UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1993

UNITED NATIONS

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 1993

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

UNITED NATIONS
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This Report is dedicated to
the memory of Michael Tobin

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Explanatory notes

Classification by country or commodity group

The classification of countries used in this Report generally follows that of the UNCTAD *Handbook of International Trade and Development Statistics 1992.*[1] It has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The term "country" refers, as appropriate, also to territories or areas.

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 1992.* References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

The terms "economies in transition" (or similar terminology) and "Central and Eastern Europe" refer to Albania, Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and the former USSR (comprising the Baltic republics, the Commonwealth of Independent States (CIS) and Georgia).

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 1992.*

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1992* refers to *Trade and Development Report, 1992* (United Nations publication, Sales No. E.92.II.D.7).

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

The term 'billion' signifies 1,000 million and 'trillion' 1,000 billion.

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. 1988-1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 1990/91, signifies a fiscal or crop year.

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

A dash (-) 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.

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1 United Nations publication, Sales No. E/F.93.II.D.9.

Abbreviations

ACP	African, Caribbean and Pacific
AfDB	African Development Bank
AsDB	Asian Development Bank
ALADI	Latin American Integration Association
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
CD	certificate of deposit
CDSD	countries with debt servicing difficulties
CEPAL	Economic Commission for Latin America and the Caribbean (Comisión Económica para América Latina y el Caribe)
CFA	Communauté Financière Africaine
CIS	Commonwealth of Independent States
c.i.f.	cost, insurance and freight
CMEA	Council for Mutual Economic Assistance
DAC	Development Assistance Committee (of OECD)
DDSR	debt and debt service reduction
DMEC	developed market-economy country
DRF	Debt Reduction Facility (of IDA)
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
ECOWAS	Economic Community of West African States
ECU	European currency unit
EEC	European Economic Community
EFF	Extended Fund Facility
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESAF	Enhanced Structural Adjustment Facility (of 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
HS	Harmonized Commodity Description and Coding System
IDA	International Development Association

IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IPR	intellectual property right
ISIC	International Standard Industrial Classification of All Economic Activities
ITTO	International Tropical Timber Organization
LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
MERCOSUR	Southern Common Market
MFA	Multi-Fibre Arrangement
MFN	most favoured nation
NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NIEs	newly industrializing countries
NMP	net material product
NTB	non-tariff barrier
NTM	non-tariff measure
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OMA	orderly marketing arrangement
OPEC	Organization of the Petroleum Exporting Countries
PE	public enterprise
QR	quantitative restriction
R&D	research and development
RAP	Rights Accumulation Programme
RCA	revealed comparative advantage
REER	real effective exchange rate
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDR	special drawing right
SELA	Latin American Economic System
SIGMA	System for Interlinked Global Modelling and Analysis
SILIC	severely indebted low-income country
SIMIC	severely indebted middle-income country
SITC	Standard International Trade Classification
SSA	Sub-Saharan Africa
STF	Systemic Transformation Facility (of IMF)
UNCED	United Conference on Environment and Development
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USITC	United States International Trade Commission
VAT	value added tax
VER	voluntary export restraint

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OVERVIEW
by the
Secretary-General of UNCTAD

In last year's Trade and Development Report we predicted that without a strong boost to global demand the world economy would continue to stagnate. So it has. Belying almost all other official forecasts, the North has failed to recover. As a result, commodity prices are falling yet again, intensifying poverty in the South, and the unemployed are multiplying, intensifying poverty in the North. Joblessness is now not only the prime issue in domestic politics: by providing humus for protectionist sentiments and xenophobia, it is also forcing itself onto the international agenda.

The tide of market-oriented reform has continued to flow strongly in developing countries and the former socialist countries of Eastern Europe. In Asia, the fast-growing economies, which had managed to steer clear of the turbulence of debt and policy shocks, have continued ahead at full steam. Thanks to reform, Latin America has been showered with finance. In Africa, the winds of change have turned into a gale, but the economies are still in the doldrums. In the transition economies of Europe, the worst is over in some but not in others.

International financial flows have been bringing many benefits but also problems. Exchange rates have been under severe strain, and international trade negotiations have been teetering between openness and protectionism.

The new era after the Cold War should not be allowed to become one of economic conflict. Governments acknowledge the need for cooperation, but the real challenge remains. It is to translate the aspiration for harmony into practice - and do so in a way that will advance development and push back poverty.

The right approach is to marry boldness with realism. Without boldness structures will not change, but unless policies are tempered with realism there will be costly excesses. Boldness is also required to clear the debt overhang, which continues to bear down on many developing countries. And unless there is boldness, too, in fighting global deflation, the problems of the world economy will further multiply, and instability will overwhelm confidence.

Deficits and the dole in developed market economies

The projected recovery in the developed market economies has failed to materialize. The recessionary trend has prevailed because it is triple-strength:

- In the United States and elsewhere, financially over-extended firms and households have been cutting back their spending, and banks their lending, in order to restore their balance sheets to health;
- Japan's monetary contraction has succeeded all too well in bursting the bubble of inflated asset prices;
- Interest rates in Western Europe have been kept sky-high by the Bundesbank's policy of taming the German unification boom with monetary overkill.

Nevertheless, the major industrialized countries, apart from Japan, are reluctant to pursue counter-cyclical fiscal policies. Their wariness stems in part from fear that demand management will be inflationary - even though inflation is no longer the prime threat. But it is also in part a reflection of the escalation of government debt relative to national income. Notwithstanding the general aversion to Keynesian economics, public indebtedness grew faster than output in the 1980s. In some countries it was because monetarism kept interest rates high, in some because it was thought that tax cuts would revolutionize supply, and in others because international capital markets were content to let the Government postpone adjustment. Government deficits and debt have been accumulating even more rapidly in the 1990s because of recession.

Governments now find themselves on the horns of a dilemma. An expansionary fiscal stance will reduce unemployment but raise government deficits and debt even further, whereas fiscal consolidation will lengthen the dole queues; and inaction will throw more people out of work as well as increase government borrowing to pay them.

Can monetary policy provide a way out? The scope for interest rate cuts is quite narrow in the United States and Japan now that short-term rates have been brought down so low. For Western European countries, the room for manoeuvre depends on the Bundesbank, and will continue to do so as long as priority is given to keeping exchange rates unchanged vis-à-vis the Deutsche mark. The rationale for doing so is strong: exchange rates should be determined by the needs of trade, not of finance. However, in many Western European countries the main source of deficits is the large interest bill on the stock of public debt, and the main impediment to growth the high cost of money. Raising interest rates in quest of stability in the external value of the currency is therefore a source of disequilibrium domestically. Financial markets have sensed this, and responded with repeated waves of speculation even against currencies that are not overvalued on the usual criteria. The result has been to put great strain on the European Monetary System. Paradoxically, by trying to maintain parities intact, Governments are making it very difficult for themselves - and in some cases impossible - to meet the conditions for monetary union agreed at Maastricht in the form of convergence targets for government deficits and debt.

The dilemma between deficits and the dole is sharpened because national policy making is taking place without international coordination. In an individual economy, especially a very open one, even a moderately expansionary fiscal stance can worsen the budget deficit considerably as the stimulus and the accompanying benefits to public finances leak to its trading partners. But by the same token, when countries apply fiscal stimulus in concert, the deterioration in each of them in government finances can be kept quite small.

This provides a compelling case for countering global deflation through global reflation. Unfortunately, the stance of policy in most developed economies is facing the opposite direction:

The fiscal package proposed by the new United States Administration has been shorn of the planned short-term stimulus to demand, leaving only the longer-term adjustment of the deficit. However, the debt-to-income ratio will only come down if income growth speeds up considerably. The same is true for unemployment;

- Most Western European countries attach overriding priority to strengthening government finances. However, because of the cumulative impact of high interest rates and recession a serious attempt to follow the Maastricht recipe of coordinated fiscal contraction would drag Western Europe into depression.

Thankfully, Japan's fiscal policy is expansionary. The public debt ratio was relatively low because for many years demand creation for the private sector came from the massive trade deficits of some of Japan's trading partners rather than from government deficits at home. The fiscal packages adopted so far represent a sharp turnaround in policy, but they will not be enough to counteract the full force of global deflation.

Although none of the major developed economies will be providing a significant stimulus to the others, many of them appear to be banking on export growth to lower unemployment. It is well known that trying to capture a larger share of world demand is a zero-sum game. Most, if not all, participants - as well as the bystanders - stand to lose from resort to beggar-my-neighbour import protection or export subsidization. Every country can increase productivity, but all cannot increase competitiveness, and if they all try to do so rather than to increase global demand collectively, the result will inevitably be more recession and unemployment all round. Sure enough, protectionist sentiments are mounting, vis-à-vis not only surplus countries but also other exporters. They will keep mounting so as long as the idleness of men and machines continues to spread.

