States to rise more than elsewhere; in 1988 the dollar strengthened against the deutsche mark although the short-term interest differential was narrowing, and weakened on two occasions despite a widening interest differential in favour of the dollar; and in the last quarter of 1988 the dollar again depreciated against the yen at a time when the interest rate differential widened in its favour.

As well as increased difficulties in predicting the future course of monetary policy, one of the factors increasing the volatility of market sentiment, and thus adding substantially to both the short-term variability of exchange rates and, more important, the medium-term swings, has been inconsistencies in the fiscal and monetary policies of the major OECD countries. The expansionary fiscal and restrictive monetary policies pursued by the United States, at a time when the overall stance of policies in the other major OECD countries was contractionary, was a major factor in the appreciation of the dollar in the early 1980s; this, together with disparities in the pace of domestic demand in the United States and its major trading partners, was the most important reason for the huge United States trade deficit. Most major OECD countries, however, chose to ignore these developments for almost half a decade.

The Plaza meeting in September 1985 marked for most Governments a major reassessment of the roles to be assigned to markets and public policy in the determination of exchange rates. It marked the beginning of exchange rate management which played a major role in correcting the misalignment of the dollar until the Louvre meeting in early 1987. However, the Plaza agreement emphasized primarily monetary policy and intervention in exchange markets. The dollar had already begun to decline before this date, and it was believed that co-ordinated intervention and monetary measures were needed to bring about further devaluation thought necessary for adjustment; but there was no general agreement on the need for expansionary fiscal policy outside the United States.

At first this did not prove troublesome as monetary policy actions were "leaning with the wind". However, the exchange rate mechanism proved much less effective than expected in correcting payments imbalances, given the pattern of demand generation. At the Louvre meeting in February 1987, consensus was reached among Group of Seven Governments that the dollar should be stabilized, and the adjustment in trade balances be achieved through enhanced co-ordination of macroeconomic policies among the participating countries directed at changing the international pattern of domestic demand; the actions taken

Table 34

SWINGS IN MONTHLY NOMINAL EFFECTIVE EXCHANGE RATES [a] OF THE MAJOR RESERVE CURRENCIES, 1980-1990

Period	*United States dollar*	*Japanese yen*	*Deutsche mark*
1980/1-1985/9	53.4	30.6	14.0
1985/10-1987/2	23.1	24.1	14.8
1987/3-1987/9	2.9	6.2	0.8
1987/10-1990/3	11.2	21.3	7.6

Source: IMF, *International Financial Statistics*, various issues.
a Difference between highest and lowest monthly average rate during the periods indicated, divided by the average rate during the period.

in pursuit of this objective were to include fiscal policies. This implied a restrictive monetary policy and budget cuts on the part of the United States, and the pursuit of more expansionary management of domestic demand, partly through a stronger fiscal stimulus, on the part of the Federal Republic of Germany and Japan. Thus, it was broadly agreed that the trade adjustment required was not attainable solely through exchange rate management.

The period from February 1987 to September 1987 witnessed a degree of exchange rate stability unprecedented during the decade. The orderly decline in the dollar attained between the Plaza and Louvre meetings, and the subsequent success in keeping the dollar stable, gave impetus to new initiatives to manage exchange rates in the OECD area. The reasons for this move towards managed floating were clearly expressed by the Chancellor of the Exchequer of the United Kingdom at the annual meetings of IMF and the World Bank in September 1987: "The belief that markets would provide a stabilizing influence, through the operations of medium-term speculators, has not been borne out. ... In particular, we have seen wild gyrations in the dollar that have clearly not been a reflection of economic fundamentals. ... Moreover, these gyrations have damaged growth in world trade. ... And the major uncertainties about exchange rate movements inhibited risk taking and required a switching of resources at a pace that was totally unrealistic."[110] The regime of managed floating adopted at the Louvre meeting has worked because countries have "been prepared in practice to give significant weight to exchange rates in the conduct of monetary policy ... and to back up (the) agreement with co-ordinated intervention". Moreover, the experience gained should be used "to build up a more permanent regime of managed floating".[111]

However, the exchange rate stability between February and September 1987 was attained at the cost of increased pressures on monetary policy. The Louvre agreement was translated only partly into actual measures, the United States trade deficit failed to improve and, consequently, pressures on the dollar intensified. Heavy intervention in foreign exchange markets by the United States, the Federal Republic of Germany and Japan was therefore required. Thus, monetary policy had to bear the brunt of adjustment and soon became overburdened. Intervention and the consequent monetary expansion by surplus countries gave rise to concerns that exchange rate management would undermine their efforts to maintain price stability and contain inflationary expectations. As a result, monetary policy was tightened in the course of the year, causing interest rates in the major OECD countries to rise.

However, this created a situation of fragility in financial markets. Rising long-term bond yields were accompanied by falling dividend yields; in the three major stock markets, increases in share prices pushed the price-

110 See Press Release No. 44 of the Annual Meetings (30 September 1987), p. 3.
111 *Ibid.*, p. 5.

earnings ratios to record levels.[112] On the other hand, failure of the depreciation of the dollar to significantly improve the United States trade deficit gave rise to concerns that interest rates in the United States might have to be raised further to stem downward pressures on the dollar. Fears that such developments would cause a drop in activity and profitability triggered the collapse of stock prices in October 1987.

This collapse induced monetary authorities, particularly in the United States, temporarily to put aside other objectives and provide the financial markets with additional liquidity. This succeeded in its objective of containing financial market turbulence and in avoiding a recession, but it also meant a relaxation of exchange rate management. The perception of an inflationary danger mounted as output growth intensified, and the choice between exchange rate and domestic stability in deficit countries came increasingly to be decided in favour of the latter. Thus, monetary policy tightened again in the course of 1988 and interest rates were pushed even higher than before the crash.

A similar situation also evolved in the course of 1989. In October 1989 the second largest day-to-day fall in the Dow Jones index was recorded, and again this was closely related to exchange rate pressures and monetary policy. The dollar had been rising when the United States trade deficit increased unexpectedly in October 1989, generating uncertainties about future macroeconomic policies and interest rates. Bringing down the external deficit through currency depreciation would have required United States interest rates to be lowered, but that was considered inimical to domestic price stability; alternatively, reducing imports through cuts in domestic demand via monetary restraint would have implied higher interest rates and depressed corporate profits.

Finally, the behaviour of the Tokyo Stock Exchange during early 1990 generated similar destabilizing feedbacks between currency and financial markets, and policies failed to block their propagation. The Tokyo Stock Exchange was not affected by the "mini-crash" of 1989 in the United States and the Federal Republic of Germany, but continued to boom, reaching a new peak at the end of that year. However, during the subsequent four months the Nikkei index dropped by about 25 per cent (steeper though slower than the drop in the Dow Jones in October 1987), government bonds by more than 20 per cent and the yen by over 10 per cent. These changes were interrelated. As fears of recession in the United States subsided and inflation became the primary concern of monetary policy, interest rates tended to rise. This, in combination with the policy of low interest rates in Japan and the expectation of higher rates in the Federal Republic of Germany (prompted mainly by developments in Eastern Europe), exerted substantial downward pressure on the yen, and triggered massive shifts from yen-denominated assets, which accentuated the downward pressures on the value of the yen and also brought down bond and equity prices. The central banks of the other major countries gave only limited support to the yen. This created a dilemma for Japan, similar to that faced by the United States in 1987; higher interest rates were needed to stabilize the currency, but these could further destabilize the equity market. Moreover, the continued decline of the yen triggered expectations of substantial increases in domestic interest rates, which fed into further declines in bond and equity prices. Eventually interest rates had to be raised, with the discount rate reaching double the level of mid-1989.

These episodes illustrate the point that interactions among financial and currency markets are often destabilizing and that monetary policy cannot easily deal with them simultaneously. Monetary policy has had to shift from one objective to another as actions taken to ensure stability in one market have destabilized others. These shifts have tended to make the future course of key financial prices more unpredictable and uncertain. Moreover, because the burden of adjustment has generally been on weak-currency and/or deficit countries, efforts to manage exchange rates have tended to push up interest rates.

The enthusiasm regarding exchange rate management faded away with the 1987 stock market crash, brought about because, as noted above, there was an unwillingness, particularly in the United States and the Federal Republic of Germany, to make the necessary fiscal policy adjustments. Immediately after the crisis, exchange rate instability rose again as monetary policy was focused first on the stability of the financial system and then on internal objectives, in particular the price level. Foreign exchange market intervention was reduced and monetary policy largely lost view of exchange rates.

There can be little doubt that there is now an increased awareness by policy makers that action is needed to attenuate instability. Thus, these shifts of direction in the conduct of mon-

112 *TDR 1987*, Part One, chap. II, sect. B.4.

etary policy simply reflect the major dilemmas that the policy makers are facing; namely, too few policy instruments to attain many objectives simultaneously in an environment characterized by increased volatility of markets and continued failure to co-ordinate policies in order to manage exchange rates and reduce trade imbalances.

D. Strengthening the international monetary system

The adverse consequences of the increased instability of the international monetary and financial system are not always fully appreciated, in large part because visible and significant damage to the real economy of developed countries has so far been averted. However, the experience of the past decade shows that financial instability and disruption are costly not only potentially but also in fact. Moreover, the incidence of these costs do not always fall on countries and sectors whose actions contribute most to instability. Developing countries are particularly vulnerable to financial disruption and exchange rate disorder, as amply illustrated by the experience of the 1980s.

The adverse effects of instability on growth and development work primarily through debt, investment and trade, and flow from three sources. First, there is a systemic bias towards higher rates of interest. Second, exchange rates are delinked from the fundamentals of the real economy. Third, both interest rates and, particularly, exchange rates tend to move excessively and unpredictably .

The stock of external debt of developing countries is the most important channel of transmission of disruption and instability in world financial and currency markets into their domestic economies. Thus, the absence of a tendency for equalization of rates of return on assets denominated in different currencies means that the cost of servicing debt depends crucially on its currency composition, and is influenced not only by changes in the overall level of interest rates, but also by changes in exchange rates. This causes serious problems in the management of debt, and can give rise to significant losses when there is a mismatch between the currency composition of debt and foreign exchange receipts and reserves. On the other hand, since most developing countries do not have unlimited access to each of the major international capital markets, they cannot easily adjust the currency composition of their external debt or take forward cover to alleviate the effects of financial and currency market disturbances.

There can be little doubt that the systemic tendency of interest rates to remain high has been an important factor in the debt crisis of the 1980s. Its effects on developing countries have been aggravated because a large stock of debt had already been built up before this tendency emerged in force; interest rate increases were passed on to the debtors via the variable-interest loan practice; and rates of return on real domestic assets in debtor countries were depressed by deflationary adjustments, mainly because of investment cuts.

The tendency of interest rates to stay high depresses investment permanently unless the increase in the cost of finance is offset by reductions in other costs. Declines in real unit labour and material costs in the major industrial countries in the 1980s have indeed helped first to stem and then reverse the downward trend in rates of profits, raising them by the end of the decade to the levels of the late 1960s and early 1970s.[113] However, this has been attained at the cost of a substantial rise in unemployment and a fall in commodity prices. Since real interest rates remain, on average, much higher than in the 1960s, profit rates characteristic of the 1960s may not translate into investment rates experienced during that period. Indeed, despite recent increases, the share of investment in GDP in the Group of Seven countries remains below the level of the late 1960s and early 1970s.

Given the present and prospective stance of fiscal policies, the degree of monetary relaxation needed to bring interest rates down to levels conducive to a rapid pace of capital accumulation is likely to be regarded as too expansionary by many central bankers. At the same time, systematically high interest rates

113 *Ibid*, chap. II, sect. B.

place monetary policy on a tightrope. Should there be a supply shock on prices, for example, policy makers would be faced with the unattractive option of either tightening policy, allowing interest rates to shoot up from already high levels, thereby virtually ensuring recession, or allowing prices to feed through, thereby creating a ratcheting upward of rates of inflation. While this dilemma is always present, the higher the interest rates to begin with the more acutely it is felt.

Investment is hindered also by increased instability of exchange rates. Unpredictable swings in exchange rates tend to deter investment in the tradeable goods sector because of uncertainty as regards profitability: for, once in place, production capacity cannot be redeployed from one industry to another without incurring substantial costs. Moreover, increased unpredictability of exchange rates distorts the spatial allocation of foreign direct investment, which tends to be governed by the desire to reduce the exchange rate risk rather than by considerations of efficiency.

Exchange rate volatility also increases the risk and uncertainty in international trade, and depresses exports and imports; this happens even when risks are covered in forward markets because of the costs involved. Indeed, many studies indicate that exchange rate fluctuations have had significant adverse effects on trade for a number of both developed and developing countries, in large part because of increased costs on the demand and supply sides.

More important, exchange rate misalignments tend to disrupt the international trading system by triggering protectionism. Overvaluation of currencies gives rise to protectionist pressures, and ultimately to protectionist measures which are not removed when misalignment is corrected; often permanent protection is sought in order to compensate for long-term exposure to exchange rate risk. Similarly, currency undervaluation can lead to investment in industries which are otherwise uncompetitive; again, such industries could exert substantial pressure for protection when the exchange rate misalignment is corrected. Evidence strongly suggests that these effects have played a major role in the proliferation of non-tariff barriers in the 1980s.

These and other adverse consequences of instability, as well as the susceptibility of the financial system to crisis, necessitate actions designed to attain a more stable system of international money and finance. The previous sections show that while the factors that generate disturbances and disruption are several and complex, and it is not always easy to assess accurately their relative importance, action will be needed simultaneously on two broad fronts - namely, markets and policies. This section briefly discusses possible ways of improving the functioning of markets, and the design and mutual compatibility of policies in the major OECD countries.

1. Regulation and supervision of finance and capital flows

Given the degree of development of the organization of financial markets, and the increased predominance of speculative activities, it is not altogether clear that an appropriate design of policies both within and among the major OECD countries would be sufficient to avert financial disruptions and destabilizing capital flows. Consequently, there is a need to give serious consideration to possible ways and means of reducing the scope of markets to generate disruption and instability without undermining their ability to facilitate the proper allocation of investment. In this respect, two main questions arise: is regulation necessary to ensure stability? and does regulation undermine efficiency?

Answers to these questions will clearly be shaped, *inter alia,* by the type of regulation being considered. In this respect a distinction can be made among three categories: (a) prudential regulations designed to limit the risk taken by financial institutions (such as capital adequacy and liquidity requirements and diversification rules); (b) protective regulations designed to shelter investors, in particular depositors at commercial banks (e.g., deposit insurance and the lender of last resort facilities); and (c) what may be called "systemic (or macroprudential) regulations" designed primarily to reduce systemic disturbances and instability. Clearly, both prudential and protective regulations also serve this purpose, but their focus is more on specific institutions and investors. Among the types of measures included in systemic regulations are various controls and restrictions on capital movements, and taxation designed to discourage speculation.

Under conditions in which interest rates are fully deregulated, and restrictions are significantly eased on access to financial markets and types of transactions permitted, the importance of having an effective system of prudential regulations is considerably enhanced. However, in the 1980s, until recently, the tendency was to broaden protective regu-

lations (through deposit insurance or *ex post* financial rescue operations) without matching this with prudential regulation. This created a moral hazard problem and played a major role in financial disruptions in certain countries (e.g. the Savings and Loan Associations in the United States). There is now an increased consensus concerning the need for vigorous prudential regulations to avoid such disruptions, at least for financial intermediaries.

Prudential regulations often trigger innovations by markets to avoid them, and with increased financial openness such reactions tend to gravitate more to the international than to the national level. Recent efforts to harmonize the regulatory regimes for the financial systems of different countries reflect awareness of this tendency. An important reason for improving international co-operation in the area of banking supervision is that differences in national regulatory regimes can generate international financial transactions with little or no underlying economic justification. Various evidence indicates that large capital movements frequently take place solely with the aim of circumventing monetary regulations such as minimum reserve requirements, prudential controls regarding capital adequacy and liquidity, and restrictions and rules concerning foreign exchange transactions. Moreover, during periods when confidence is adversely affected by financial turbulence, large movements of funds may be triggered from financial centres perceived as "soft" to safer havens, principally the major financial markets in the OECD area. Thus, the Basle Agreement of July 1988 among the central bank governors of the Group of Ten countries and Luxembourg concerning a common, risk-based standard of capital adequacy for international banks[114] constitutes a useful step in the process of reducing the incentive to international capital movements associated with divergences in national regulatory regimes.

Since such agreements concerning prudential regulations do not cover offshore centres, they may encourage further relocation of banking activities. This had indeed happened in the 1960s and 1970s and subsequently triggered competitive deregulation in the major money and capital market countries. Now the need for effective prudential regulation is increasingly recognized, but unless the regulatory regime becomes truly international, differential regulatory and tax treatment may continue to shift activity to offshore centres.

Moreover, there are serious gaps in preventive regulations even at the national level. Many countries do not have adequate and effective safeguards against the assumption of excessive risks in securities markets. Thus, the 1980s have seen increased proliferation of high-risk debt instruments used primarily for corporate takeovers (such as junk bonds in the United States). Absence of prudential regulations in such areas has also encouraged regulated institutions to enter into such transactions via off-balance-sheet business.

While it is widely recognized that financial and currency markets have become increasingly speculative, the issue of restrictions on short-term capital movements remains highly controversial. The resistance to such measures is based on two premises; namely, they will not be effective, and they tend to result in inefficiencies in the allocation of resources internationally because it is not possible to separate speculative flows from those that respond to fundamentals.

There can be little doubt that restrictions on capital flows can be ineffective and even counterproductive if they are used as substitutes for exchange rate alignment and/or policy adjustment. However, as stressed above, regulations and restrictions regarding financial transactions and flows would need to complement appropriate policies rather than be a substitute for them, and would be used solely for the purpose of reducing the scope of markets to create autonomous disturbances.

On the other hand, there are forms of regulations, other than quantitative and administrative controls, that work primarily via the price mechanism and that help to deter short-term, as opposed to long-term, capital movements. An example of such a measure is the interest equalization tax which was used in the past before the advent of floating. Another measure available for the purpose is the application to foreign exchange markets of the tax on financial transactions originally proposed by Keynes:

> "It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges. That the sins of the London Stock Exchange are less than those of Wall Street may be due, not so much to differences in national character, as to the fact that to the average Englishman, Throgmorton Street is, compared with Wall Street to the average American, inaccessible and very expensive. The jobber's 'turn', the high brokerage charges and the heavy transfer tax payable to the Exchequer, which attend dealings on the London Stock Exchange, sufficiently diminish the liquidity of the mar-

[114] See *TDR 1989*, annex 2.

> ket to rule out a large proportion of the transactions characteristic of Wall Street. The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States".[115]

Such a tax, to be effective, should be an internationally agreed uniform tax, applied in proportion to the size of transactions involving conversions of one currency into another in order to raise the cost of short-run transactions relative to longer-run currency conversions and maturities. Such an agreement would be of unprecedented scope. Its benefits, however, would be fully commensurate with the effort required.

2. Exchange rate arrangements

There is now a widespread recognition that the floating exchange rate system has failed to promote stable and sustainable current account balances, and that there is a need to move to a more stable system of exchange rates. Such a system should be sufficiently flexible to allow exchange rates to adjust to underlying economic conditions, in particular to changes in prices and productivity and, hence, to avoid the mistakes of the Bretton Woods regime. It should also avoid the mistakes of the last two decades.

One of the arguments in favour of floating exchange rates was that they would give countries autonomy and independence in domestic policy making. The autonomy in question was partly with respect to monetary policy; since there would be no obligation to defend a particular exchange rate, monetary policy would have greater scope to deal with domestic objectives. However, as discussed above, this has proved rather illusory, because of increased financial integration of the countries and increased instability of exchange rates. It is no longer possible to ignore the consequences of exchange rates for domestic policy objectives, and pursue an autonomous monetary policy.

A broader issue of policy autonomy is related to trade adjustment. It was implicitly, and sometimes explicitly, assumed that external equilibrium could be attained primarily through movements in exchange rates, rather than in domestic demand and income, thereby allowing countries to pursue macroeconomic policies geared to full employment and growth. This expectation was based on two premises. First, there would be no major shortcomings in the conduct of policies both within and across the countries. Secondly, trade balances would respond swiftly to changes in exchange rates. However, as recent experience has shown, both of these assumptions have proved wrong.

There can be little doubt that no exchange rate system can work efficiently when there are serious macroeconomic policy shortcomings. As the experience of the United States has demonstrated, inconsistency in the mix of monetary and fiscal policies can cause exchange rate movements that aggravate trade imbalances. On the other hand, when trade imbalances are due primarily to major divergences between the overall stances of the macroeconomic policies of the major trading partners, and/or because trade policy is significantly restrictive in some of these countries, attempts to reduce trade imbalances through exchange rate movements would entail sharp swings in exchange rates; or, should exchange rates come under pressure, attempts to stabilize them could cause serious strains.

Regarding the second assumption of the floating system, recent experience has also shown that the response of exports and imports to exchange rates can be very sluggish. Markets for traded goods do not necessarily operate on the basis of the type of competitive pricing envisaged by the proponents of floating exchange rates. In particular, greater instability of exchange rates raises the average profit margin. The latter also becomes much more variable in order to allow prices to be adjusted to changes in exchange rates, thereby rendering exchange rate movements much less effective in correcting trade imbalances. The sharp depreciation of the dollar since early 1985 brought about much less improvement in trade imbalances among the major OECD countries than had been expected because exporters preferred to take cuts in their profit margins rather than reduce export volumes and lose their share of the United States market, whereas United States producers tended to respond to the dollar depreciation not so much by raising their export volumes as their profit margins.

These considerations show that the scope for attaining a stable pattern of exchange rates will depend, *inter alia*, on the degree of consistency of policies within and across the major countries. However, experience has

115 Keynes, *op. cit.*, pp. 159-160. See also James Tobin, "A Proposal for International Monetary Reform", *The Eastern Economic Journal*, vol. 3, Nos. 3-4, July/October 1978.

shown that the discipline needed to eliminate policy inconsistencies is hard to obtain without effective multilateral surveillance, an issue that will be taken up in the following sub-section.

The second important issue in the management of exchange rates is the need for an international commitment by the major OECD countries to an explicitly announced pattern of exchange rates that is compatible with underlying fundamentals, and to defend it by intervention in currency markets and regulation and control of financial flows. Such commitments would play an important role in achieving stability by providing an anchor for expectations, thereby influencing market behaviour, and by disciplining policy making.

The experience with exchange rate management by the Group of Ten countries after the Louvre meeting (i.e. the so-called reference ranges) constituted a direct targeting of exchange rates without, however, containing some of the above elements needed for durable stability. The ranges were not announced explicitly; they were agreed provisionally with a view to short-term adjustment needs, and not because they reflected fundamentals; there were no formal obligations and rules in the event of the divergence of the rates from the agreed reference ranges; and, more important, the agreement did not secure policy adjustments needed to reduce pressures on exchange rates.

Lack of a firm commitment to defend the agreed pattern of exchange rates is also a feature of a version of the target zones proposal which favours "soft margins" in order to allow considerable flexibility and facilitate exchange rate management. Wide margins (e.g. plus and minus 10 per cent) are advocated, *inter alia*, in order to absorb certain temporary shocks within the zones, and because of substantial uncertainty in calculating the appropriate pattern of exchange rates. However, wide margins make sense only if there is a commitment to defending the targets. Moreover, it is not clear if such a sytem can ensure the discipline needed, and thereby be regarded as credible by the markets.

Since a firm commitment among participating Governments is essential for achieving greater exchange rate stability, and since reduction of unsustainable trade imbalances should rely more on adjustment in policies in both deficit and surplus countries than exchange rates, the question arises as to whether an adjustable peg system with predefined obligations and narrow ranges along the lines of the EMS would be feasible. Such a system, in combination with regulation and control of short-term capital flows discussed above, would leave much less room for speculative pressures and policy inconsistencies to build up, and could thus be more successful in preventing the emergence of misalignments. However, like other proposals for reference ranges and target zones, it would require not only agreed intervention rules but also a framework within which national monetary and fiscal policies would have to be conducted and co-ordinated.

3. Interdependence, policy co-ordination and surveillance

Since exchange rate instability is undesirable because of adverse effects of unpredictable and misaligned exchange rates on growth and development, it is essential that a system designed to attain exchange rate stability does not contain a deflationary bias. This clearly raises the question of assigning responsibilities and obligations to defend exchange rates and to undertake policy adjustment in order to correct destabilizing and unsustainable trade imbalances. Indeed, it evokes the whole question of the management of interdependence, which has become the central concept in recent discussions of policy co-ordination among the major OECD countries. However, actions have not always reflected its true meaning and policy implications.

Interdependence among countries implies that the economy of each is both sufficiently *open* for it to come under considerable influence from abroad, and sufficiently *large* for its own policies to make a significant impact on others.

An appropriate management of interdependence implies that no country with a sufficiently open economy (even if it is too small to have itself an impact on other economies) should be expected to be able to put its house in order regardless of what the other countries are doing. Otherwise, the burden of adjustment would be put on deficit countries, thereby introducing a global deflationary bias. Nor should any country set its policies without paying attention to their possible international consequences, an approach that would lead to "beggar my neighbour" policies designed to export unemployment or inflation, thereby creating considerable frictions in the international monetary and trading systems. The experience of the 1980s leading to the emergence of serious exchange rate misalignments and large trade imbalances, and the subsequent failure to reduce them and to manage exchange rates, show that the major OECD countries have been unable to take a proper account of interdepend-

ence, and to co-ordinate their macroeconomic policies accordingly.

Effective policy co-ordination necessitates agreement on certain goals, and on policy actions needed when outcomes differ from the agreed goals. First, certain objectives need to be set for each country concerned, including admissible rates of growth of domestic demand as well as exchange rates and current account balances. Consistency of objectives needs to be attained both within and across the countries concerned. It is particularly important to secure a pattern of demand generation consistent with trade and exchange rate objectives; and the latter need to be mutually consistent among the countries since the number of exchange rates or current account balances that can serve as independent targets is less than the number of countries. There should be a clear understanding about the allocation of the burden of adjustment when the outcomes persistently deviate from the agreed targets.

Second, a set of global targets and indicators may be used to prevent a deflationary or inflationary bias in the overall policy stance, and to provide a basis for global action by all the countries concerned. A recent proposal in this respect is that of introducing a commodity price index as an indicator to help in "monitoring the performance of the group (of industrial countries) as a whole",[116] and to serve "as an early-warning signal of potential price trends".[117] This proposal is based on the assumption that global demand pressures are reflected in movements in commodity prices; indeed deflationary policies have played a major role in the collapse of commodity prices in the 1980s. Since they still remain depressed, an important issue is the level to be taken as the basis for assessment of their future movements. An upward adjustment would certainly be necessary before embarking on the use of this index as an indicator of global demand pressures.

Co-ordination of policies within such a framework does not necessarily imply automatic policy reactions to developments in certain indicators. A considerable amount of flexibility and discretion may be introduced, based on extensive consultations among the parties concerned. However, it should also be recognized that it necessarily implies a certain degree of constraint on national policy making.

There can be little doubt that there are serious difficulties in attaining the required degree of co-ordination. Experience shows that co-ordination has been more successful when collective goals were pursued (such as the adjustment to the oil price rises in the 1970s), but it is not always possible to reach agreement on such goals. Often, policy co-ordination is required where the precise nature and causes of problems affecting several countries do not command consensus. For instance, in the present situation the problem of trade imbalances is perceived differently by different countries. Moreover, there may be considerable differences in priorities attached to different ultimate goals by different countries. For instance, views as to what is sustainable in terms of output growth can differ according to perceptions regarding trade-offs with environmental objectives. Another major difficulty is that the contribution of a national Government to international economic co-operation carries little weight in the formation of voters' opinion,[118] and the policy record of a Government usually takes little account of external influences on the home economy. A basic requirement to overcome such difficulties is that policy makers and electorates in the major OECD countries understand that the international orientation of macroeconomic policy is a necessity stemming from interdependence that the very same countries have been promoting by advocating more liberal policies and open economies; nor is it against their own country's interest since the alternative would be serious disruptions to national and global economies.