The situation demands a bold and innovative response. But the leading industrialized countries - as well as the leading international institutions - are seeking solutions to the legacies of the 1980s in the motto of that decade: "Leave it to the markets!". It is said that unemployment is predominantly a microeconomic phenomenon whose solution lies in flexible labour markets. There is much to be said for flexible labour markets - and, no less, for well-organized ones. But the curse of unemployment will remain as long as demand is insufficient to induce firms to hire more workers.

Governments need more room to raise demand by increasing their own expenditures on goods and services. Accordingly, they need to reduce their interest bills by tackling the stock of existing debt. Reducing deficits in the traditional way - i.e. by reducing public expenditure or raising taxes - would inevitably be deflationary. But doing so by reducing debt through privatization and a one-time tax on private-sector holdings of financial assets need not be.

Some headway has, of course, already been made in privatization, and there is scope for further action in many countries. But so far little thought has been given to taxing the stock of private wealth in order to tackle the stock of public debt. Practical difficulties are not absent. But to overcome them requires first a turnaround of thinking centred on a simple fact: since the main source of government deficits is the interest payable to the private sector, in the final analysis the private sector must pay most of that bill itself. The most promising way to deal with deficits, debt and deflation is a one-time capital levy combined with privatization to reduce debt, alongside one-off spending increases to sustain private incomes.

Even if that were done, monetary relaxation would also be necessary, not least in order to reduce the interest bill of the public sector. The scope for easing monetary policy is substantial in Western Europe. In the United States, the main need is to avoid putting on the monetary brakes too soon in the recovery process; otherwise, the imbalances and tensions of the early 1980s could be repeated.

Reform, growth and the external environment in developing countries

Market-oriented reforms have been high on the economic agenda of most developing countries for a number of years. It is no less true that these countries have maintained, and in some cases speeded up, the pace of economic activity in the face of global recession. But it would be wrong to conclude that root-and-branch market-orientation provides a sure recipe for recovery and sustained growth regardless of the external trading and financial environment.

East and South-East Asia represents the brightest spot on the international economic landscape, with repeated success over many years in raising output, productivity, exports and employment. In all the fast-growing countries of the region Governments have given strong support to private business and to exports. In some, rapid growth in manufacturing industry has come spontaneously, from commerce and an influx of footloose industries seeking cheap labour. But some of the most outstanding performers have industrialized using a panoply of controls and subsidized credit in favour of activities picked by the Government as having a potential for rapid productivity gains, including heavy industries.

Government intervention has on the whole diminished in recent years. This withdrawal has generally been carried out in an orderly fashion following success; it has not been a rout after failure. Some countries retired old subsidies and other forms of protection because they had ceased to be useful; but some intervened actively to bring industry closer to the world technological frontier. The virtual absence of "policy shock" is a reflection of the fact that a timely and relatively smooth switch towards export expansion had already been made. Consequently, almost no highly indebted country in the region suffered the disruptive withdrawal of lending characteristic of other developing regions, and growth was not interrupted by a vicious circle of macroeconomic disorder, sagging investment and economic retrogression. Rather, it continued to be driven by high and rising levels of public and private investment, continuously growing productivity and export diversification, mounting confidence, and continuous enterprise formation and development.

China's rapid growth owes much to the reform of its central planning system. This started with the introduction of market mechanisms in agriculture and the liberalization of foreign trade and investment, and was then extended gradually to other areas of the economy. As a result, productivity has increased sharply, and exports have shot up, in part driven by inflows of foreign direct investment. The reform process, while not smooth, has been devoid of shock treatment. A severe stabilization programme was not necessary at the outset since no monetary overhang had been allowed to accumulate. Moreover, communes could be transformed back into family farms quite smoothly. In industry, China has been able to improvise new organizational forms such as town and village enterprises which, while behaving according to the rules of the market, do not involve a sharp break with public ownership. It has let price controls go gradually, and liberalized trade in stages. Integration into the international economy has been rapid, but selective. However, with the lessening of central control over finance and investment, the economy has been overheating. Expenditure will need to be curtailed, and the sooner that is done, the less painful it will be.

Growth in East and South-East Asia has had significant spillover effects, since the countries of the region have provided each other with fast-growing markets for manufactures as well as primary commodities. The pattern of specialization has been changing rapidly, with the more industrialized economies moving out of simple manufactures into more sophisticated lines of production, and the less industrialized ones taking their place. This "flying geese" pattern has accelerated export and productivity growth in both the leaders and the followers. The relocation of textiles and other industries has received strong impetus from direct investments by enterprises within the region, pushed by rising labour costs and currency revaluations at home and pulled by welcoming policies in the host countries.

The persistence of the growth-*cum*-integration dynamic over a period of years has made the countries increasingly interdependent and the region more self-reliant in both trade and finance. As success breeds success, the "external" finance and trading environment of the countries is becoming increasingly internal to the region as a whole. Indeed, the region is on the way to becoming a growth pole for the world economy at large.

Nevertheless, exports to Europe and North America remain important. Continued world economic growth and open markets thus remain crucial. Moreover, a loss of dynamism in the larger economies, whether because of domestic factors or external shocks, could spread to others in the region. The pace and pattern of growth in Japan will be especially important, as will be China's success in cooling its economy.

Unlike these Asian economies, ***Latin America and the Caribbean*** encountered an acute debt crisis in the 1980s. This turned a macroeconomic disequilibrium into disorder, and disrupted economic growth. By and large, the response has been a radical change in economic policy, involving monetary and fiscal austerity, decontrol, trade liberalization, encouragement of direct private investment, and extensive privatization. The speed and extent of reform has been amazing. Latin

America today is more market-oriented than the Asian "success stories": restrictions on both trade and capital movements, for instance, are fewer.

Both financial and real performance has generally improved. Excluding Brazil (which accounts for about one third of the region's GDP, and whose much-needed fiscal adjustment remains unaccomplished), inflation last year dropped to less than half the almost 50 per cent reached in 1991, while the annual growth rate rose to 5 per cent during 1991-1992, from less than 3 per cent in 1990.

The impact of policy reform thus far has been largely indirect, via the encouragement it has provided to capital inflows. Indeed, the most striking feature of Latin America's changing fortunes has been the huge swing in the annual net transfer of resources, amounting to $50 billion, from 1988-1989 to 1991-1992. Savings on debt service payments yielded by Brady deals account for a very small fraction of the turnaround; lower dollar interest rates have contributed twice as much. Foreign direct investment, which could provide a continuing source of financing, has picked up smartly. However, the inflow has also included large-scale repatriation of flight capital, a source which is not inexhaustible, and movements in response to privatization, which are probably one-off. More ominously, there appears to be a bandwagon in trail: an influx of capital in response to interest rate differentials shifts the mood of markets and encourages a further influx, which then acquires further momentum by putting upward pressure on the exchange rate, thus enlarging opportunities for profitable arbitrage. Hence, much of the capital inflow may not be sustainable.

The issue of sustainability is central because the inflow has been a key factor in the improved macroeconomic situation of many Latin American countries. By allowing the Government to keep the nominal value of the currency unchanged, or devalue by less than the increase in domestic prices, inflows have served to bring down inflation. They have also covered the huge current account deterioration which emerged partly in response to the real currency appreciation generated by the inflows themselves and partly in response to the liberalization of trade. The more relaxed external situation has also improved fiscal performance by raising growth and government revenues. These various gains could be lost if the inflow were to slow down sharply or collapse. In the meantime, there is a loss of competitiveness and a build-up of trade deficits which might prove difficult to reverse later without another depression. Some countries, such as Brazil, have preferred to forgo the gains in order to maintain competitiveness; but sterilizing the capital inflow by borrowing from domestic markets at very high interest rates has had severe fiscal consequences.

Recent growth in Latin America has been generally driven by consumption rather than investment. Rates of private savings and investment are little more than half those in the fast-growing economies of Asia. Public sector investment in infrastructure has been especially weak, with adverse consequences for the private sector in the longer term. The entrepreneurial class is being enlarged and strengthened through privatization, but has yet to choose to make use of its new opportunities by investing vigorously.

Another characteristic - and contrast with the fast-growing Asian economies - has been the lack of dynamism of exports, especially manufactures. One reason why exports have not boomed upon removal of the anti-export bias that characterized traditional import substitution has already been mentioned: the loss of competitiveness. But that is not the whole story. The Asian experience shows that export success requires not only "getting prices right" but also active government support, and that well-targeted protection of domestic producers can be a springboard for entry into the international market place. The pendulum has swung so far that whereas in the past protection in Latin America was often excessive and badly targeted, it is now almost non-existent.

Translating capital inflows into growth led by investment and exports is a major challenge. In several countries the present configuration of interest rates and exchange rates is not helpful in this respect. If the configuration is not improved in time there may be a payments crisis later. But if it is changed abruptly, funds might start flowing out rather than in.

In ***Africa***, the swing towards the free market philosophy has been no less pronounced. Most countries in sub-Saharan Africa have been pursuing structural adjustment programmes (SAPs) for the better part of a decade. Nevertheless, recovery has been slow and growth performance remains extremely poor. Per capita incomes today are well below the 1970 level, and on current trends it would take 70 years to double them.

Africa's development has, of course, been damaged not only by the structural problems addressed by SAPs but also by various catastrophes, such as wars, civil wars and climatic disasters. Nevertheless, it is striking that even after allowing for these factors SAPs have generally brought

only a small improvement in the trend rate of growth. Only Mauritius - which is highly atypical in many other ways as well - has been able to grow while shedding adjustment programmes supported by IMF and the World Bank.

Africa, unlike Latin America, has been suffering from a continuous deterioration of its external environment. Falling commodity prices have hit both those regions, but sub-Saharan African countries have suffered much more, especially those dependent on cocoa and coffee. Besides, the region has received no offset comparable to Latin America's massive influx of private funds. It has received increased assistance, but losses on the terms of trade have been a multiple of the aid increment. Such losses have rarely been anticipated; indeed, forecasts have tended to predict recovery in export prices, and thus in growth performance.

Increasingly, the purpose of aid has become simply to induce policy change to the neglect of its more important role, which is to finance growth and investment. The short-leash approach and the paucity of assistance have made many countries dependent on aid simply to sustain a low level of activity. The financial squeeze has been reflected not only in the persistence of the region's debt crisis (discussed further below), but also in problems in the design of adjustment programmes:

- It has tightened the fiscal constraint, necessitating sharp cuts in public investment;
- While considerable devaluation was indeed called for, the severe shortage of foreign exchange has resulted in too much pressure being put on the exchange rate instrument, with very severe repercussions on activity and prices. As a rule, any policy instrument has a positive effect on its main target and a number of negative side effects, and when taken beyond a certain point, the gains diminish while the side effects mount;
- Confidence and the willingness to invest have also been damaged by the continuing debt and foreign exchange crisis and the repeated postponement of recovery;
- SAPs have been right to emphasize the need to improve the quality of investment, but growth is not possible unless investment is sufficiently high. Poor investment performance has resulted in a tendency to de-industrialize. So has the sudden withdrawal of import protection;
- SAPs have been right in seeking to correct the past neglect of agriculture. But, largely because of underfunding, they have done so largely at the expense of domestic industry;
- SAPs have also been right in trying to remove the past bias against exports. However, by relying on devaluations and other purely market-based mechanisms, they have improved incentives not to manufactured exports but to traditional ones (sometimes, indeed, at the expense of domestic food production). Consequently, little if any genuine diversification has occurred;
- No effort has been made to avoid overproduction of primary commodities. Indeed, many countries have received encouragement to increase their market share of traditional exports.

There have also been shortcomings as regards reform of the public sector. The main aim appears to be to privatize or close down public enterprises, on the grounds that economic activity should, as a general rule, be left in the hands of private agents, and that in sub-Saharan Africa Governments cannot be counted upon to correct market failures without creating other, more serious, failures. There is undoubtedly considerable scope for the private sector to play a greater role. Nevertheless, the basic reasons remain for an active government role in Africa; these include the paucity of private agents in a position to take long-term risks (and with the financial and managerial capacity to create and run large-scale organizations), and the need to support and promote the diversification and marketing of agricultural output. Reforming public enterprises is fraught with difficulties, but the game is worth the candle, especially in countries at a very low level of development, where market failures are widespread and growth must be accelerated by all possible means.

Collapse and transition in the former socialist countries of Eastern Europe

In the ***former socialist countries of Eastern Europe*** political change has been followed by severe economic contraction. Output has declined on average by about one third since the beginning of the transition process. Inflation, after shooting up initially, has been brought down consider-

ably in most of Central and Eastern Europe; in Russia and other former Soviet republics, however, the situation is approaching hyperinflation. Those countries which began reforms (and suffered declines) first are showing signs of a bottoming-out or even some slight recovery. Unemployment, however, is extremely high and is not expected to fall. In the former Soviet Union and a few other countries, joblessness is likely to increase sharply; output is also expected to fall further.

In many countries the euphoria that greeted the collapse of communism has given way to pessimism. One school of thought blames the economic instability and collapse on the system of central planning, while another sees reforms as the villain of the piece. The real difficulty, however, is that the transition economies have entered a twilight zone where there is neither plan nor market, and most have done so without the slightest preparation:

- Price liberalization has served as the cutting edge of reform by severing the control of the centre over enterprises. This, together with currency devaluation and trade liberalization, has brought massive changes in relative prices. The losing sectors have naturally shrunk, but the gaining sectors have often not increased output in response because there was no properly functioning financial system and because managers have been unwilling or unable to restructure their enterprises. Cuts in demand for the production of heavy industries, in particular armaments, have also been reflected in lower output rather than restructuring. Often the response of firms to price liberalization has taken the form of monopolistic price increases, resulting in cost-push inflation; mechanisms to control monopolistic behaviour have been weak;
- Financial liberalization and enterprise autonomy have put an end to the discipline of the plan, but many firms have been able to escape the financial discipline of the market, by borrowing from banks under their control or from other enterprises, or because the Government has bailed them out to avoid adding to unemployment;
- The transformation of production structures cannot proceed without an effective system of financing long-term investment by enterprises. The Government is no longer willing to provide such financing, while the banking system and capital markets are not yet equipped to. Indeed, the transition itself, and the accompanying economic contraction and financial instability, have rendered most of the new banks unsound;
- Since the goal of reform is *market economy* (as distinct from *market socialism* which inspired previous unsuccessful reform efforts) an ownership vacuum has emerged. Publicly owned enterprises are no longer responsible to the centre but still lack real owners. Whereas privatization of small firms has advanced rapidly (and a new private sector is emerging from below), privatization of large-scale industrial enterprises remains problematic. Relatively little effort has been made to put such enterprises on a commercial footing while keeping them under public ownership. Voucher schemes for mass privatization offer a way of redistributing ownership relatively quickly and fairly; but the holders of the vouchers are unlikely to be able to ensure management accountability and good corporate governance. *Nomenclatura* privatizations are also quick, but unfair. Other forms of privatization are generally time-consuming;
- Economic activity has been disrupted by the breakdown of the CMEA system of State trading and the economic disintegration of the former Soviet Union. Few of the economies were adequately prepared for these shocks, and mechanisms to cushion them have been lacking;
- The transition places much greater demands on monetary and fiscal policy than did central planning. However, Governments have found it very hard, in some cases impossible, to control money and credit and the fiscal balance, not least because of the disequilibrium set loose by the transition itself, including the emergence of open and disguised unemployment on a large scale.

The main reason why many transition countries have found themselves in the twilight zone is that the prevailing free-market ideology has sought to dismantle the old system of ownership and intervention at maximum speed, while avoiding new forms of government intervention as far as possible, including those prevalent in many fast-growing developing economies. In the long run, it is argued, shocks bring less pain and more gain than piecemeal reform.

Shock therapy can, indeed, prove very effective for an economy that has been destabilized and where the resulting turbulence threatens to become chaotic; for instance, as a remedy for hyperinflation, when the prime need is to bring expectations and behaviour back to normal as quickly as possible. However, shocks are not a reliable recipe for introducing the new thinking, behaviour and norms required. A market economy consists not simply of a predominance of private ownership and a minimum of government control, combined with appropriate laws; it is also

a complex multitude of organizations, traditions and understandings that have usually evolved organically over time. Nature abhors a vacuum, but the vacuum left by dismantling "real socialism" will not be filled by the spontaneous appearance of appropriate market mechanisms and institutions. The history of the region itself has shown that success in destroying an old system is no guarantee of success in creating a new one.

The fundamental challenge before Governments is to improvise new ways to advance the deep and complex process of systemic change required, and to guide it through successive stages to completion. The issue is not whether reform should be more or less radical, but how to ensure that the reconstruction of the institutional micro-structure and development of new norms do not lag behind liberalization and decontrol. But can the *apparat* be trusted to accelerate the transition to market economy? Will it not sabotage the reform or alternatively become completely corrupt? Perhaps the answer is to widen the reform agenda to encompass a complete overhaul of the economic administration, so as to permit the Government to play a more active role in advancing transition and reviving growth. Difficult as this may be, it could advance the development of capitalism more effectively than faith in the spontaneous working of market forces.