Policy co-ordination among the major countries would also need to take into account its implications for *small* but *open* economies, and, particularly for developing countries. As experience has demonstrated, these countries are affected not only by the the overall stance of macroeconomic policies in the major OECD countries, which exerts a major influence on their volume and terms of trade, but even by the mix of monetary and fiscal policies which, through its effects on interest rates, has a major influence on their external debt burden. This is perhaps one of the most important reasons why conduct of policies in the major countries should be subject to multilateral surveillance.

The record in this respect is extremely poor. Increased interdependence among the

116 The statement of Chancellor of the Exchequer Nigel Lawson at the Annual Meetings of IMF and the World Bank, Washington, D.C., September 1987 (as reproduced in Press Release No. 44 of 30 September, p. 6).

117 The statement of Secretary James Baker III at the Annual Meetings of IMF and the World Bank, Washington, D.C., September 1987 (as reproduced in Press Release No. 50 of 30 September, p. 3).

118 This has been exemplified by the continued failure of many industrial countries (with some honourable exceptions) to comply with their commitments for ODA.

major OECD countries, increased dependence of economic performance in developing countries on the mix and stance of policies in the major OECD countries, and the greatly enhanced capacity of financial markets and capital flows to generate global disturbances, mean that the world economy today is considerably different from the one envisaged by the architects of the post-war monetary arrangements. This would have required the strengthening of the surveillance function of IMF in order to help attain the objectives of growth and stability as laid down in article I of its Articles of Agreement. Instead, the last two decades have seen a considerable strengthening of the Fund's position vis-à-vis the developing countries while issues of great importance to the global economy have continued to be decided within the Group of Five or the Group of Seven countries.

The inadequacy of IMF surveillance is now widely recognized. The Group of Ten countries, for instance, agreed that "surveillance has not been as effective as desirable in influencing national policies and in promoting underlying economic conditions conducive to exchange rate stability", while also noting that some "countries appear to have been able on occasion to sustain policy courses not fully compatible with the goals of international adjustment and financial stability".[119] The Group of Twenty-Four has argued that surveillance should not be limited to members' exchange rate policies, but should also include the international adjustment process.[120] There is a broad agreement that effective surveillance requires assessment of all policies affecting trade, capital flows, external adjustment, and the effective functioning of the international monetary system, particularly of the major OECD countries.

IMF has so far developed a number of medium-term economic indicators, and used them primarily for periodic bilateral consultations with Governments. However, the surveillance function of the Fund has particular importance for the process of policy co-ordination itself; it should be conducted on a multilateral basis before issues regarding policies and indicators are taken up in bilateral consultations. In this way, it may help allocate the burden of adjustment between deficit and surplus countries, and assure that co-ordination of macroeconomic policy in the major industrial countries leads to results for the world economy that are conducive to growth as well as stability.■

119 *IMF Survey*, Supplement on the Group of 10 Deputies' Report, July 1985, para. 36.

120 *IMF Survey*, Supplement on the Group of 24 Deputies' Report, September 1985.

Chapter II

TOWARDS A MULTILATERAL FRAMEWORK FOR INTERNATIONAL TRADE IN BANKING SERVICES

A. Introduction

As a result of the numerous interactions between financial and non-financial activities in most types of economy, pivotal importance is generally attributed to the sector which provides banking services.[121] Not only are a great many transactions between economic agents linked to the use of one or more of such services, but the very pervasiveness of this connection also means that the banking sector can be a powerful instrument for controlling or influencing the character and scale of production. This potential and the large number of different banking services make the establishment of norms and regulations in this field a particularly complex matter. This statement applies alike to national regulatory regimes and to agreements about norms at an international level.

The impetus for an agreement on international trade in banking services as part of the current multilateral trade negotiations comes mainly from certain OECD countries, their objectives concerning both each others' markets and those in developing countries. Under the first heading is the achievement of a more uniform competitive regime for banks throughout the OECD area. Agreement on such a regime will have to reconcile divergences among the countries in question stemming from differences in the competitive strengths of their financial sectors and in existing regulatory systems. The objectives regarding markets in developing countries spring from the belief that, as a group, banks in OECD countries possess a competitive advantage in the provision of a wide range of financial services vis-à-vis their counterparts in the rest of the world. This competitive edge is based on such factors as wider mastery of banking technique and relevant advanced technology, economies of scope,[122] superior access to information and to currencies widely used in international transactions, greater capacity for innovation, and stronger links to suppliers of other supporting services for international trade such as insurance and shipping.[123]

[121] This chapter is limited to international trade in banking services and does not cover insurance. Financial services are often defined as including insurance, and an agreement on the sector reached at the current multilateral trade negotiations may comprise insurance as well as banking. But for an explanation of the issues to be tackled at the negotiations, banking should be treated separately from insurance owing to major differences in such areas as industrial organization, the role and importance of the various categories of transaction included in services trade, and significance for macroeconomic management and monetary policy.

[122] Economies of scope are those which result when goods or services are produced together in one unit rather than in separate ones. More formally, if C is a function representing cost of production, and X and Y are two goods or services subject to economies of scope, $C(X,Y) < C(X) + C(Y)$.

[123] It might be argued that a competitive edge based on superior links to the suppliers of the other supporting services required for international trade are already covered under the first two factors cited in the main text. However, there is a case for drawing separate attention to these links owing to the role which they have played historically in the rise of many of the world's traditional financial centres.

In 1985 the world's 100 largest banks maintained more than 2,200 offices in developing countries.[124] With only a few exceptions the home bases of these banks were in the OECD area, so that this figure indicates the scale of the presence of banks from OECD countries in developing ones. Although the figure has ceased to increase during the 1980s, flows of foreign direct investment in the financial sector by major OECD countries to all destinations have continued to grow rapidly. Moreover, there can be no doubt of transnational banks' conviction that there remains widespread untapped demand in developing countries for many of their services, access to which could be facilitated by an agreement liberalizing the international regime for this sector.

Developing countries too can benefit from increased international competition in the provision of banking services (as explained in more detail in section C). However, there are dangers for such countries that an agreed regime may contain restrictions on their options as regards policies in areas such as monetary management and credit allocation, and may take insufficient account of their need in many cases to accord infant industry protection to their banks owing to the lower levels of development typically characterizing their financial systems. Pressures for a regime with shortcomings of this kind are especially great in a period noteworthy for widespread belief in liberalization among policy makers in OECD countries not only as an instrument for the achievement of well-defined objectives but also as a more general panacea.

The focus of the sequel is the North-South dimension of current negotiations concerning international trade in banking services. However, it should be emphasized that issues primarily related to the regime for banking trade among OECD countries will inevitably have an important influence on the shape of any eventual agreement, with the result that such issues are raised incidentally at various points below. Section B takes up key aspects of the definition and measurement of international trade in banking services, and section G surveys some of the more systematic evidence concerning market access for foreign banks and restrictions on their operations in developing countries. Key concepts and principles at the centre of the multilateral negotiations on services are discussed in section H. Certain problems here derive from the practicalities of the application of these concepts and principles to banking, in some cases because they were originally designed for trade in goods. Other problems, particularly many of those relating more specifically to the position of developing countries, are connected to the nature and effects of competition in banking (the subject of section C), perceptions concerning financial dependence (some possible implications of which are explored on the basis of historical illustrations in section D), the role of banking systems as instruments for the allocation of credit for development purposes (considered in section E), and the impact of foreign banks on various dimensions of national monetary policy, in particular on Governments' autonomy in this area (the subject of section F).

B. Definition and measurement

1. The scope of banking services

For the purpose of this chapter the definition of banking services in a recent OECD study is appropriate, namely "all financial services and related ancillary services that may be offered by financial institutions such as banks, savings banks, securities firms, brokers and other providers of financial services including non-financial enterprises."[125] Various classifications of banking services by major category and by sub-categories are possible. For example, a classification focusing on major functional categories might distinguish between payment services, facilities for holding liquidity reserves and financial savings and investments, facilities and instruments for borrowing, trading facilities for marketable financial instruments,

124 Offices include branches, subsidiaries, affiliates and representative offices.

125 G. Bröker, *Competition in Banking* (Paris: OECD, 1989), p. 105. This definition includes insurance brokerage provided by the financial institutions mentioned in the main text but not insurance underwriting which belongs under the heading of the insurance industry proper and, as noted in the introduction, is not covered in this chapter.

brokerage facilities for buying and selling financial instruments, investment services for private individuals and institutional investors, special financial services for industrial and commercial enterprises, and miscellaneous finance-related services such as real estate and commodity brokerage, tax advice and safe custody. Another broader set of major categories sometimes used consists of domestic activities taking the form of retail banking, wholesale banking, securities-related services and inter-bank services, on the one hand, and international financial services, on the other.[126]

Each major category in such classifications comprises several sub-categories. Thus, for example, international financial services include taking deposits from non-residents, traditional services associated with financing and payments in international trade, international lending not closely linked to particular international transactions, various services associated with international dealing in securities, buying and selling foreign exchange, and services associated with the provision of instruments (such as futures and options) for managing the risks of positions in foreign exchange and other financial assets.

These definitions serve to bring out the important point that banking services are provided through many different sub-markets differentiated by product, by type of customer and supplying institution, and by territorial boundaries. The set of sub-markets in any given country is determined by various features of its history, geography and economic development. Thus, for example, many aspects of the availability of a country's financial services, including the modalities of their provision, reflect the influence of its legal and regulatory framework. In view of this connection between a country's particularities and the character of its financial system, it is not surprising that the various sub-markets for financial services manifest considerable differences among countries, and that some services are largely or completely absent in many countries. For example, several services such as those associated with dealing in securities or with credit cards are used by only a restricted number of people and enterprises in most low-income countries, and many of the services associated with the management of financial risk (such as forward exchange markets, futures and options) are frequently of negligible significance in such countries.

The multiplicity of sub-markets constituting banking systems and the variations among countries in the ways in which banking services are provided and regulated both bear importantly on the possible contents of an agreement on an international framework for trade in such services. Differences between sub-markets mean that for many purposes, including several relevant to such an agreement, particular banking activities need to be considered separately. It is true that a major objective of such an agreement would be to achieve greater uniformity in several aspects of the ways in which banking services are regulated in different countries. However, the effort in this direction would need to be balanced by a flexibility taking due account of differences among countries in such respects as levels of development, geography and the philosophy and modalities of economic policy.

2. The meaning of international trade in banking services

The definition of international trade in banking (and other) services has been the subject of much debate. For the purpose of an agreed international framework for such trade, the most important issue in this debate has been whether to include not only service transactions between the residents of a territory and non-residents, but also services provided by foreign-owned branches, subsidiaries and affiliates. Thus, a more restrictive definition would limit trade in services to "international transactions in services between the residents of one country and the residents of another country irrespective of where the transaction takes place".[127] Under the accepted balance of payments definition the concept "non-resident" applies to economic agents whose presence in the economy of a territory is temporary and associated with a specific purpose.[128] Such a definition would not include the branches, subsidiaries and affiliates of foreign-owned enter-

126 In the case of this latter categorization confusion is sometimes caused by failure to distinguish clearly under the first four categories between domestic and international activities. Most services provided under these four headings may now have an international as well as a domestic character either because they are employed for cross-border transactions or because they entail the use of foreign currencies.

127 "Towards a possible multilateral framework for trade in services: some issues and concepts" - report prepared by Deepak Nayyar at the request of the UNCTAD secretariat (UNCTAD/ITP/17), para. 5 (reproduced in UNCTAD, *Technology, Trade Policy and the Uruguay Round. Papers and Proceedings of a Round Table held in Delphi, Greece, from 22 to 24 April 1989* (UNCTAD/ITP/23), New York, 1990).

128 IMF, *Balance of Payments Manual Fourth Edition* (Washington, D.C.: IMF, 1977), paras. 59-66.

prises since their presence is not temporary. In consequence it would exclude several types of banking service that are difficult to provide to residents without a long-term physical presence in a territory. Yet among these services are those in which the major proponents of an agreed international framework are primarily interested. Thus, an alternative definition would extend international trade in banking services to cover resident suppliers owned abroad.

At the current multilateral negotiations on trade in services, final agreement on definition has yet to be reached. The document setting out the results adopted by the Trade Negotiations Committee at the Mid-term Review states that "Work on definition should proceed on the basis that the multilateral framework may include trade in services involving cross-border movement of services, cross-border movement of consumers, and cross-border movement of factors of production where such movement is essential to suppliers." Certain of the concepts considered by the Committee to be relevant in the context of the elaboration of a multilateral framework (such as national treatment, market access and the regulatory situation) seem especially pertinent to cases where international transactions in services are associated with a long-term presence on the spot.

The sequel focuses more on services supplied by foreign-owned banking units present in a territory. The lesser attention given to transactions between residents and non-residents reflects partly the emphasis of recent discussion. But it is also due to the difficulty of abstracting issues under this heading from the separate but related question of foreign exchange control. Several of the major categories of financial transaction between residents and non-residents (such as borrowing from foreign banks, the buying and selling of foreign securities and other financial instruments, and the servicing of external debts) are widely subject to such control in developing countries. However, policies in this area involve questions of macroeconomic management that transcend trade in banking services. Moreover, foreign exchange control is a subject covered by the IMF Articles of Agreement. Considerations such as these may complicate agreement on a framework for trade in banking services that includes developing as well as developed countries. However, a full explanation of the implications of the many connections between such trade and foreign exchange control is beyond the scope of this chapter (although there are references to the topic at various points).

3. *Measuring international trade in banking services*

Perhaps the most appropriate measure of international trade in banking services is the value added of the activities chosen for inclusion in the definition of such trade. This measure differs from the gross output concept used for trade in goods, and has the advantage of avoiding the problem of defining the gross output of the banking sector. However, it still presents serious difficulties. Current methods of measuring the contribution of banking services at a national level to GDP are still widely regarded as unsatisfactory in certain respects. One source of this dissatisfaction concerns the treatment of sales of banking services to non-residents. Unless appropriately adjusted on an *ad hoc* basis, current methods take no account of the contribution of such sales to GDP.[129] With the growth of international banking and the spread of offshore banking centres, the distortion due to this omission has increased in importance. In the extreme case of Luxembourg it resulted by the late 1970s in an underestimate of GDP amounting to about 25 per cent.