International financial markets

Borrowing by developing countries from the international capital markets has once again been notable for the difference between the minority with reasonable access and the majority without. The minority consists of countries of South and South-East Asia, which were largely unscathed by the debt crisis, and of a number of Latin American countries which have raised considerable sums in the form of external bonds since the beginning of the 1990s or attracted substantial external financing in other forms (or both). The other main borrowers came from West Asia.

Most of the developing countries, as well as the economies in transition (many of which continue to be involved in debt rescheduling), still find access to international financial markets restricted by unfavourable perceptions of creditworthiness. This is especially marked in the prevalence of high costs and restrictive conditions on official insurance cover for their export credits or, in many cases, the unavailability of such cover on any terms. As a result, net international bank lending to both Africa and the former socialist countries of Eastern Europe was negative in 1992, and there has been a large contraction in outstanding export credits to Africa since the beginning of the decade.

Increased financial flows to certain Latin American countries have been influenced by lower costs of borrowing abroad and the profitability of certain types of arbitrage. But the expansion owes much more to the new perceptions which have accompanied the movement towards incorporation of these countries into the global network of international capital markets. Exposure to the resulting flood-tide and ebb-tide of external financing has presented a major challenge to policy. Responses so far have already included several different approaches. Some of the measures used have been designed to influence economic agents' incentives by raising the costs of dependence on external financing - for example, through the imposition of non-interest-bearing reserve requirements on banks or fiscal stamp taxes. Others have involved more direct controls, such as restrictions on banks' liabilities and regulation of the size and terms of external bond issues and equity offerings.

Trade in commodities and manufactures

Commodity markets have continued to be depressed, and to be destabilized by changing demand and supply conditions. Prices of most commodities have declined further, in some cases even in nominal terms. The main influences in commodity markets have recently been the continuing abundance of supplies in the face of recession in the developed market economies, and the slump in the former socialist countries of Eastern Europe. Falls in the production of consumer durables

and investment goods in developed market economies have affected minerals and metals particularly, and several agricultural raw materials. The steep decline in the former socialist countries of Eastern Europe has resulted in a substantial fall in imports of cocoa and tea, of which the region was an important consumer, and to a lesser extent of industrial raw materials such as lead, tin and zinc. This has contributed to keeping prices depressed. Because of the severe contraction of industrial output - especially armaments - there has been a sharp increase in supplies of aluminium to the world market.

In 1992, the volume of exports of developing countries accelerated somewhat, driven by their export push. The imports of developing countries, particularly those in Asia and Latin America, grew faster than their exports, thus adding to demand in the industrialized countries. However, Africa, particularly south of the Sahara, has continued to lag behind other developing regions. The region's continued dependence on primary commodities and small industrial base has put it in a weak position to expand earnings in the context of world recession.

Manufactures continue to be the key to export growth for developing countries. Success in moving up-market and upgrading into new products involving more complex technology and greater value added has characterized much of the increased penetration of the markets of developed countries. For instance, export diversification, often in response to rising wages and changing patterns of productivity, was the driving force behind the rapid expansion of Asian exports. Trade among developing countries, especially in East and South-East Asia, has been one of the most dynamic components of world trade in general, and of trade in manufactures in particular.

The unit values of not only primary commodities but also manufactures exported by developing countries as a whole have continued to decline relative to those of manufactures exported by developed countries. It was only by increasing export volumes, particularly in manufactures, that developing countries as a group were able to register improvements in their income terms of trade. Recent experience has shown once again that such increases tend to depress prices when demand is sagging. Continued recession in the world economy can be expected to damage the terms of trade and economic prospects of developing countries.

Most developing countries have continued to reduce tariff and non-tariff barriers, despite an unfavourable trading environment. Trade liberalization has been a key component of their structural adjustment policies, which aim to achieve higher growth rates through closer integration with the world economy and greater competition at home. Joining their ranks are many countries in Central and Eastern Europe, including the former Soviet Union. But in developed countries, which are the main markets of developing countries, trade liberalization has on the whole been very modest. There has been no significant decline in protectionism for products of export interest to developing countries.

Trade conflicts among the major economic powers have mounted, with adverse repercussions on developing countries and those in transition. The unpredictability of the international trading system is adding significantly to the risk and uncertainty of export orientation. Of particular concern is the persistence of unilateral retaliatory actions, and the increasing use of non-tariff measures such as "voluntary" export restraints, which fall outside the framework of the GATT safeguard mechanism and are often applied for protective purposes. Also of concern is the spread of anti-dumping and countervailing (anti-subsidy) measures. Their practical effect in developed countries is often to protect declining domestic industries from import competition rather than counteract unfair trade practices. This tends to be less true in developing countries that have been liberalizing their trade. There, such measures have been introduced alongside the elimination or reduction of quotas, licences, minimum price schemes or foreign exchange controls.

An early successful conclusion of the Uruguay Round is essential. Each delay plays in favour of protectionism and is seen as indicating lack of resolve by Governments, particularly of the major trading nations, to honour their commitment to multilateral trade disciplines and to trade liberalization. Prospects have been brightened by the Tokyo summit, where the G-7 announced their resolve to make every effort to achieve "a global and balanced agreement before the end of the year". The "Quad Agreement" is expected to give fresh momentum to the multilateral negotiations. These will require a good deal of compromise and mutual accommodation on all sides. However, it should not be at the expense of the basic goal of the negotiations, which is to provide greater security of market access and trading opportunities for all countries, while securing specific provisions on differential and more favourable treatment for developing countries.

Debt

The debt crisis is not over. It persists in more than 60 countries. They are mainly poor and mostly in sub-Saharan Africa, but many middle-income countries, some of them formerly socialist countries, are also entangled in debt rescheduling. There are also several countries with heavy debt servicing burdens which have consistently honoured their obligations, at high cost to their economies.

But the character of the crisis has changed since the early 1980s. The international financial system is no longer in danger, and the creditworthiness of a number of major Latin American debtor countries has improved significantly. The key problems now are debts owed to Governments and international financial institutions (IFIs); Russia's debt is also a major new challenge.

The ***Paris Club*** now accords debt and debt service reduction to low-income countries. However, further improvements are needed:

- The scale of debt reduction needs to be increased well beyond the "enhanced Toronto terms". The proposed "Trinidad terms" should be adopted by all creditors as a benchmark, with further reductions when needed. Non-Paris Club creditors should consider implementing comparable measures;
- Eligibility should be widened to include all heavily indebted countries that are IDA recipients, even if they borrow on non-concessional terms from the World Bank. The needs of middle-income countries for debt reduction should also receive closer attention;
- Debt reduction should be granted all-at-once, as in the Brady deals.

By according concessional relief, the Paris Club has *de facto* become a provider of aid. Careful consideration should be given to proposals to coordinate it closely with donor groups, or even to entrust the task of rescheduling the official bilateral debt of low-income countries to the latter. A single meeting on debt and finance would make it possible to detect and act on a country's debt problems early on, to really treat debtors case-by-case, to monitor the additionality of debt relief, and to reduce the high transaction costs borne by debtors.

Rescheduling of multilateral debt has hitherto been taboo. But over 20 countries, mostly poor, are in arrears to the Bretton Woods institutions and the regional development banks. In the next few years, most of their debt will be to IFIs. This will be a major problem unless export prospects and overall net transfers improve significantly.

Arrears hurt not only the debtor but also the IFIs and all their members. The principle of giving preferred creditor status to IFIs should not be impaired, but there is room for applying it flexibly and pragmatically so as to enlarge the scope and scale of current schemes for handling arrears and to give, when warranted, effective though informal debt reduction.

In order to help avoid the emergence of arrears - and for many other reasons - IFIs need to increase their net transfers substantially. This calls for adequate replenishment of their soft windows. But in a climate of aid fatigue and fiscal pressure in donor countries, increased funding of soft windows may be at the expense of bilateral aid. To the extent that such increased funding cannot be assured through regular means, new sources of funds should be tapped, such as SDR allocations and IMF gold sales. These can also be used to help countries clear existing arrears.

Seven countries have completed debt and debt service reduction agreements with commercial banks and several others are about to do so. The ***Brady deals*** have in effect brought about a significant reduction in commercial bank debt but not much in total debt, partly because the debtor has had to provide collateral. In many cases, up-front costs have outweighed cash flow savings in the short and medium term.

A number of Latin American countries with Brady deals have recently experienced higher growth rates and a turnaround in private capital inflows. The Brady plan, by providing a framework for settling claims in an orderly way, has contributed to the improved creditworthiness

brought about by domestic economic reforms; indeed, these have provided the foundation of the deals. Most deals were not generous enough to trigger, by themselves, the shift in investor sentiment that has taken place. As already noted, other, more important, factors - such as the bandwagon effect and interest-rate arbitrage - were also at play.