These difficulties bear on the possibility of measuring international trade in banking services according to the narrower of the two definitions discussed under section B.2 above, namely, international transactions in such services between residents and non-residents. It would appear that such figures are not in general readily available from national accounts. They could be estimated from such information as charges on banks' business with non-residents and the margins between lending and borrowing rates of interest on their loans to non-residents. But the establishment of uniform guidelines for estimates on this basis would require an international initiative.

Once estimates of international trade in banking services under the narrower definition of such trade were available, measurement which includes also the value added of banking units established in foreign countries should not involve any insuperable problems in principle. Estimates of this value added could be made from data for the income of such units from

129 This paradox is due to the failure in national accounts to separate from the part of banks' value added resulting from services to economic agents other than final consumers most or all of their net income from foreign sources. According to prevailing conventions this part of banks' value added is treated as making no net contribution to GDP.

their charges and interest rate margins. The absence of data measured in accordance with generally accepted criteria for international trade in banking services on either of the definitions described here can be expected to complicate negotiations concerning such trade owing to consequent uncertainties as to the value of concessions by participating countries.

Several statistics are frequently cited to give an idea of the recent growth of different categories of international banking business. Although these statistics are typically values of assets, liabilities or transactions and are thus not measures of trade in financial services according to either of the definitions discussed above, they do give useful indications of recent trends. Thus, for example, the annual average rate of growth of the external assets in dollars (after adjustment for movements in exchange rates) of the deposit money banks of OECD countries was 22 per cent in 1960-1970, 23 per cent in 1970-1980, and 15 per cent in 1980-1985. The number of foreign branches of the Federal Reserve member banks of the United States rose from 131 in 1960 to 532 in 1970 and 916 in 1985, while the corresponding figures for the branches and subsidiaries of Japanese banks were 37, 67 and 346, respectively. Several types of financial transaction (which are frequently vehicles for international transactions in banking services) have also recently shown very rapid rates of expansion. For example, the transactions in foreign securities of the residents of four major OECD countries increased at an average annual rate of 67 per cent in 1980-1986, and for the transactions of non-residents in the domestic securities of the same countries during this period the average annual rate of growth was 53 per cent. Similarly high rates of expansion have also characterized during extended recent periods transactions in categories of futures and options that are relevant in the context of international trade in banking services.

C. Benefits and costs of a more liberal regime for international trade in banking services

The benefits claimed for a more liberal regime for international trade in banking services spring mainly from two sources: increased competition and the transfer of skills. Both types of international trade in banking services described above, namely that between residents and non-residents and that supplied through units established in foreign markets for the purpose, can bring increased competition. The transfer of skills, on the other hand, will be associated primarily with the latter type of trade.

The extent of the benefits actually achieved by means of the transfer of skills will depend to a great extent on policies in host countries. Such policies need to be taken into account in the elaboration of the concepts and principles agreed upon at the Montreal/Geneva Mid-term Review as relevant to a framework for international trade in services. Among these concepts and principles (which are taken up in section H below), those of "market access" and "increasing participation of developing countries" seem particularly appropriate for elaboration that recognizes the importance of this objective.

Competition in banking services may involve any of the spectrum of methods for managing financial institutions' assets and liabilities, and may affect any or all of the prices, costs and qualities of such services in different sub-markets. Not all of its manifestations would be generally considered to be socially beneficial, and many of them leave losers as well as gainers. Its favourable effects may include lower rates of interest to borrowers and higher rates to depositors or lenders as a result of increased pressure on profit margins or reductions in costs (or both). Other benefits are the introduction of new services or the improvement of existing ones leading to better satisfaction of the needs of banks' clientele.

The frequently complex ways in which the benefits and costs of change in banking may be interrelated can be illustrated in the case of the emergence of so-called "assets and liabilities management". This term refers to the increasingly structured approach of banks towards managing assets, liabilities and off-balance-sheet business. Banks, of course, have always had to manage their assets and liabilities, but until recently in most OECD countries their decisions reflected longer-term consider-

ations associated with the relatively stable environment in which they operated. The shift to a more active management stance resulted from various trends such as greater dependence (beginning as early as the 1950s in the United States) on wholesale funds lent by non-financial enterprises with a greater sensitivity to interest rates than traditional retail depositors, higher and more unstable interest and exchange rates since the early 1970s, and widespread financial deregulation and the growth of international banking from the 1960s onwards, one consequence of which was reduced compartmentalization of financial markets and increased competition among the different types of institution serving them. Increased risks due to greater fluctuations in interest and exchange rates also stimulated the introduction of new techniques and instruments (such as financial futures) to reduce or offset them.

For depositors and lenders there have been benefits from assets and liabilities management in the form of the higher rates of interest resulting from competition for their money, and of a greater range of financial instruments for the placement of savings and liquidity (for some of which active secondary markets have developed). However, for borrowers the outcome has been less clear-cut. These have benefited from the greater availability of funds and innovation in lending instruments which have accompanied increased competition and financial deregulation. But many borrowers have at the same time had to pay higher rates of interest. Moreover, the new techniques and instruments for risk management have in some cases had double-edged effects, and have probably themselves acted as sources of volatility in financial markets.

Thus, for example, lending at variable interest rates by banks facilitated liabilities management by making it possible to reduce or eliminate risks due to differences between borrowing and lending rates of interest. But this result was achieved by shifting the burden of possible rises in interest rates onto borrowers, thus increasing credit risks. Moreover, while new financial instruments such as futures are capable of providing protection against fluctuations in financial variables, protection by this means can be costly and its coverage is not complete. It is also widely believed that the connection between such protection and the tradeability of many of the financial instruments in question has led to a situation where the instruments themselves contribute to fluctuations in interest rates and the prices of financial assets. Indeed, in a recent book one banker referred to "the vested interest in instability" of the bulk of participants in financial markets.[130] The consequences of the greater unpredictability of financial variables for economic agents in the rest of the economy are not easy to identify precisely but are potentially quite substantial.

Levels of competition vary considerably among the sub-markets for different banking services. At one much-cited extreme is the local market for retail banking services in a village or small town. In such cases competitive pressures are typically low, although the banks in question may not abuse their monopoly positions. These pressures tend to increase in large cities, even in retail banking. They are also greater in the sub-markets for services such as credit cards or those to corporations. In certain areas co-operation among banks is encouraged by the authorities as being more appropriate than competition. Such encouragement, for example, has been evident towards efforts by banks to take advantage of the potential of new technology for the development of more efficient inter-bank payments circuits.

The position in particular sub-markets is in general significantly affected by the level of development of a country. As already mentioned in section B.1, certain banking services do not exist or are available only on a small scale in low-income countries. Moreover, even in the case of retail banking services, both the level of competition and the quality and character of services provided vary substantially between low-income and high-income countries. Indeed, in many low-income countries large parts of the population make no use of banks, depending instead for such financial services as they require on money lenders and other arrangements more or less formal. In situations of this kind it is frequently government policy to increase the number of people making use of banking services with such aims as expanding the degree of monetization of the economy, making possible a more efficient use of savings, and bringing down the cost of credit for those with no alternative to dependence on money lenders. Such a policy may be pursued through mixtures of controls and incentives, and an agreement on a framework for interna-

130 Fuller quotation of the passage in question may be of some interest. "A more controversial feature of the new shape of the financial system is that the bulk of its participants now have a vested interest in instability. This is because the advent of high-technology dealing rooms has raised the level of fixed costs. High fixed costs imply a high turnover for profitability to be achieved. High turnover tends to occur only when markets are volatile." (J. Walmsley, *The New Financial Instruments. An Investor's Guide* (New York, etc.: John Wiley and Sons, 1988), p. 13.)

tional trade in banking services should provide for flexibility in this regard.[131]

Foreign banks have in certain instances contributed to the expansion of banking networks in developing countries and to injecting increased competition into the sub-markets for particular banking services. Yet there remain widespread reservations among developing countries as to the desirability of a broad opening-up of their economies to foreign banks. These reservations go beyond concerns about the potential losses from increased competition discussed above, and involve such matters as the use of the banking system for the promotion of a country's development objectives, the possibility that the operations of foreign banks may complicate monetary policy, and more generally the competitive strength and governability of foreign banks.

The first two of these subjects are given separate treatment in sections E and F below. The third includes a number of issues on which reservations and apprehensions in developing countries are less well defined. Nevertheless, these concerns influence restrictions on the entry and operations of foreign banks and figure in parts of the discussion in section H of the concepts, principles and rules relevant to an agreed framework for international trade in banking services. Particularly important in this context is the infant industry dimension of developing countries' policies towards foreign banks. Underlying infant industry considerations in this sector is the conviction, which developing countries share with OECD countries, that the banks of the latter have a competitive edge. While in OECD countries this competitive edge is seen as a reason to press for a liberalized regime for international trade in banking services, in developing countries it is seen as a reason for protecting indigenous banking sectors whose expansion is considered to be an integral element of successful development. Finding a balance between these points of view is thus central to the effort to achieve agreement on a framework for international trade in banking services.

The concerns deriving from the size, "transnationality" and competitive strength of foreign banks have in some cases a fairly specific character. For example, there are concerns as to these banks' governability. Issues under this heading with a bearing on the conduct of monetary policy are taken up in section F. Governability also involves the capacity of transnational banks to use their international networks to evade taxes, to facilitate capital flight, or to conceal aspects of their operations from developing countries' regulatory authorities. Thus, governability, for example, is related to the concept, "transparency", discussed in section H, which covers the exchange of information under an agreed framework for international trade in banking services.

Another apprehension sometimes expressed concerning foreign banks is that their superior strength makes it possible for them to squeeze or stifle indigenous competitors through price discrimination between markets in different countries. Such discrimination would be for international trade in banking services the counterpart of dumping in the case of trade in goods. The possibility of such practices undoubtedly exists. A prerequisite of successful price discrimination is the existence of impediments to arbitrage between the lower-price and higher-price markets. In the case of services the impossibility of storing them is generally cited as preventing arbitrage. As regards many services, including those of a bank in different countries, there are also many other obstacles both to acquiring the knowledge about price differentials necessary for arbitrage operations and to carrying them out. Systematic evidence concerning price discrimination by banks is unsurprisingly difficult to obtain. Predatory price discrimination clearly exists only when losses associated with low prices in some markets for the purpose of damaging competitors are subsidized from profits made elsewhere. In other instances both the identification of price discrimination and the demonstration of its connection to unfair competition are much more complex. In all cases of discrimination the relevant information concerning prices and costs is not generally available, and even if it were, its interpretation would be controversial. It can perhaps at most be conjectured that the use by foreign banks of price discrimination as a competitive weapon is unlikely to have been extensive in their retail banking operations in developing countries. But it should not be discounted that such discrimination may sometimes be used in the provision of banking services to businesses, whether domestic or transnational enterprises.

[131] For example, it is an objective of government policy in India to extend banking facilities throughout the country's villages, estimated to number about 575,000. One of the instruments for achieving this objective is an entitlement formula under which the right to open offices in urban areas already having several banks is linked to the number of offices opened in rural or semi-urban areas with few or none.

D. Some relevant historical experience

There can be little doubt that, in developing countries as elsewhere, attitudes towards foreign banks and beliefs in the desirability of promoting domestic ones have been formed partly in response to historical experience. The many different relevant aspects of such experience are much too extensive to be discussed here. Nevertheless, a little history of international and interregional banking may serve to bring out more clearly reasons why it has been an objective of policy in so many countries to limit or reduce relations of dependency in banking, and why the belief is so widespread that an indigenous banking sector is an indispensable part of economic development. Historical experience is always in many respects unique. However, situations today do often have analogies with those of the past. Moreover, historical experience is an abundant source of perceptions, political folklore and other determinants of attitudes towards foreign banks and international banking transactions.

1. Financial dependence on New York in the ante-bellum South. London as global financial pivot before 1914

The plantation economy of the southern states of the United States before the Civil War furnishes an interesting example of dependence for the services needed for its trade and payments on external suppliers, in this case middlemen and bankers in New York City and elsewhere in the North-East of the country. Via a system of intermediaries in which a key role was played by agents known as factors, cotton planters depended on bankers from New York and the North-East for long-term loans for the purchase of land and slaves, for the short-term borrowing necessary for buying supplies, and for the realization of their receipts from the sale of their crops.

The short-term credit was usually provided through arrangements highly favourable to the factors. For example, in return for making such credit available, the factor was given the exclusive right to sell the borrowing planter's crop. Under another frequently used arrangement the factor was guaranteed a minimum number of bales, and his commission as selling agent was paid on this number even when there was a shortfall in production. The interest rates under these financing and payments arrangements tended to be fairly high. Moreover, the receipts accruing to planters were subject to further risk in that payment typically consisted of a draft or bill payable in two to four months in New York. Such a bill or draft could be discounted at a rate depending on conditions in financial markets over which planters had no control. Planters were generally under pressure to receive payment quickly. In the event of one of the periodic financial crises experienced in New York, the bills and drafts could be discounted only at rates involving heavy losses. Resentment at this financial dependence and the desire to substitute direct trading and financial relations with export markets in Europe became one of the reasons for growing pressures in the South for secession from the Union.

The dependence of whole regions on highly localized financial and entrepôt centres for the services required for international trade has been common throughout history. Perhaps the outstanding instance during the last two centuries is provided by London, where suppliers of all the main types of service required for international trade have long been clustered together . During its halcyon period before the world war of 1914-1918, London's dominance of world banking was such that "if a man in Peru wished to send money to a man in Afghanistan, the final payment, as like as not, would be made by a bookkeeping transaction in London".[132] Dependence on financial centres has not always been a source of resentment such as that which characterized relations between the ante-bellum South and banks in the North-East United States, since the centres' pre-eminence was often acknowledged as being associated with efficient provision of banking and other trade-related services. Nevertheless, there has been inevitable growth of the perception that international banking can be highly profitable, and that the activities of which it

[132] C. Quigley, *Tragedy and Hope. A History of the World in Our Time* (New York: The Macmillan Company; London: Collier-Macmillan, 1966), p. 68.

consists demand skills which can be acquired by anyone (although development of a financial centre also depends either on location conducive to economies of scope or, as in the case of present-day offshore centres,[133] on the willingness of the government to extend tax and regulatory advantages). This perception unsurprisingly often acts as a stimulus to efforts to promote indigenous enterprises capable of international banking in countries lacking them.

2. *Foreign banks in Africa before 1950*

Various aspects of the performance of foreign enterprises supplying financial services in Africa between the 1880s and the 1950s illustrate reasons for the convictions in developing countries concerning the need for an indigenously controlled banking sector. This performance was marked not only by omissions as regards the financing of indigenous development but also by involvement in non-commercial political or administrative functions. The latter historical role of such enterprises has undoubtedly left lasting traces in political attitudes.

The activities of foreign banks and the spread of their networks in Africa during this period were in general closely linked to the interests of enterprises from their home countries. Some of the larger of these enterprises were highly diversified, and were themselves suppliers of several banking services (in some cases being responsible for the establishment of banks). Financing from these sources went mainly to expatriates, a large part of the borrowing being used for such purposes as foreign trade and mortgages. The capital needs of indigenous farmers, traders and peasants were mostly met in other ways, for example, from money lenders and associations for mutual help. The failure of foreign banks to be more active in the promotion of indigenous development was due not only to their links to expatriates but also to the lack of borrowers with suitable collateral and of lending opportunities which would have been considered suitable according to these banks' usual guidelines. Indeed, such promotion would have been possible in most cases only if the banks had assumed a much more entrepreneurial role than that to which they were accustomed in their home countries.[134]

The large, diversified enterprises were in some cases more entrepreneurial. But the banking and trade-related services provided by them generally either met the needs of their own constituent businesses or those of other expatriate firms. Moreover, among these enterprises were those whose activities often went beyond the commercial sphere and extended to involvement in political and administrative matters.[135] Their role in such cases might include the use of police powers and the collection of customs duties and other taxes, not to mention the exercise of great influence over the character and direction of government in the countries in which they operated.

E. Credit allocation and development policy

As noted in the introduction to this chapter, finance offers powerful means of control.[136] Credit can thus be an important instrument for influencing the pace and character of economic development. Consciousness of the potential role of banks as tools for promoting

[133] Such offshore centres may not be particularly relevant to a discussion of the rationale of policies promoting indigenous participation in international banking, since the banks using them frequently have at most limited links with the economies where the centres are located.

[134] British banks, for example, typically preferred the provision of short-term credit. While this should not have excluded meeting demands for such lending from indigenous as well as expatriate economic agents, it did serve as an impediment to longer-term lending for development.

[135] For example, the 1889 charter of the British South Africa Company gave it authority, *inter alia*, to "make treaties, promulgate laws, preserve the peace, maintain a police force and acquire new concessions".

[136] As a recent study of the relation between financial systems and economic policy in a number of OECD countries put it, "Very simply, in market economies ... money is not only a medium of exchange but also a means of political and social control: it is one way of deciding who gets what." (J. Zysman, *Government, Markets and Growth. Financial Systems and the Politics of Industrial Change* (Oxford: Martin Robertson, 1983), p. 8.)

industrialization first became widespread in the second half of the nineteenth century. The involvement of the Crédit Mobilier (established by the Pereire brothers in France) in the provision of long-term financing to industry is often cited as the most notable pioneering example in this regard. But more systematic links, with more pervasive effects, were those between large banks and industry in Germany. The strength of these links was based on the broad range of financial services that such banks furnished to industrial enterprises, services which included short-term and long-term lending, the underwriting and marketing or placement of securities, and the making of equity investments on their own account. A major manifestation of these links was the appointment of bank officials as directors of industrial enterprises. It was thus frequently true that "a German bank, as the saying went, accompanied an industrial enterprise from the cradle to the grave, from establishment to liquidation throughout all the vicissitudes of its existence".[137] Among the results generally attributed to German banks' close involvement in industry during the period between the 1850s and 1914 were great influence over the evolving structure of the country's industry, in particular as a result of their role in promoting mergers, amalgamations and cartelization, and a significant contribution to its technical innovativeness.[138]

Recognition in countries now developed of the potential usefulness of controlling credit allocation as part of economic policy has not been limited to cases where banks had a central role in the mobilization of the resources required for laying the foundations of national industry. For example, during much of the period since 1945 Governments of OECD countries have intervened in the process of credit allocation through measures designed to influence the price and pace of lending for different purposes.[139] This intervention has taken place both as part of overall industrial policies and in pursuit of narrower or sectoral goals such as export promotion and aid to agriculture.

Intervention of an analogous kind is a well-established feature of economic policy in most developing countries. Such intervention can be classified under five main categories: lending requirements imposed on banks, schemes for refinancing loans, lending at preferential interest rates, credit guarantees or insurance, and lending through specialized financial institutions designed to provide types of lending believed to be otherwise unavailable or insufficient. In many instances the intervention has a long history. In several countries in Africa, for example, the original introduction of such policies, especially the establishment and promotion of financial institutions for particular purposes, was a response to foreign banks' concentration on expatriates and the difficulties faced by indigenous economic agents in obtaining loans. Policies of this kind were already under way in a few cases early in this century. One example was the establishment in Egypt in 1902 of an Agricultural Bank designed to provide cheap credit to poorer peasants. However, the main beneficiaries of most of these early efforts in other African countries were colonial settlers engaged in farming.

The record of government intervention in credit allocation in developing countries, as in developed ones, has been mixed, including many successes as well as failures. The banks in developing countries through which such intervention was carried out did not escape the spread of financial distress during the 1980s, which has affected financial institutions in most major regions of the world economy. This distress is often connected to the policies that financial institutions were used to promote, and in many instances reflects mismanagement and inadequate regulation. But it should also be noted that policies to influence credit allocation become more difficult to implement successfully in an environment of macroeconomic instability (such as that which followed the debt crisis in several developing countries), and one in which particular sectors (such as agriculture)

137 A. Gershenkron, "Economic backwardness in historical perspective", in B. Hoselitz, ed., *The Progress of Underdeveloped Countries* (Chicago: Chicago University Press, 1952) and reprinted in A. Gershenkron, *Economic Backwardness in Historical Perspective. A Book of Essays* (Cambridge, Massachusetts: the Belknap Press of Harvard University Press, 1962), p.14.

138 Alfred Marshall quotes a pamphlet of this period by William Olsson, a Swede who had undertaken a comparison of the methods of finance in Germany, Britain and other countries as follows: "[in Germany] the pioneer would take his proposal to one of the great banks with an Industrial department; and the proposal would immediately be put before experts, scientific and technical, well known to the bank and thoroughly trusted who (on the assumption that the proposed business was really good) would report well on it, *and would be believed*". Marshall clearly thought that the scale of the effort made by German banks in the scientific and technical sphere was exceptional. (A. Marshall, *Industry and Trade*, 4th edition (London: Macmillan, 1923), pp. 347-348.)

139 The reference here is not to policies designed to influence or control broad lending aggregates as part of macroeconomic policy. It should, however, be noted that in practice the macroeconomic and the other dimensions of credit policy cannot be kept separate, since measures to regulate the quantity of credit are often accompanied by attempts to influence the direction of banks' lending.

are subjected to strains to a significant extent beyond their control.

In a recent study[140] national financial systems in developed countries are classified under three major types: firstly, capital market-based systems, in which there is heavy reliance for long-term financing on borrowing in the form of securities, and relations between Governments and borrowers tend to have an arm's-length character; secondly, credit-based systems, in which a much larger role in the provision of long-term financing is played by banks and specialized lending institutions, while the Government exerts a measure of control over key prices and the allocation of financial resources; and, thirdly, credit-based systems, also characterized by a major role for financial institutions in long-term financing but in which government intervention to affect prices and the allocation of lending is more limited. Most financial systems in developing as well as developed countries can be broadly characterized as belonging to one of these three types (though borrower-lender relations in particular sectors may often more closely approximate those in one of the other two). In the context of a possible agreement on a framework for international trade in banking services the most important points indicated by the discussion of this section are that the evidence does not suggest the superiority of any of these three types of financial system over the others, and that reliance on one rather than the others in a particular country should be understood in the light of its historical and current circumstances.[141] Thus, incorporation in such an agreement of explicit or implicit assumptions as to the superiority of a particular type of financial system (which would inevitably be a source of pressure to adopt this system on the countries covered by the agreement) is not justified.

F. Foreign banks and the conduct of monetary policy

There is concern in developing countries that liberalization of international trade in banking services is capable of reducing the effectiveness of monetary policy. This concern applies both to the regimes for banking transactions between residents and non-residents and to those for foreign banks with a long-term presence in a country.

As noted in section B.3, the question of liberalizing banking transactions between residents and non-residents cannot be abstracted from that of foreign exchange control. Exchange control with respect to financial transactions may serve major objectives of a country's monetary policy such as those regarding inflows and outflows of capital and the level of the exchange rate. Thus, the strategic nature of such control may have an important influence on the nature of commitments that developing countries are prepared to make as to the liberalization of trade in banking services between residents and non-residents.[142] In the case of foreign banks with a long-term presence

140 Zysman, *op. cit.*, pp. 18 and 70-72. The word, "borrowers", has been substituted in the main text for the author's "industry". Zysman's book is concerned with relations between financing and industrial policies, and the substitution is intended to bring out that his categories of financial system have a broader applicability.

141 This statement should not be taken as suggesting that the functioning of particular financial systems of any of the three types could not usually be improved.

142 Controls over international capital transactions are permitted under article VI of the IMF Articles of Agreement, of which section 3 provides that "Members may exercise such controls as are necessary to regulate international capital movements" subject to certain provisos, such as that measures for this purpose should not conflict with a member country's commitments under article VIII as to the convertibility of its currency for current transactions.

Capital transactions are those not included in the following definition of current transactions given in article XXX(d):

> "Payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation:
>
> (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
> (2) payments due as interest on loans and as net income from other investments;
> (3) payments of moderate amount for amortization of loans or for depreciation of direct investment; and
> (4) moderate remittances for family living expenses."

Consequently, a large number of cross-border financial transactions such as certain forms of borrowing and lending and the sale and puchase of several types of financial instrument would be classified as "capital" and not "current" according to this definition.

in a country, concern as to the possible consequences of their operations for the effectiveness of monetary policy stems from the belief that such banks typically have better access than domestic ones to external sources of funds, and that, thanks to their links to other banks abroad owned by the same parent, they also have greater latitude as regards their lending. Thus, it is feared that foreign banks may borrow from external sources in order to evade the impact of policies designed to restrain monetary expansion, and that they may use their connections with banks abroad to shield borrowers from other effects of restrictive monetary policies. A further concern about foreign banks in the context of monetary policy is that they may be less susceptible to "moral suasion" than domestic ones.

Some of the instruments of monetary policy take the form of open-market operations designed to increase or decrease banks' reserves, and by this means to influence their liquidity and the level of interest rates. Other instruments affect reserves, lending and interest rates more directly. These include the imposition on banks of minimum ratios of cash to deposits, the setting of ratios of liquid to total assets, the immobilization of part of banks' lendable resources, limits on the amount banks may borrow from the central bank, ceilings on the pace of banks' lending, measures designed to restrain the growth of banks' interest-bearing deposits (such as the siphoning-off of increases above prescribed levels into special deposits with the central bank that pay no interest), and direct control of interest rates. Ceilings on the pace of banks' lending may be accompanied by attempts to influence its direction. The authorities' recourse to persuasion (the "moral suasion" to which reference was made above) takes place principally with regard to the pace and qualitative character of lending but also in some cases involves other matters such as levels of interest rates.

The degree of reliance on the different instruments of monetary policy varies greatly among countries. The relative importance of open-market operations has tended to increase in most OECD countries during recent years. However, heavy reliance on these so-called "classical" techniques of monetary policy is possible only in countries where there exist well developed money markets (i.e. markets for liquid, mostly short-term, financial assets). This precondition is rarely met in developing countries, which in consequence have to place greater reliance on the more direct methods of controlling credit and interest rates. The increased prominence of the "classical" techniques of monetary policy in developed market-economy countries has tended to be accompanied by reduced recourse to "moral suasion", which has, however, not disappeared in such countries. As might be expected, "moral suasion" plays an important part in the conduct of monetary policy in several developing countries.

The possibility for banks of borrowing abroad in such a way as to frustrate the impact of monetary policy depends partly on the incidence of a country's banking regulations. For example, use of such borrowing to evade policies to reduce the growth of credit in the economy can be rendered impossible by appropriately designed regulations. Nevertheless, certain practices remain difficult to control under any regulatory system leaving economic agents some degree of latitude as regards the nature of particular banking transactions. Moreover, it should be emphasized that recourse to these practices need not be limited to foreign banks, since they are also available to local ones with foreign branches or subsidiaries.

These points can be illustrated for the technique of back-to-back loans, in a case involving a local borrower (denoted here as firm L) and an enterprise under the same ownership abroad (firm F), on the one hand, and a local bank (bank L) and one under the same ownership abroad (bank F), on the other. Firm F makes a deposit in a foreign currency at bank F, while bank L lends a corresponding amount in local currency to firm L. When monetary policy is being tightened, the loan by bank L may carry a rate of interest below market levels, firm F frequently in such cases also receiving a low rate of interest on its deposit. The bank L in this scenario is not necessarily foreign-owned. On occasion locally-owned banks in developing countries with foreign branches or subsidiaries also have had recourse to such operations.

Similarly, domestic as well as foreign banks may resist "moral suasion". Nevertheless, there is a presumption that domestic banks are generally more biddable than foreign ones, owing to the greater importance to them of considerations such as the authorities' regulatory favour and facilities provided by the central bank. This biddability may be strengthened in the case of domestic banks if their major shareholders include the Government.