Many of the smaller countries negotiating Brady deals hold extremely low international reserves and are unlikely to attract a big inflow of private capital. They need lower up-front financing costs and larger debt reduction than have proved agreeable so far to banks. With the conclusion - or virtual conclusion - of deals for the major debtor countries, the risk of setting a precedent no longer exists. Reduction of commercial debts should be accelerated by Governments of creditor countries by exerting greater moral suasion on banks to agree to debt reduction; improving their regulatory and tax provisions would also be helpful.

The conclusion of debt reduction agreements for low-income countries benefiting from IDA's Debt Reduction Facility (DRF) also needs to be speeded up. This will require:

- Expansion of DRF operations through increased multilateral and bilateral funding;
- Higher DRF lending limits; and
- Enlargement of eligibility from IDA-only countries to all affected low-income countries.

The debt inherited by ***Russia*** represents a heavy burden on its economy. The Paris Club has shown considerable flexibility, but has maintained its traditional short-leash approach to rescheduling. Russia needs a comprehensive medium-term debt relief programme. Two useful lessons can be drawn from the international debt crisis:

- If the Paris Club agreements continue to deal only with debt service falling due each year, rather than with the stock of debt, arrears might keep emerging, damaging the confidence of foreign investors and lenders and fuelling capital flight;
- Actions by the various groups of creditors must be coordinated in order to avoid delays in providing relief and to ensure that the burden is fairly shared by official and private creditors.

Russia's transition is likely to be hard and long, and reforms will need external financing. It is too early to say whether the present liquidity crisis is being handled in ways compatible with solvency in the longer term. Should a solvency crisis become probable, debt and debt service reduction would be warranted, perhaps accompanied by provisions to allow creditors a share of any unexpected increases in oil revenues. If Russia were to reduce its own claims on other troubled debtors, including other former Soviet republics - as it should - this should be matched by increased aid or debt relief for Russia.

K.K.S. Dadzie

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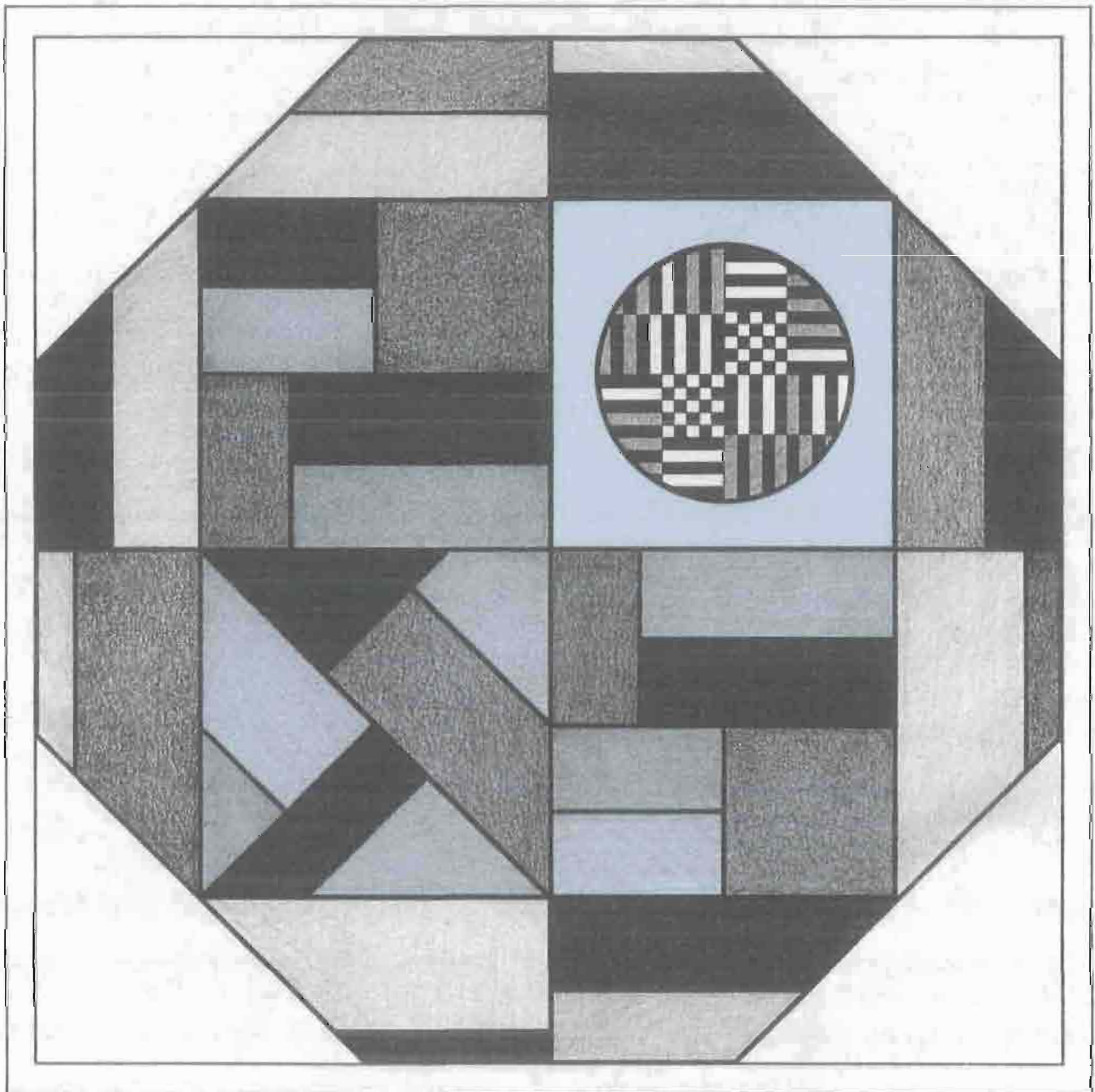
GLOBAL TRENDS



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Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Recent performance

The world economy has continued to perform poorly. Once again, the outcome for the past year was worse than foreseen. After negligible growth in 1991, there was only a modest recovery of world output in 1992, and growth in that year was well below the average since the 1980-1982 recession. Unlike the previous year, there were signs of a turnaround in some of the transition economies, and in developing countries as a whole growth continued to be high. By contrast, the expectation of a broadly based recovery among developed market economies failed to materialize. Indeed, the economic malaise of these countries has persisted and become even more pervasive. Currently, there is widespread concern about trends in global economic activity. As a consequence, short-term forecasts carry a serious risk of being overoptimistic.

In 1992, the growth of both world output and world trade accelerated for the first time since 1988 (see table 1). While, as noted above, the recovery in output was modest, the volume growth of world trade was much greater, due in part to the recovery in the United States. Also responsible were the import boom in Latin America and the continued expansion of intra-Asian trade at rates considerably above the world average.

1. *Developed market economies*

Developed market-economy countries, which currently account for over 54 per cent of world production, remained largely in recession in 1992, but inflation was down. Output growth for the group as a whole amounted to 1.4 per cent, a slight improvement over the 0.7 per cent achieved in 1991. In most countries the problem of high and rising unemployment has been accentuated.

Most of the growth in 1992, however, was attributable to the recovery, still rather hesitant and erratic, which occurred in the United States. Furthermore, recovery in that country is the weakest on record, well below that of comparable phases of previous postwar business cycles. While it proved sufficient to offset the deceleration of economic activity in Western Europe and Japan it was not accompanied by any substantial gain in employment; consequently, the unemployment rate continued to rise, from 6.7 per cent in 1991 to 7.4 per cent in 1992. While monetary policy was relaxed, the large federal deficit was considered to limit the scope for a more active fiscal policy.

Table 1

WORLD OUTPUT, 1980-1993

(Percentage change)

Country group	1980-1990 (Annual average)	1991	1992	1993 [a]
World	2.8	0.4	1.4	1.4
Developed market-economy countries	2.7	0.7	1.4	0.8
of which:				
United States	2.5	-1.3	2.1	2.0
Japan	4.2	4.4	1.3	1.0
EEC	2.3	1.4	1.1	-0.5
of which:				
Germany [b]	2.2	3.6	2.0	-1.7
France	2.2	1.1	1.3	-0.8
Italy	2.2	1.4	0.9	-0.2
United Kingdom	2.6	-2.2	-0.6	1.3
Central and Eastern Europe [b]	1.9	-14.9	-15.9	-12.0
Developing countries	2.9	3.9	4.4	4.6
of which:				
America	1.0	3.6	3.0	2.7
Africa	1.9	2.5	1.5	3.0
Asia	4.6	4.5	6.0	6.2
China	8.9	6.6	12.8	11.0
Memo item:				
World trade (volume)	3.7	3.0	4.5	5.6

Source: UNCTAD secretariat calculations, based on national and international sources.
a Forecast.
b After 1990, the former German Democratic Republic is included in Germany.