In the context of a possible agreed framework for international trade in banking services the relation of the presence of foreign banks to the conduct of monetary policy thus raises matters bearing on the issue of market access for such banks. Some countries may be reluctant to grant foreign banks right of entry

to those parts of the banking system, control over which is regarded as indispensable to the conduct of monetary policy. Governments in other countries may have apprehensions concerning the presence of foreign banks for the same reason, while none the less being unwilling to impose an outright ban on their entry to the sub-markets in question because of the prejudice which this would cause to other policy objectives. Any guidelines adopted as part of an agreed framework would need to acknowledge the great sensitivity of most Governments concerning the question of maintaining autonomy in the conduct of monetary policy. One approach which might merit consideration would entail acceptance that the granting to foreign banks of access to certain sub-markets would be provisional in the sense that it could be withdrawn if the banks in question engaged in operations that conflicted with national monetary policy. However, it should be noted that whereas such an approach would provide Governments with flexibility in this area, its embodiment in actual guidelines may not be a simple matter. For example, such guidelines would need to provide for some form of redress where there were good grounds for believing that the ostensible withdrawal of a bank's licence owing to operations prejudicial to the conduct of monetary policy was in reality due to other causes not acceptable for this purpose under an agreed framework for trade in banking services.

G. Some evidence concerning restrictions on foreign banks' market access and operations in developing countries

Recurrent surveys of the treatment of foreign banks in developing countries are not available. It seems reasonable to assume that a mechanism for producing such surveys would be a required feature of an agreed framework for international trade in banking services owing to the importance for its application of up-to-date information. At present the most recent comprehensive study of restrictions on entry and operations faced by foreign banks remains that undertaken for the United States Department of the Treasury in 1979.[143] This study was followed by two updating exercises in 1984 and 1986, but the numbers of developing countries included were small - eight in 1984 and ten in 1986.[144]

Although the results of the 1979 study can no longer be taken as an accurate representation of the position in particular countries, its overall picture of the situation continues to be of interest for its illustration of the wide variety of restrictions and regulations used in this context, and its evidence concerning the relation between policies towards foreign banks, on the one hand, and such characteristics of countries as their levels of economic and financial development, on the other. The study contains a classification of countries by degree of the restrictiveness of their policies towards the entry of foreign banks, which is shown in table 35. The degree of restrictiveness decreases in the table from (B) to (E), and each country is included only in the most restrictive category applying to it. Categories (B) and (C) are self-explanatory. The restriction of foreign banks to representative offices (category (D)) precludes the taking of deposits and the making of loans, such offices serving merely as vehicles for soliciting and developing business relationships on the spot. Branches, the subject of the prohibition specified in (E), are integral parts of the parent bank and can borrow and lend. Banks may also expand abroad through subsidiaries and affiliates. The first of these forms is a legally separate entity in which the original bank holds a controlling interest, while the second denotes an enterprise of which the bank owns less than a majority of the equity. Some of the countries in the table which prohibited branching none the less permitted the acquisi-

143 Department of the Treasury, *Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations* (Washington, D.C., September 1979) (henceforth cited as *National Treatment Study*).

144 Department of the Treasury, *Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations 1984 Update* (Washington, D.C., July 1984) (henceforth cited as *1984 Update*) and idem, *National Treatment Study 1986 Update* (Washington, D.C., December 1986) (henceforth cited as *1986 Update*).

Table 35

RESTRICTIONS ON ENTRY OF FOREIGN BANKS [a] IN DEVELOPED MARKET-ECONOMY AND DEVELOPING COUNTRIES, MID-1979

	Number of countries
(A) No restrictions	
Developed market-economy countries	9
Developing countries	27
(of which by region)	
Africa	15
Latin America	9
West Asia	1
South and South-East Asia	1
(of which by income group - GDP per capita in 1980)	
Over $1500	8
$500-1500	9
Under $500	10
(B) Prohibition of presence of foreign banks in any form by law [a]	
Developed market-economy countries	-
Developing countries	10
(of which by region)	
Africa	5
Latin America	1
West Asia	1
South and South-East Asia	3
(of which by income group - GDP per capita in 1980)	
Over $1500	3
$500-1500	-
Under $500	7
(C) Prohibition of entry of foreign banks in any form by current policies or licensing practices [a]	
Developed market-economy countries	-
Developing countries	7
(of which by region)	
Africa	2
Latin America	3
West Asia	2
South and South-East Asia	-
(of which by income group - GDP per capita in 1980)	
Over $1500	4
$500-1500	1
Under $500	2
(D) Prohibition [b] of entry of foreign banks except in form of representative offices [a]	
Developed market-economy countries	4
Developing countries	14
(of which by region)	
Africa	1
Latin America	6
West Asia	3
South and South-East Asia	3
(of which by income group - GDP per capita in 1980)	
Over $1500	6
$500-1500	5
Under $500	3

For source and notes see end of table.

Table 35 (concluded)

RESTRICTIONS ON ENTRY OF FOREIGN BANKS [a] IN DEVELOPED MARKET-ECONOMY AND DEVELOPING COUNTRIES, MID-1979

		Number of countries
(E)	**Prohibition [b] of entry of foreign banks in form of branches**	
	Developed market-economy countries	4
	Developing countries	30
	(of which by region)	
	Africa	10
	Latin America	9
	West Asia	4
	South and South-East Asia	5
	(of which by income group - GDP per capita in 1980)	
	Over $1500	12
	$500-1500	13
	Under $500	5
(F)	**Prohibition [b] of any purchase by foreign banks of interest in indigenous banks**	
	Developed market-economy countries	-
	Developing countries	5
	(of which by region)	
	Africa	-
	Latin America	2
	West Asia	-
	South and South-East Asia	2
	(of which by income group - GDP per capita in 1980)	
	Over $1500	2
	$500-1500	1
	Under $500	2
(G)	**Limitation [b] on purchases by foreign banks to less than controlling interest in indigenous banks**	
	Developed market-economy countries	10
	Developing countries	23
	(of which by region)	
	Africa	8
	Latin America	4
	West Asia	6
	South and South-East Asia	4
	(of which by income group - GDP per capita in 1980)	
	Over $1500	12
	$500-1500	7
	Under $500	4

Source: Estimates based on Department of the Treasury, *Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations* (Washington, D.C., September 1979), tables 5.2-5.8. The survey covered by this report includes 109 developing countries.

a Countries appear under the most restrictive of the headings (B)-(E) to which they belong. Thus a country classified under (B) does not appear under (C)-(G); a country classified under (C) does not appear under (D)-(G); a country classified under (D) does not appear under (E)-(G). However, some countries classified under (E) appear also under (F) or (G).

b By law, policy or administrative practice.

tion of minority interests in indigenous banks and are thus included in (G) as well as (E).[145]

One point evident from the table is the relatively large number of developing countries found to be imposing no restrictions on the entry of foreign banks, and the prominence within this group of relatively low-income countries (GDP per capita in 1980 either below $500 or between $500 and $1,500). Another point about the figures in the table which should be noted is that their implications for a bank differ according to its preferred strategy of expanding its presence abroad. For example, United States banks tend to prefer the branch form for such expansion, especially during its early stages. Thus, for United States banks the relatively large number of developing countries prohibiting entry through branching has particular significance. More generally, the table suggests the lack of any clear-cut relation between the restrictiveness of countries' policies towards the entry of foreign banks and levels of economic and financial development.

The 1979 study of the United States Treasury also surveyed various restrictions and other discriminatory measures affecting foreign banks' operations. Many of these restrictions are designed to protect domestic banks, but some are also imposed primarily for prudential reasons. Among those cited in the study were restrictions on foreign banks' access to deposits and limits on their branching networks (both of which were found to be particularly prevalent), the non-availability of discount facilities at the central bank, limits on diversification that excluded foreign banks from major submarkets, differential regulations as to capitalization, requirements concerning the nationality of staff, and differentially higher rates of taxation.[146] The form that restrictions took might differ among countries. For example, limits on access to deposits might involve prohibitions on accepting particular types of retail deposit or restrictions on access to the deposits of public sector institutions. The various kinds of differential regulation as to capitalization frequently were due at least in part to prudential considerations. One such regulation reflected the decision to treat branches of foreign banks as entities independent of their parents, and thus to limit their lending to a multiple of the branches' own capital rather than the combined capital of the branches and their parents.

Not all the differential treatment described in the 1979 study and the 1984 and 1986 updating exercises was unfavourable towards foreign banks. Thus, for example, in India foreign banks, unlike nationalized domestic ones, are not required to open branches in rural areas or to lend to small, frequently high-risk borrowers at concessionary rates of interest. In the Republic of Korea foreign banks have benefited from exemption from requirements to support government bond issues and to devote substantial proportions of their lending to specific sectors, while also enjoying certain tax privileges. Legal lending limits for foreign banks in Taiwan Province of China were found in the 1984 study to be less restrictive than those for domestic ones. Perhaps mention under the heading of differentially favourable treatment for foreign banks should also be made of the exemption of Citibank from the nationalization of banks in Mexico in 1982.

The updating exercise carried out by the United States Treasury in 1984 comprised only eight developing economies (Brazil, India, Republic of Korea, Mexico, Philippines, Thailand, Venezuela and Taiwan Province of China), and that of 1986 covered the same group plus Argentina and Singapore. The two studies focused principally on restrictions on foreign banks' operations, although developments involving entry were also mentioned in cases where they had taken place. The changes between 1979 and 1984 cited were mostly modest. On balance, some relaxations in levels of restrictiveness were found in three economies (India, Republic of Korea and Taiwan Province of China), and some increase in two others (Philippines and Thailand), while no significant change was identified in a further three (Brazil, Mexico and Venezuela). Little change appeared to have taken place between 1984 and 1986, except in the Republic of Korea and Taiwan Province of China (although the continuing entry of additional foreign banks was noted in the case of India). In the Republic of Korea and Taiwan Province of China foreign banks were found to have benefited from sig-

[145] The maximum permitted size of foreign banks' interest in indigenous banks varied from 10 per cent to 50 per cent among the countries in the survey prohibiting acquisition of a controlling interest. Some countries which did not permit branching by foreign banks also prohibited their purchase of any interest in domestic banks. Such countries are included under (F) as well as (E).

[146] The distinction between restrictions on entry and those on operations in *National Treatment Study* does not coincide precisely with analogous concepts in section H. Thus, "market access" in section H refers to admittance to particular banking sub-markets, while "entry" in *National Treatment Study* denotes admittance to any part of a country's banking system. In consequence certain measures classified as restrictions on foreign banks' operations in *National Treatment Study* (such as those limiting diversification of their activities by banks that have obtained "entry") belong under the heading, "market access", of section H.

nificant relaxations of operating restrictions closely associated with the more general programmes undertaken to liberalize their national banking systems.

H. The application to trade in banking services of key concepts and principles

1. *Introduction*

As mentioned earlier, certain concepts and principles bearing on central features of a possible agreed framework for international trade in banking services were singled out for special attention at the Mid-term Review of the Uruguay Round. No attempt will be made here either to comprehend all the subjects that may need to be covered by an eventual agreement or to provide a blueprint for the integration of the concepts and principles into such an agreement. Rather, the discussion which follows takes up aspects of the concepts and principles and of their interrelations suggested by the discussion of trade in banking services in previous sections.

It is convenient to begin with the three concepts that are at the heart of the issues at which an agreed framework would presumably be directed, namely "market access", "national treatment", and "progressive liberalization". Various matters discussed under these three headings also have a bearing on "most-favoured-nation/non-discrimination" and "increasing participation of developing countries", the concepts which are thus taken up next. "Transparency" and "regulatory situation", which have a number of interrelations, follow, and the final concept discussed is "safeguards and exceptions".

2. *Market access*

It is important to make a clear distinction between "market access", which covers the right of entry to particular banking sub-markets, and "national treatment", which concerns the treatment received from the authorities by a supplier of banking services after the granting of such access. Control over market access is the policy instrument perhaps most crucial to enabling Governments in developing countries to choose the banking regimes which they believe to be most appropriate to their particular circumstances and needs.[147] As emphasized in section B.1, banking consists of several sub-markets, and the access granted to foreign banks generally applies only to certain of them. Thus, control over such access makes it possible for governments to pursue policy objectives towards the different constituent parts of a country's banking system.

These policy objectives may concern various subjects discussed elsewhere in this chapter. Particularly important here are the objectives which may be pursued through infant industry policies for financial sectors and other policies that can be expected to play a role in eventually increasing the participation of developing countries in international trade in banking services. Thus, for example, control over market access can serve as an instrument for the achievement of the transfer of banking skills (as noted below in section H.6.). Furthermore, such control can be used to influence the level and character of competition in banking. By this means it should be possible to avoid certain adverse effects of such competition (mentioned above in section C), while employing the entry of foreign banks as a stimulus to increasing efficiency among indigenous ones. In particular, control over market access enables Governments to restrict activities likely to be associated with financial instability, and to protect indigenous banks from premature exposure to unfair pricing practices (a matter discussed further in section H.7). Moreover, as already noted in section F, control over market access may enable Governments to rec-

[147] The remarks in the main text concentrate on the strategic policy rationale of control over market access. An agreed framework for international trade in banking services may also need to cover various matters related to modalities such as the procedures to be followed when there is a change in the nationality of the parent institution of a bank branch or subsidiary which has been granted market access.

oncile the objectives of liberalizing regimes for foreign banks, on the one hand, and of maintaining desired levels of autonomy in the conduct of monetary policy, on the other.

3. National treatment

The principle of national treatment is designed to ensure that foreign suppliers are not subject to discriminatory treatment under a country's internal taxes, laws and regulations. In the case of international trade involving services provided by non-resident banks national treatment would appear to have implications similar to those for trade in goods. But in the case of services supplied by a foreign enterprise with a long-term presence in the country in question, different problems have to be faced. Thus, for banking services provided in this way national treatment is intended to ensure to foreign banks a measure of equality of competitive opportunity. It should be emphasized that the degree of competitive equality thus afforded will necessarily be less than complete. Several types of competitive inequality among enterprises may exist even in instances where laws and regulations do not discriminate in any way in favour of particular suppliers. For example, competitive advantages may accrue to certain enterprises mainly as a result of their being early entrants into an industry or market, and may have adverse implications for other domestic as well as foreign suppliers. Such cases, which are a commonplace of industrial economics, may sometimes be an appropriate subject for the country's competition policy, but the remedy does not belong under the heading of national treatment.