In the other major industrialized countries there were no real signs of recovery. On the contrary, the Japanese economy began to weaken in 1991, and conditions deteriorated sharply and rather unexpectedly during the second half of 1992 because of a drastic fall in investment. Despite lower interest rates, a policy package to help strengthen the balance sheets of commercial banks and despite a supplementary budget appropriation, output growth in 1992 was considerably less than the 1991 rate or the average for the 1980s. In contrast to widespread expectations, economic growth in Western Europe did not strengthen in the course of 1992. Instead, economic conditions deteriorated significantly, with unemployment in the EEC countries as a whole rising to 10.1 per cent from 9.2 per cent in 1991. In the second half of 1992, there was a decline in output in France and Italy, and stagnation in the United Kingdom, while Germany moved into outright recession. Output growth for the Community as a whole was just over 1 per cent, even less than the relatively low rate of the previous year.

In sharp contrast to the monetary stance of the United States, Germany persisted in maintaining a tight monetary policy to contain inflation stemming from unification. This imposed severe constraints on the policy options of other member countries of the European Monetary System (EMS) and created tensions in European currency markets. The depreciation of the dollar and uncertainties arising from the initial rejection by Danish voters of the Maastricht Treaty were two important factors that eventually precipitated a crisis in the EMS in the latter half of 1992. As a conse-

quence, both Italy and the United Kingdom suspended membership in the exchange rate mechanism (ERM) while others devalued within the system or severed their links with the ECU.

2. Developing countries

For developing countries as a whole, output continued to expand in 1992 at a slightly higher rate than the previous year, in spite of the weakness of activity in major industrial countries. However, a continuation of the trend in the persistently fast-growing economies, mostly in Asia, has been in sharp contrast to stagnation in many others, mainly in Africa. Indebted developing countries benefited from reduced debt service payments due to lower dollar interest rates, while stable oil prices helped to improve the balance of payments of oil importers. Some oil exporters benefited from the continuing recovery in oil production. On the other hand, many countries suffered seriously from the persistence of low commodity prices and further deterioration of the terms of trade.

Among developing regions, economic performance in Africa continued to be the worst. The downturn in growth which had started at the beginning of the decade continued in 1992. Output growth for developing Africa as a whole is estimated to have further decelerated, to 1.5 per cent (from 2.5 per cent in 1991). With population growing at some 3 per cent a year, 1992 was thus another year of absolute decline in per capita income. The performance of sub-Saharan African (SSA) countries has continued to be weak, with a fall in per capita output by more than 5 per cent since the beginning of the decade. SSA countries have been particularly vulnerable to the recession in the industrial world: while they have suffered from sharp declines in the terms of trade, they have benefited little from lower dollar interest rates. Furthermore, an unprecedented drought in southern Africa, as well as continued civil strife, wars and political crises in a number of countries, had a serious impact on output during 1992, resulting in an increased occurrence of starvation and disease.

In Latin America (including the Caribbean) the recovery which started in the early 1990s has continued. However, growth in the region was somewhat slower in 1992 as recession deepened in Brazil and a number of smaller countries. Although the region was adversely affected by a worsening of the terms of trade, a number of countries (including Argentina, Chile, Uruguay and Venezuela), registered very high growth rates, ranging from 7 per cent to over 10 per cent. In addition, with the notable exception of Brazil, inflation in the region continued to subside, falling by more than one half from 1991 to 1992. Although investment and exports have been rising steadily in a few countries, growth in Latin America has generally been driven by private consumption. There has been a surge in imports sustained by massive inflows of private capital, with the result that in 1992, for the first time since 1983, the region as a whole ran a trade deficit.

Growth in developing countries in Asia accelerated in 1992. In the newly industrializing economies (NIEs) and South-East Asian countries, widespread labour shortages and bottlenecks in infrastructure resulted in lower rates of growth compared to 1991, but the fall was more than offset by growth in other parts of the region, notably South and West Asia. Outstanding has been the doubling in 1992 of the growth of the Chinese economy, to a rate of nearly 13 per cent. Because of its close economic ties with developing countries in the region, the dynamism of China was a major factor underlying the expansion of Asian intraregional trade.

Effective exploitation of subregional and intraregional complementarities and cooperation in Asia in recent years has resulted in the emergence of several "growth triangles", where surplus capital from relatively developed economies in the region complements surplus skilled labour in neighbouring countries to generate production of exportables at competitive prices. Growth has thus been driven by trade and investment. The increasing flow of goods and foreign direct investment among economies in the region served to compensate to some extent for slower growth in the major industrial countries. The triangle (the "Chinese Economic Area") consisting of China, Hong Kong and Taiwan Province of China is becoming a new growth pole for the global economy.

3. Economies in transition

For the economies in transition as a whole, economic performance continued to weaken in 1992, with output continuing to contract by some 15 per cent. There were considerable differences in performance, however, among countries. Contractions in output

ranged from some 40 per cent in Latvia and Armenia to an estimated 4-6 per cent in Hungary. A modest increase was registered in Poland. For some countries the contraction of output appears to have slowed down in 1992, and in those which had advanced furthest in their programmes of institutional and structural reform (i.e. former Czechoslovakia, Hungary and Poland) there is some evidence of a gradual revival. In Bulgaria and Romania, however, output continued to decline at double-digit rates comparable to those of 1991.

In the former Soviet Union, the slump in production deepened considerably in 1992 as most countries continued to suffer from major macroeconomic imbalances, widespread supply shortages and falling external trade as well as political and social unrest and ethnic conflicts. Production in the Russian Federation declined by some 20 per cent in 1992, twice as much as in the previous year. The loss of output was even larger for many other countries of the former Union. A major threat at present is the onset of hyperinflation.

B. Short-term prospects

The world economy is not expected to show any improvements in 1993. In keeping with the trend of the past decade, world trade in volume terms is projected to grow faster than production (at around 5.6 per cent), due to a continued rapid expansion of trade among developing countries.

Up to late 1992, there was widespread optimism that there would be a global recovery. It was based on the belief that several elements crucial to a turnaround in economic activity were in place, including monetary relaxation in Germany, fiscal stimulus in Japan, improvements in the transition economies, and a general consensus that a financial collapse in the United States and Japan had been averted. Such optimism, however, has been tempered as the economic situation in Japan and the major industrial countries in Europe deteriorated sharply. As a consequence, initial estimates and projections for both 1992 and 1993 were revised downwards. For 1992, the revisions have been moderate, but extensive, affecting all major economic regions. For 1993, however, the revisions are substantial, especially for Germany, France and Japan. Countries members of EEC continue to be affected in varying degrees by the aftermath of the exchange rate turbulence. For 1993, the latest forecasts for the Community as a whole are for no growth in as much as output in Germany is expected to decline by nearly 2 per cent.

Recovery in North America remains subdued. It is expected to continue, but at a modest pace of 2 per cent, during 1993. In Japan, after the sharp downturn in 1992 a relatively strong upturn is not expected to take place until 1994. For developed market-economy countries as a whole, therefore, growth in 1993 will continue to come primarily from North America.

Growth in developing countries is expected to remain strong. The disparity in economic performance among the various regions will, however, persist. Prospects for Africa are mixed, as many countries are still in the process of consolidating their adjustment. Some recovery may be expected in sub-Saharan Africa as the effects of the drought peter out, but it is likely to be limited by the continued weakness of commodity prices. Growth in Latin America can be expected to decelerate unless there is a significant improvement in Brazil during the second half of 1993. Developing countries in Asia are likely to continue to maintain their current rates of growth of output and intraregional trade due to the dynamism of China, where the economy is expected to grow by over 10 per cent in 1993, fuelled by rapid increases in domestic and foreign direct investment as a result of reforms.

Some countries in transition, notably Poland and Hungary, are expected to register modest positive growth in 1993, while prospects for the Czech Republic and Slovakia are uncertain. Prospects remain bleak for most other countries, especially for the former Soviet republics. For the transition economies as a whole output is expected to fall by a further 12 per cent.

Table 2

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1993 FOR SELECTED OECD COUNTRIES

(Percentage)

Country	LINK	ECE	OECD	EEC	IMF	NIESR	Nomura
United States	3.2	3.0	2.6	2.5	3.2	3.3	2.5
Japan	1.4	1.5	1.0	1.5	1.3	2.1 [a]	1.4
Germany	-0.7	-1.0	-1.9	0.0	-1.3	-0.3 [a]	-1.4
France	0.3	-0.5	-0.7	1.0	0.0	0.9	-0.1
Italy	0.5	-0.5	-0.2	0.8	0.3	1.1	-1.2
United Kingdom	1.4	1.0	1.8	1.5	1.4	2.0	0.3

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook" (mimeo), Post-meeting forecast, 21 April 1993; ECE, *Economic Survey of Europe in 1992-1993* (United Nations publication, Sales No. E.93.II.E.1) (cutoff date March); OECD, *Economic Outlook* (June 1993); Commission of the European Communities, *European Economy, Annual Economic Report for 1993* (Brussels, 1993) (cutoff date January); IMF, *World Economic Outlook* (April 1993); National Institute of Economic and Social Research (London), *National Institute Economic Review* (February 1993); and Nomura Research Institute (Tokyo), *Quarterly Economic Review* (May 1993).

a GNP.