So long as a country has control over market access, it is reasonable to assume that the presence of foreign banks in particular banking sub-markets is in accord with (or at any rate does not conflict with) the Government's policy objectives. In such circumstances it can be argued that the regulatory and tax regime should be the same for foreign as for domestic banks. Nevertheless, this principle is likely to be accepted only subject to various provisos, of which three possible examples are given in the paragraphs which follow.

Firstly, reference was made in section G to several countries which imposed on foreign banks differential requirements as to capitalization for prudential reasons. Such measures can be justified by differences in the regulatory regimes under which domestic banks and the parent institutions of foreign banks operate, and by a degree of confidence concerning the support likely to be forthcoming from its parent to a foreign bank in difficulties that is lower than in the case of an analogous situation involving a domestic bank.[148] It should be added that the reasons that justify differential capital requirements for foreign banks also draw attention to the desirability of improved co-ordination among the supervisory authorities of the countries that would be covered by an agreed framework for international trade in banking services, a subject discussed further below under "transparency" and "regulatory situation".

Secondly, if allowance is to be made for infant industry protection for domestic banks in developing countries, references in an agreed framework to national treatment may need to accommodate measures designed to serve this objective such as differential income or profit taxation. The concept of national treatment in GATT article III is intended to apply to goods supplied by non-residents, and permits the levying of import taxes at the frontier. It is thus compatible with infant industry tariffs. When banking sub-markets are supplied by firms on the spot, this option is not available. But higher income or profit taxation for foreign banks or restrictions designed to impose differentially higher operating costs[149] on such banks could be used for the same purpose. The danger here is that infant industry protection by such means could easily become a way of circumventing the obligations entailed by national treatment. This danger might be avoided if recourse by a country to infant industry protection were to be hedged with a duty to specify both the particular tax or restriction used and a limited duration for the period of protection.

The third proviso relates to regulations that have the effect of increasing the hiring of local staff by foreign banks. Such regulations may be an important vehicle for achieving the transfer of banking skills. As was mentioned in section C, the transfer of skills is a major ele-

148 A few countries are prepared to accept lower prudential requirements as to capitalization if the parent institution provides to the regulatory authority a letter of comfort concerning its obligation to support the branch or subsidiary in the event of difficulties.

149 Restrictions on the operations of banks are often classified according to their "tax-like" or "quota-like" characteristics. The former raise banks' costs in a manner analogous to the effect of a tax, and thus suggest themselves as a substitute for tariffs. Examples of "tax-like" restrictions are differential reserve requirements, limits on or prohibitions against accepting retail deposits, and lack of access to refinancing facilities at the central bank.

ment of the rationale for admitting foreign banks to developing countries, so that it would be incongruous if an agreed framework were not to accommodate staffing regulations intended to achieve this aim.

4. Progressive liberalization

The earlier discussion in this chapter, in particular that in section C, indicated that liberalization and increased competition in banking can be expected to result in both benefits and costs. The thrust of policy towards this sector during recent years in developed market-economy countries has been in the direction of deregulation. However, during earlier periods policy was characterized by less emphasis on the benefits of competition, and deliberate use was often made of banks as instruments for the achievement of sectoral and developmental goals. There is thus no reason to anticipate generalized willingness among Governments in developing countries to view liberal banking systems as being appropriate to their circumstances and needs. Various steps (some of which are mentioned below) might be undertaken as part of an agreed framework for trade in banking services to enhance the prospective benefits of liberalizing regulations affecting the entry and operations of foreign banks. But the possibility remains that many countries will still choose not to make significant moves in this direction.

This possibility raises important questions as to the relation not only of "progressive liberalization" but also of other key concepts and principles to an agreed framework. The way in which the possibility might be handled depends partly on whether a framework for banking is to be part of a larger, overall agreement also covering other service sectors, or whether it is to stand alone. If the former option is chosen, cross-sectoral concessions can be envisaged under which countries unwilling to liberalize restrictions in banking may none the less be prepared to make offers for other services. By enabling such countries to participate in an overall agreement, offers of this kind would make them eligible for benefits under a framework for trade in banking services even in the absence on their part of concessions affecting this sector.

However, if an agreed framework for banking were to be separate or self-contained, more intractable problems might arise. In this case the unwillingness of countries to reduce restrictions on the entry and operations of foreign banks could not be balanced by concessions involving other services. Reciprocity has been a significant influence in many developed and developing countries on their willingness to grant market access to foreign banks.[150] Thus, it is difficult to visualize general acceptance by participants in a separate agreement on trade in banking services that countries unwilling to commit themselves to reduce restrictions on foreign banks should be eligible for benefits under the agreement.

There remains the question of what kinds of commitment to liberalization might be acceptable for an agreement. Such commitments would not necessarily need to be large so long as the framework for banking was part of a larger, overall agreement, since in this case they could be accompanied by concessions affecting other sectors. For a separate agreement on banking, willingness to accept commitments to liberalization would almost certainly be enhanced by allowing for considerable discretion as to the timing of the phasing-in of the measures to be taken. Articles VIII and XIV of the IMF Articles of Agreement may provide a useful precedent in this regard.

Article XIV allows a Fund member to avoid committing itself to the obligations of article VIII as to the convertibility of its currency. Instead, it may avail itself of transitional arrangements under which it is permitted "to maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member". Article XIV is especially interesting in the context of a possible framework for trade in banking services owing to two of its provisions. Firstly, although under the article a member may "adapt" its restrictions to changing circumstances, introduction of new restrictions and the reintroduction of restrictions withdrawn are not permitted. Commitments under article XIV may thus be considered similar in certain respects to the "bindings" (maximum tariffs) contained in countries' schedules of tar-

150 Reciprocity is not a precise term in this context. It covers policies under which countries admit banks from another country only if their own banks are granted broadly similar opportunities in that country. The lack of precision concerns what are acceptable as broadly similar opportunities. Mirror-image reciprocity is not generally insisted on owing to the discriminatory nature and complexity of policies based on this principle. Other possibilities range from the granting of national treatment to more stringent conditions that still fall short of mirror-image reciprocity.

iff concessions under GATT article II.[151] Secondly, article XIV does entail the commitment to move in the direction of a more liberalized foreign exchange regime. However, it should be noted that while the flexible modalities of article XIV may provide an interesting precedent in the context of the application of "progressive liberalization" to trade in banking services, there is an implicit ultimate objective of a particular norm of convertibility, namely that in article VIII. An analogous norm in the field of banking would have to be defined more loosely to allow for the variety of different banking regimes that participants in an agreed framework for this sector could be expected to wish to maintain.

5. *Most-favoured-nation/non-discrimination*

Inclusion of the most-favoured-nation (MFN) principle in an agreement on international trade in banking services would be intended to prohibit discrimination among the parties to it, thus guaranteeing that concessions made by one party would be equally accorded to all. However, extension of this principle from its usual field of application, trade in goods, to services such as banking raises new problems, two of which are discussed below owing to their bearing on other matters treated in this chapter.

Firstly, there is the question of the relation of the MFN principle to the form of an agreement or agreements concerning services more generally and banking in particular. Presumably, as in the case of "progressive liberalization", the principle would apply to all parties to an overall agreement covering several services, if banking were part of such an agreement, but would be limited to the parties to a separate agreement on banking if this was the form of agreement reached.

Secondly, the identity of the parties to which the MFN principle would apply presents peculiar difficulties in the case of trade in banking services. If the definition of such trade were to be limited to transactions between residents and non-residents, the principle would seem to involve issues similar to those arising in the case of trade in goods. But its application to transactions associated with the long-term presence of suppliers on the spot is less straightforward. The granting of market access must be bank-specific and not to countries if, as suggested above, it is to be used as a policy instrument for such purposes as providing infant industry protection. Restriction of market access to banks from countries covered by an agreement and granting it to such banks on the basis of first come first served might be considered as representing a form of non-discrimination among the parties. However, it would be non-discrimination in a sense different from that traditionally envisaged under the MFN principle.

Whatever the solution to this problem adopted as part of any agreement, the need for transparency as regards the procedures for granting market access should be emphasized. Absence of transparency could be expected to increase the probability that certain countries would feel unfairly treated under these procedures.

6. *Increasing participation of developing countries*

The aim of this principle is to increase developing countries' role in international trade in banking services. Banks from developing countries already participate in this trade but to a still limited extent. Further progress for the great majority of developing countries requires first the strengthening of domestic banking systems. Such a strengthening can be expected to lead eventually not only to greater participation by domestic banks in banking transactions between residents and non-residents but also to an increase in their presence abroad through the usual means of representative offices, branches, subsidiaries, and affiliates. Thus, subjects within the ambit of "increasing participation of developing countries" can be broadly classified under two headings: one comprising measures directed at the domestic banking systems of such countries; and the other measures directly affecting participation in international trade in banking services.

Under the first heading a key point is admission of the right of Governments of devel-

151 As noted in section H.7 below, some countries still have only rudimentary systems of banking regulation or are currently in the process of establishing such systems virtually from scratch. Countries in these situations may not be prepared to accept commitments of a character analogous to those under IMF article XIV as part of an agreement concerning international trade in banking services, at least for a period long enough to enable them to carry out certain changes regarding national banking regulations.

oping countries to use market access as an instrument for the achievement of policy goals regarding banking. As already discussed, control over market access can be a vehicle for infant industry protection of the sector. It can also provide developing countries with leverage for the acquisition of knowledge and skills, since the granting of market access can be subject to conditions designed to contribute towards this objective. One such condition has already been mentioned, namely requirements as to the hiring of local staff. Others might relate to the transfer of new technologies used in banking and the undertaking of management contracts.[152]

Expansion abroad is likely to continue to be the objective of only a limited number of banks from developing countries during the early years of any agreement. But the pressure for expansion abroad can eventually be expected to grow as the trade of such countries increases and their banking sectors mature. It is difficult to anticipate the character of the impediments to entry and restrictions on operations in the banking sub-markets of developed market-economy countries that will then have to be faced by banks from developing countries. As already noted, the recent thrust of policy in developed market-economy countries towards their financial systems has been in the direction of greater competition and openness. But the eventual policy regimes for foreign banks in such countries will emerge from discussions and negotiations still going on, including those taking place as part of the process of completing a single EEC market[153] as well as the current multilateral trade negotiations themselves.

Despite uncertainty concerning these regimes, an agreement on international trade in banking services should address the subject of impediments to developing countries' access to banking markets in developed market-economy countries. In the case of regulatory impediments consideration should be given to the possibility of including provisions for their reduction or removal (if necessary, on a preferential basis), thus increasing the incentives for such countries to participate in the agreement. Moreover, whatever the outcome of current negotiations and discussions for regulatory impediments to developing countries' market access, there remains the possibility that it will still be adversely affected by restrictive practices on the part of other banks already present.[154] Such practices, for example, might restrict access to clearance, payments and settlements systems, and might be permitted under the competition policies of the countries in question. Thus, it can be argued that an agreement for trade in banking services should explicitly provide for modalities whereby the unfavourable impact of such restrictive practices on market access could be brought to the attention of the parties to the agreement, and redress be sought where appropriate. The availability of such modalities might be more important in facilitating access for banks from developing countries owing to the more limited capacity of their Governments for bringing pressure to bear by other means on the countries where restrictive practices were found to exist.

A further matter which may merit consideration under ways of increasing developing countries' role in international trade in banking services relates to the mutual trade of such countries. A rise in banking transactions between developing countries can be expected to accompany expansion of their mutual trade in goods. There is thus a possibility that in this context developing countries may wish to accord each other's banks certain kinds of preferential treatment. A precedent for admitting such treatment subject to appropriate criteria and conditions is to be found in a decision of the GATT Contracting Parties known as the "enabling clause".[155]

152 Such contracts, which have already been used by some developing countries, entail the management of indigenous banks by teams from banks in developed market-economy countries. They are a way of giving a country access to advanced banking technology and management skills while enabling the continuation of local ownership of the banks in question.

153 The Second Banking Directive adopted by the Council of Ministers in December 1989 includes provisions regarding banks owned by parents from countries outside the Community. According to these provisions, subsidiaries owned by non-EEC parents that are authorized to operate in one EEC member country are eligible for a Community-wide banking licence granting the same freedom of establishment and operations as that enjoyed by EEC-owned banks. Branches owned by non-EEC parents are allowed to operate only in the country and sub-markets in which they receive specific authorization. Bilateral reciprocity between EEC and non-EEC countries may continue to apply to the granting of such authorization.

154 The banking sectors of developed market-economy countries are typically characterized by various so-called "club arrangements" which include some of a primarily social nature and professional associations as well as groupings with specific objectives involving such matters as payments systems, quotation, dealing, clearing and settlement systems for securities markets, and co-operative efforts for the setting-up of market systems for new financial instruments and data banks of market information.

155 The "enabling clause" permits contracting parties "to accord differential and more favourable treatment to developing countries", and among the arrangements to which such treatment may apply are "regional and global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in ac-

7. Regulatory situation and transparency

Some relevant dimensions of "regulatory situation" and "transparency" have already been treated under previously discussed concepts and principles, in particular under "market access", "national treatment", "progressive liberalization" and "most-favoured-nation/non-discrimination". The remarks in this subsection are limited to certain matters not yet raised or not sufficiently elaborated earlier.

The right of countries to regulate the provision of services within their territories in the light of national objectives is generally acknowledged. The relevant question for an agreement on international trade in banking services is the relation of this right to commitments undertaken as part of such an agreement. This is at the heart of many of the issues involved in the application to banking of the concepts and principles singled out at the mid-term review of the current multilateral trade negotiations. But one point under this heading perhaps deserves separate emphasis. There are large differences among countries in the levels of development of their regulatory systems for banking. Such systems are fairly rudimentary in many developing countries. Moreover, the Governments of several Eastern European countries are completely restructuring their systems of banking regulation as part of the market-oriented reforms of their economies. As a result, many potential participants in an agreement on international trade in banking services may need to be accorded a particularly high degree of flexibility as regards their national regulatory systems for banking.

Another point meriting special attention in the context of both "regulatory situation" and "transparency" is the need (already mentioned in section G) for a vehicle for the regular exchange of information concerning the situation as regards market access for, and restrictions on the operations of, foreign banks in the countries that are parties to an agreement. One model for such a vehicle would be a publication with a coverage analogous to that of IMF's annual reports, *Exchange Arrangements and Exchange Restrictions* (though owing to the greater inertia in most countries of the regulations in question the periodicity of the publication could be less frequent than that of the Fund). This publication should be supplemented by modalities guaranteeing the parties to an agreement prompt notice of any regulatory changes with a bearing on commitments under the agreement.

In the discussion under "national treatment" of prudential regulations that discriminate between domestic and foreign banks, reference has already been made to the desirability of improved co-ordination among national supervisory authorities for banking. Recent years have witnessed a series of steps in the development of a framework of international supervisory co-operation in this area. These steps, principally the result of a series of initiatives of the central bank governors of the Group of Ten countries and Luxembourg, have been directed towards the establishment of principles concerning the distribution between parent and host authorities of supervisory responsibilities over branches, subsidiaries and joint ventures in international banking, the international convergence of regulations as to the capital adequacy of international banks, and the mutual exchange of information.[156] Much of the impetus behind these steps has come from the growth of awareness among the national authorities in OECD countries of their banking systems' vulnerability to disruptions over which, as a result of the internationalization of banking and of divergences in the strictness of national regulatory regimes, they have little or no control. The steps also reflect realization of the need to ensure that banks compete internationally in conditions under which no country's institutions are unduly favoured by particular features of their regulatory regimes so that, as far as possible, success is due to differences in efficiency. Extension of this framework of supervisory co-operation to countries not currently covered might facilitate the removal of discriminatory prudential regulations among parties to an agreement on trade in banking services.

Exchange of information among the supervisory authorities of parties to an agreement may also help towards allaying concerns in developing countries (already mentioned in section C) as to the governability of foreign banks and as to their resort to unfair pricing practices. Concerns as to governability comprise the possible use by banks of their international networks to evade taxes and regulations re-

cordance with criteria or conditions which may be prescribed by the Contracting Parties, for the mutual reduction or elimination of non-tariff measures, on products imported from one another".

156 Although the agreements reached so far cover the Group of Ten countries and Luxembourg, the vehicle for these initiatives, the Committee on Banking Regulations and Supervisory Practices, maintains contacts with other bodies concerned with the supervision of international banking such as the Advisory Banking Committee (and its Contact Group) established to assist the EEC Commission and the Offshore Supervisors Group.

garding such matters as levels of foreign exchange exposure and maturity mismatching. Concerns as to pricing practices relate to the scope for foreign banks to deploy price discrimination as a competitive weapon, with effects analogous in some respects to dumping in the case of trade in goods.

However, while the willingness of supervisory authorities to make available information regarding the financial positions and any tax or regulatory problems of parent institutions could be of considerable assistance to host authorities, such willingness would be unlikely by itself to remove the aforementioned concerns. For example, those regarding governability could be expected to persist owing to awareness that the capacity of regulatory authorities in developed market-economy countries to monitor banks' international operations remains subject to major limitations, and that its improvement will take time. As for resort by banks to unfair pricing practices, identification of predatory price discrimination is generally very difficult (as already noted in section C), and there would appear to be little case law in this area covering banks on which an agreement for trade in banking services could draw. Thus, there seems to be little alternative in this connection to accepting that the possibility of unfair pricing practices by foreign banks constitutes another reason for admitting that developing countries need control over market access as an instrument for policies aimed at strengthening domestic banks to the point where they can compete effectively.

8. *Safeguards and exceptions*

Various objectives cited as justifying provision for safeguards and exceptions in an agreement for international trade in banking services can be achieved through control over access to different banking sub-markets. For example, as mentioned in section F, such control can be used to ensure that a country maintains autonomy in the conduct of monetary policy. Nevertheless, provision for safeguards and exceptions remains important owing to the need for a proviso to cover unforeseen circumstances in which a country may feel constrained to backtrack with respect to its commitments under the agreement.

Possible instances of such circumstances might be situations of acute balance of payments pressure, hyperinflation, or both. Recent events in certain Latin American countries serve as a reminder that in such circumstances Governments may decide to deploy unconventional policy instruments in their efforts to achieve economic adjustment or reduce inflation. It is in the nature of such policy packages that their constituents cannot be anticipated in advance. However, in an agreement on trade in banking services allowance seems necessary for the possibility that responses to crises of this kind may include the adoption of discriminatory controls over banking operations which involve temporary infringements of commitments under the agreement.■

Chapter II: Supplementary notes and references

Section

A Concerning the number of offices in developing countries of the world's 100 largest banks and the location of these banks' home bases see UNCTC, *Transnational Corporations in World Development, Trends and Prospects* (United Nations publication, Sales No. E.88.II.A.7), tables VII.2 and VII.3. Figures for the growth of foreign direct investment in the financial sector by five OECD countries from the second half of the 1970s until the mid-1980s are given in *ibid.*, annex table C.6.

B.2 Concerning the use in this context of the concepts, "location" and "ownership", see *Production and Trade in Services: Policies and their Underlying Factors Bearing Upon International Services Transactions* (United Nations publication, Sales No. E.84.II.D.2), paras. 100-101.

B.3 The most widely used approach to the treatment of banking services in national accounts is summarized in P. Host-Madsen, *Macroeconomic Accounts. An Overview*, IMF Pamphlet Series No. 29 (Washington, D.C., 1979), pp. 33-35, and there is a more detailed discussion of the same subject in H.W. Arndt, "Measuring trade in financial services", *Banca Nazionale del Lavoro Quarterly Review*, June 1984, pp. 204-212 (who gives the underestimate of Luxembourg's GDP on p. 207). Estimates of net income from international activities are available for the largest United States banks in, for example, J.V. Houpt, "International trends for U.S. Banks and banking markets", *Staff Study 156, Board of Governors of the Federal Reserve System* (Washington, D.C., May 1988), table 14.

The figures for the average annual rate of growth of the external assets in dollars of deposit money banks of OECD countries, the number of foreign branches of Federal Reserve member banks of the United States and of the foreign branches and subsidiaries of Japanese banks, and the average annual rates of growth of transactions in various categories of security were taken from G. Bröker, *Competition in Banking* (Paris: OECD, 1989), tables 6.2, 6.3 and 6.6. Figures for recent rates of expansion in transactions in futures and options can be found in J. Walmsley, *The New Financial Instruments. An Investor's Guide* (New York, etc.: John Wiley and Sons, 1988), tables 6.2 and 8.1, and R.E. Fink and R.B. Feduniak, *Futures Trading: Concepts and Strategies* (New York: New York Institute of Finance, 1988), figs. 1-5 and 25-6.

C The brief account of assets and liabilities management relies heavily on J.S.G. Wilson, *Banking Policy and Structure: a Comparative Analysis* (London, etc.: Croom Helm, 1986), pp. 233-260 and chap. 8; R. Harrington, *Asset and Liability Management of Banks* (Paris: OECD, 1987); and E.W. Reed and E.K. Gill, *Commercial Banking*, 4th edition (Englewood Cliffs, New Jersey: Prentice-Hall, 1989), pp. 152-157. For a discussion of the various costs of increased financial unpredictability in relation to techniques and instruments for protection against financial risk see *TDR 1988*, Part One, chap. II, sects. D and E.

For examples of alternatives to banks in low-income countries see J.S.G. Wilson, "Building the financial system of a developing country", *Lloyds Bank Review*, No. 93, July 1969, pp. 39-40 and 46-47. The remarks concerning policy towards banks in India are taken from the same author's, *Banking Policy and Structure*, pp. 143-144. The literature on foreign banks' role in developing countries is voluminous, including as it

does significant parts of that treating historical economic relations between major metropolitan countries and their colonies or countries within their traditional spheres of influence. For a recent discussion of issues discussed in this chapter, such as the role of foreign banks in branch networks, the distribution of their lending by categories of borrower and loan, and comparison of their techniques and management with those of domestic banks, see the case studies of Malaysia and Thailand in UNCTC, *Transnational Banks: Operations, Strategies and their Effects in Developing Countries* (United Nations publication, Sales No. E.81.II.A.7), chap. I (sect. C) and chap. IV (sects. A-D).

The susceptibility of services to price discrimination is emphasized in classic discussions of the subject such as those of J.M. Clark, for example, *Studies in the Economics of Overhead Costs* (Chicago: University of Chicago Press, 1923), chap. XX (especially pp. 425-428), and *Social Control of Business*, Second Edition (New York: McGraw-Hill Book Company, 1939), pp. 209 and 350-351. The difficulties confronting attempts to interpret data concerning prices and costs relevant to the demonstration of predatory price discrimination or dumping are discussed in the first of these two books, chap. XX, and in J.H. Jackson, *The World Trading System. Law and Policy of International Economic Relations* (Cambridge, Massachusetts, etc.: The MIT Press, 1989), chap. 10.

D.1 The account of the financial dependence of the South is based on D. Dillard, *Economic Development of the North Atlantic Community. Historical Introduction to Modern Economics* (Englewood Cliffs, New Jersey: Prentice-Hall, 1967), pp. 344-349.

D.2 Concerning the lending patterns of foreign banks in Africa see, for example, P.L. Wickins, *Africa 1880-1980. An Economic History* (Cape Town: Oxford University Press, 1986), pp. 60, 63, 94, 120 and 145. The quotation from the 1989 charter of the British South Africa Company is taken from Dillard, *op. cit.*, p. 490. The powers and influence of certain large foreign enterprises in Africa during the colonial period are discussed in Wickins, *op. cit.*, pp. 21-24 and 43-46.

E Concerning qualitative credit controls see Wilson, *Banking Policy and Structure*, pp. 420-421. The classification of interventions in credit allocation is similar to that of the World Bank in its *World Development Report, 1989* (New York, etc.: Oxford University Press, 1989), p. 56. Concerning early initiatives as regards the provision of credit by Governments in Africa see Wickins, *op. cit.*, pp. 83, 120, 138, 161 and 223. Concerning the spread of financial distress during the 1980s see, for example, World Bank, *op. cit.*, chap. 5 (where box 5.1 contains a useful list of major instances of recent financial crises in developed and developing countries).

F Concerning the use of "moral suasion" in developed market-economy countries see, for example, Wilson, *Banking Policy and Structure*, pp. 382-383. In a survey published in 1982 of the financial systems of six developing countries in South-East Asia an important role as part of monetary policy was explicitly attributed to "moral suasion" in four, namely Hong Kong, Malaysia, Singapore and Thailand. S.Y. Lee and Y.C. Jao, *Financial Structures and Monetary Policies in Southeast Asia* (London, etc.: The Macmillan Press, 1982), pp. 39-40, 43, 48-49, 86-87, 118 and 165. Back-to-back loans are described in D. Ross, I. Clark and S. Taiyeb, *International Treasury Management* (Cambridge: Woodhead-Faulkner, 1987), pp. 151-152. Concerning their use by banks of Latin American countries see, for example, B. Kucinski, "Where parallel loans may meet", *Euromoney*, January 1984. On the way in which the Government's shareholdings are capable of facilitating "moral suasion" see Lee and Jao, *op. cit.*, p. 118.

G The preference of United States banks abroad for the branch form is described in *National Treatment Study*, pp. 19-20, and Houpt, *op. cit.*, pp. 4-11. *National Treatment Study*, chap. 6, summarizes the findings concerning restrictions on the operations of foreign banks. Concerning differentially favourable treatment of foreign banks see, for example, *National Treatment Study*, pp. 31, 63 (India), and 83 (Republic of Korea); *1984 Update*, pp. 18 (India), 30 (Republic of Korea), and 56 (Taiwan Province of China); and *1986 Update*, pp. 119 (India) and 125-126 (Republic of Korea). For the synopsis of the *1984 Update* see pp. vi-vii. The details are contained in separate chapters devoted to particular countries. For a synopsis of the *1986 Update* see pp. 5-10. Country details are given in separate chapters, as in the *1984 Update*.

The classification of developing countries by region and GDP in table 35 is a coarse one. More refined categorizations are capable of generating various statistically significant relations between countries' policies towards foreign banks and the characteristics of their economies. On the basis of a combined ranking of the countries in the United States Treasury sample by the degree of restrictiveness of their policies as regards both entry and operations, one study finds several significant associations between restrictiveness and various characteristics of countries' Governments, of their economic and financial policies in other areas, and of the relations between their economies and banks and those abroad. A.E. Tschoegl, "The regulation of foreign banks: policy formation in countries outside the United States", *Monograph 1981-2 of the Monograph Series in Finance and Economics of the Salomon Brothers Center for the Study of Financial Institutions* (New York: Graduate School of Business Administration, New York University, 1981).

H.3 The implications of national treatment for international trade in goods have been discussed at length in the literature. For a useful summary see E. McGovern, *International Trade Regulation. GATT, the United States and the European Community* (Exeter: Globefield Press, 1982), chap. 8.

H.4 For a discussion of the role of reciprocity in the arrangements for the completion of a single EEC market as well as in the current multilateral trade negotiations see Lord Douglas Croham, "Reciprocity and the unification of the European banking market", *Group of Thirty Occasional Papers 27* (New York and London: Group of Thirty, 1989).

H.6 Concerning management contracts for banks see *National Treatment Study*, pp. 114 and 120. For a commentary on the Second Banking Directive of EEC see "European Community adopts Banking Directive designed to harmonize national banking laws", *IMF Survey*, 5 March 1990, pp. 68-69. "Club arrangements" in the banking sectors of OECD countries are described in Bröker, *op. cit.*, p. 89. Concerning the advantages to banks of participation in a country's payments system (as opposed, for example, to relying for such facilities as cheque clearance on links with correspondent banks) see M.K. Lewis and K.T. Davis, *Domestic and International Banking* (Oxford: Philip Allan Publishers, 1987), pp.158 and 172-174.

H.7 The example of a large international bank which exploited its international network for the purpose of evading banking regulations and reducing its tax burden is discussed in R. Dale, *The Regulation of International Banking* (Cambridge: Woodhead-Faulkner, 1984), appendix 2.

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Printed in Switzerland
GE.90-52056
August 1990–9,010

UNCTAD/TDR/10

04000P

United Nations publication
Sales No. E.90.II.D.6

ISBN 92-1-112291-0
ISSN 0255-4607