C. Risks and uncertainties

The present state of the world economy is characterized, as noted above, by considerable discrepancies in the economic performance of various regions and countries as well as the relative fragility of the recovery in parts of the developed world. The recovery remains hesitant and uneven, although inflation is down in many countries, both developed and developing. Prospects continue to be affected by persistent high interest rates in Europe, adjustment to debt deflation in some major industrial countries, tensions in currency markets, weak business and consumer confidence, and efforts to reduce budget deficits.

Prospects for developing countries that have been expanding continuously are positive, but overshadowed by the threat of increasing protectionism through the formation of trading blocs, and by "managed trade". The increasing need to adopt or strengthen measures to address environmental concerns could also have significant macroeconomic implications. Crucial to the prospects of the Asian economies is the sustainability of the performance of the Chinese economy, which already shows signs of overheating and is confronted by serious bottlenecks in transportation, energy and raw material production. Growth in Africa continues to depend on the evolution of the terms of trade, external aid and the weather, as well as on progress in resolving armed conflicts and civil strife. In Latin America, prospects depend to a large extent on the continuity of capital inflows and the ability to translate them into investment-led growth.

A major factor clouding world short-term prospects is the uncertainty about the timing, extent and strength of a more generalized recovery in the developed market-economy countries. The degree of uncertainty is reflected in the wide range of growth projections for the major OECD countries made by various international organizations and research institutes (see table 2). The discrepancies are partly a reflection of different perceptions of the worsening of the economic climate in recent months. By and large, more recent forecasts give lower growth rates.

The influence of the debt deflation process on private spending and economic activity in a number of major industrial countries remains important. The severing of the conventional linkages between the financial and the

Box 1

WRONG TURNINGS AND FALSE DAWNS: THE RECENT RECORD OF ECONOMIC FORECASTING

The recession in major industrial countries since 1990 was generally not foreseen by most national or international forecasters, and, once the downturn could no longer be doubted, its scale and duration were poorly forecast. Both the IMF, *World Economic Outlook* and the OECD, *Economic Outlook*, which publish forecasts of growth of the international economy biannually, have had to make successive downward revisions since the onset of the current recession. As seen in the table below, there were large forecasting errors for 1991 and 1992, and a persistent overprediction of growth in 1992 and 1993 (UNCTAD's one-year-ahead forecasts for growth in 1991 and 1992 published in previous issues of *TDR* were also largely off the mark).

Comparable errors in OECD and IMF forecasting had occurred previously as regards the recession of 1974 and the weak growth in 1982 (when recovery was predicted). The unexpected rise in savings rates after 1974, which coincided with the appearance of double-digit inflation, was an important reason for poor forecasting during the first oil shock. The recession associated with the second oil shock was fairly accurately forecast, as the experience of the 1974 episode had led to modifications in the consumption function in forecasting models, in recognition of the effects of changes in net private wealth, including capital gains. In 1982, on the other hand, growth remained very weak, contrary to forecasts: the cumulative adverse effects of tight monetary policy on output and employment do not appear to have been well understood at the time.

Despite the earlier modifications in forecasting models and the absence of an external shock, in the forecasts for 1990 and beyond the turning point of the cycle was missed. Furthermore, both the strength of the credit-led boom in the mid-1980s and the duration of the subsequent debt deflation-*cum*-recession were underestimated. Model-builders failed to understand the changes in functional relationship between net wealth and spending, as well as the transmission of the effects of monetary policy on economic activity that resulted from the financial deregulation and integration of capital markets in the 1980s.

After the mid-1980s the willingness and ability of households to hold debt changed drastically as financial deregulation in many countries eased access to new forms of borrowing. The relationship between wealth and consumption shifted and aggregate savings ratios declined steeply: how far and how long the adjustment would take was extremely uncertain. Forecasters' consumption equations with conventional wealth effects would not only fail to take account of these changes, but the predictions would be perverse because, in the framework of the forecasting models the increase in debt, by reducing net wealth, would cause the savings ratio to rise.

The clearest example of changes was in the housing market. Increased competition of banks with savings and loans institutions (in the United States) and building societies (in the United Kingdom) led to the lifting of ceilings on mortgage rates and greater availability of 100 per cent mortgages for financing house purchases. The rules on maximum loans relative to income were relaxed. The boom in house prices which followed brought large capital gains to home owners which they easily realized, in the new credit regime, by restoring the initial gearing of their mortgage-financed debt. The additional mortgage loans, often available at interest rates well below other forms of unsecured bank loans and consumer credit, were used to finance higher consumption.

When interest rates began to rise sharply in 1989, house prices collapsed and some home owners with excessive mortgage commitments had to sell their homes, depressing prices further. Although in some countries early reductions in interest rates brought some relief to the burden of servicing debt, consumption remained depressed because the private sector had first to adjust to more sustainable debt ratios. Similar difficulties emerged in the corporate sector, where firms had made takeover bids and purchased assets with borrowed funds in the expectation that the capital gains would be more than enough to pay off the loans.

The pressure on firms and households to cut back their debt commitments and the fall in asset prices began to interact with one another in a process of 'debt deflation' which both deepened and prolonged the recession. This process was pointed out in *TDR 1991* and explained at some length in *TDR 1992*. Government advisers as well as forecasters misread the implications of financial deregulation and the destabilizing effects of debt accumulation, believing instead that markets would quickly bring about equilibrium between spending and wealth. Priority continued to be

Box 1 (concluded)

given to the reduction of government deficits and the containment of inflation. It could be argued that these forecasting failures contributed to Governments being tone deaf to the risks of a major recession as the credit bubble of the 1980s burst.

Forecasting models tend to rely on inertia in the movements of output, employment and prices; they are likely to do well, at least in forecasting the direction of change, most of the time. But it is when there are major turning points that the forecasts have occasionally gone badly wrong. If the disturbance is a novel one, the forecasts will be especially uncertain. It is at such times that an experienced forecaster has to make an unusually important act of judgement, by modifying the model to take account of the effects of the new behaviour, even though there is at first very little quantitative evidence of the magnitude of the effects. If the record of forecasting is to be improved, it will require not only technical advances in modelling and learning from previous mistakes, but also the "experienced intuition" that is the privilege of only a relatively small number of experts.

FORECASTS OF REAL GDP IN THE INDUSTRIALIZED COUNTRIES BY OECD, IMF AND UNCTAD

(Annual percentage change)

Institution/date of forecast	*Forecasting horizon*					
	1988	*1989*	*1990*	*1991*	*1992*	*1993*
OECD						
December 1988	4.0	3.2	2.7			
December 1989		3.6	2.9	2.9		
December 1990			2.8	2.0	2.5	
December 1991				1.1	2.2	3.3
December 1992					1.5	1.9
IMF						
April 1988	2.8	2.6				
April 1989		3.3	2.9			
April 1990			2.7	2.9		
May 1991				1.3	2.8	
May 1992					1.8	3.3
UNCTAD						
Mid-1988	2.7	2.4				
Mid-1989		3.1	2.8			
Mid-1990			2.8	2.9		
Mid-1991				0.7	2.3	
Mid-1992					1.5	3.0
Out-turn	4.4	3.3	2.4	0.7	1.4	...

Source: OECD, *Economic Outlook*; IMF, *World Economic Outlook*; UNCTAD, *Trade and Development Report*.

Note: IMF and OECD forecasts are published - at different dates - twice a year and subject to frequent revision. UNCTAD forecasts, based on the SIGMA model and made as of end-May, were published in the *Trade and Development Report* until 1992; they have been discontinued with this Report. It would be inappropriate to compare the performance of the three forecasts, since the differing dates of publication in the course of the year imply that the available information underlying the forecasts is not the same.

real economy due to widespread financial deregulation has been a major cause of the failure of the models of most national and international forecasters to predict the depth and the length of the current recession (see box 1). It is not known to what extent the current versions of these models have been revised as a result of the forecasting errors of recent years.

In the United States, the Government will continue to contend with the competing goals of reducing the budget deficit, on the one hand, and creating more jobs, on the other. There is considerable uncertainty surrounding the outcome of the Clinton economic package, as well as its likely effects on the economy. Equally important for growth prospects is the evolution of monetary policy and interest rates. In Japan, while there have recently been signs that the recession may be bottoming out, there are many uncertainties regarding the effects of the fiscal stimulus. The contribution of the external sector to output growth is also uncertain; much will depend on the strength of the United States recovery, the strength of the yen, and the outcome of international pressure on Japan to cut its trade surplus. In Western Europe recovery will depend on German monetary policy as long as other members of EMS continue to be ready to sacrifice employment and growth to maintain a strong currency. The fiscal measures recently undertaken in Germany will in all probability lower growth and raise prices. Even if the Bundesbank responds to increasing national and international pressure to lower interest rates considerably, recovery in Western Europe will be forestalled if the members of EEC maintain the debt and deficit targets agreed at Maastricht and make the massive fiscal retrenchments needed to that end.

Given the extent and speed of transmission of the spillover effects of domestic macroeconomic policies among the major industrial countries, recovery in one country is not likely to get far in the absence of a corresponding recovery in others. Indeed, it is more likely to create tensions in international trade and finance. The current global economic situation, therefore, demands a swift coordinated expansion by the major industrial countries, designed to put the global economy on a long-term growth path.■

Chapter II

INTERNATIONAL TRADE AND COMMODITY MARKETS

A. Introduction

International trade has recently been affected by structural and policy-driven changes as well as by macroeconomic developments in the world economy. The latter include the recession and large currency misalignments and realignments; and the former include: the collapse of the political and economic systems of the former socialist countries of Eastern Europe, including the USSR; the unification of Germany; initiatives regarding regional trading blocs, new environmental policies; trade conflicts and selective protectionism in OECD countries; policies in many developing countries aimed at liberalizing trade and expanding exports; increased productivity in the supply of many primary commodities; the military conflict in the Persian Gulf; and the emergence of China as a major participant in world trade. More difficult to document, but none the less important, have been uncertainties due to the failure to complete the Uruguay Round of multilateral trade negotiations. Some of these changes enlarge developing countries' trading opportunities but others have resulted in reduced demand and intensified competition in OECD markets, in some cases accompanied by reduced predictability and greater risks. The latter changes are a threat to the momentum of export expansion in both developing countries and those of Central and Eastern Europe and of the former USSR.

The chapter begins with a review of the principal recent trends in world trade (in section B), with emphasis on the export performance and market prospects of developing countries, especially with regard to manufactured goods. The review includes discussion of recent changes in their net barter and income terms of trade in the light of their export expansion and of recession in the developed world. Section C examines trade in primary commodities, focusing principally on ways in which the factors described above have affected the demand for and supply of individual commodities. Section D takes up various aspects of recent developments in trade policies. These include trends in protection in OECD countries as well as the liberalization of trade policies recently undertaken in several developing countries, and in some instances in developed countries also.

B. Recent trends in world trade

1. Summary

The annual growth in the volume of world exports (excluding the former socialist countries of Eastern Europe and the socialist countries of Asia) slowed down moderately from 1988 to 1992 (i.e. during the period of recession), as may be seen from table 3. In value terms, however, the impact of recession was less evident, basically because of increases in

the price of petroleum in 1990 caused by tensions in the Persian Gulf. Moreover, in that year there was a slight recovery of the economy in Japan and Germany. In 1992 world merchandise trade accelerated slightly in terms of both volume and value, mainly because of the improved trade performance of the United States (see table 4).

The value of exports from developing countries expanded, on average, faster than world trade in all years during the recession, and trade among these countries expanded much faster than their exports to developed market-economy countries (see tables 5 and 6).

Developing countries' increased export revenues were achieved largely through the expansion of export volumes, which rose by an annual average of nearly 8 per cent from 1987 to 1991, compared to 1.8 per cent in 1980-1987 (see chart 1 and table 7). The increase in value terms was 11 per cent and 1.8 per cent, respectively, in these two periods, which implies an increase in unit value of about 3 per cent per annum during 1987-1991 (against an annual average fall of over 4 per cent during 1980-1987).

The faster growth of imports than of exports in developing countries provided some offset to the weakening of demand in the industrialized countries in the recessionary years. Table 5 shows that the growth of imports exceeded that of exports every year, in value terms, with the exception of 1989. Their imports also increased faster than trade among OECD countries (see table 6). In the last two years the strong import growth has been mainly in Latin America, the Middle East and a few Asian major exporters of manufactures and over the past several years there has also been a spectacular expansion of imports into China.

In the former socialist countries of Eastern Europe (which previously accounted for about 10 per cent of world trade) import demand has fallen since 1989, the decline being particularly sharp in 1991.

The overall trade performance of developing countries hides important variations among regions. The best performers were the established major exporters of manufactures and the South and South-East Asian countries. Export performance was generally poor in Africa (except for the oil-exporting countries), in West Asia and in the least developed countries in general.[1] The marginalization of Africa in world trade, which began in the 1950s, has thus been accentuated. The share of non-oil-exporting sub-Saharan African countries in world exports and imports, which fell relatively gently in the 1950s and 1960s, dropped rapidly in the 1970s and 1980s and by the end of the latter decade the share in world exports was only 0.9 per cent. Moreover, as discussed below, there has also been a further severe decline in these countries' terms of trade.

2. *Exports of manufactures from developing countries*

(a) *Performance*

Manufactures have been the main driving force behind the export expansion of developing countries, with a small but growing number of Asian countries accounting for the bulk of the expansion. Table 7 shows that in 1987-1991 over two thirds of the growth of total exports from developing countries (80 per cent if fuel is excluded) was due to manufactures and table 8 indicates that all but 10 per cent of this growth of manufactured exports was accounted for by eight Asian countries. Four of these countries (Hong Kong, Republic of Korea, Singapore and Taiwan province of China) together were responsible for about half of total exports of manufactures from developing countries in 1987. Thailand, Malaysia, Philippines and Indonesia accounted for a further 8 per cent. Singapore, Malaysia, Thailand, Indonesia and Philippines have shown greater than average export growth rates in 1987-1990, thus increasing their share in total exports of developing countries.

Manufactured exports from a number of Latin American countries, particularly Mexico, Argentina, Colombia, Venezuela and Chile, also expanded faster during 1987-1990 than the average for developing countries as a whole, but such exports constitute only 12 per cent of total manufactured exports from developing countries. Except for Mexico and Brazil, the export base is still small in most countries of Latin America, so that it contributed only 1.4 per cent to the total growth of 11.8 per cent in manufactured exports from developing countries in that period.

1 For developing Africa as a whole there was an accelerated export growth in 1987-1991, but it was almost entirely accounted for by oil.

Table 3

WORLD [a] EXPORTS, 1980-1992: VALUE, VOLUME AND UNIT VALUE

(Percentage increase over previous year)

	1980-1986 (average)	1986	1987	1988	1989	1990	1991	1987-1991 (average)	1992 [b]
Value	0.9	10.9	17.8	14.5	7.6	14.5	7.0	9.9	7.0
Volume	3.1	7.1	5.9	7.9	6.6	5.5	5.2	7.9	5.5
Unit value	-2.1	3.5	11.3	6.1	0.9	8.6	1.8	2.7	1.1

Source: Statistical Division of the United Nations Secretariat, *Monthly Bulletin of Statistics*, January 1993, special table B.

a Excluding countries of Eastern Europe and socialist countries of Asia.

b Estimates by the UNCTAD secretariat.

Table 4

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS IN 1991 AND 1992

(Percentage increase in value over previous year)

	Exports		*Imports*	
Grouping/region	*1991*	*1992 [a]*	*1991*	*1992 [a]*
Developed market-economy countries	1.5	7.9	0.2	6.0
North America	5.1	8.3	-1.4	9.4
Western Europe	-1.2	7.6	0.6	5.5
EEC	0.2	7.8	2.1	5.9
EFTA	-3.8	5.8	-6.1	0.4
Japan	9.6	8.1	0.8	-1.6
Developing countries	5.8	6.3	9.9	8.7
Asia	9.5	8.2	13.5	9.6
West Asia	-4.1	5.6	10.3	12.8
South and South-East Asia	14.1	9.0	14.3	8.9
America	-0.3	3.2	11.7	12.4
Africa	-1.2	1.4	-4.4	4.7
North Africa	6.3	3.5	-9.1	8.3
Sub-Saharan Africa	-6.9	-1.1	3.2	1.8
China	15.7	14.2	19.6	22.0
Countries of Eastern Europe	-47.4	0.5	-53.4	8.2
Memo item:				
Least developed countries	-6.7	2.8	-10.4	0.4

Source: UNCTAD, *Handbook of International Trade and Development Statistics 1992* (United Nations publication, Sales No. E/F.93.II.D.9) and UNCTAD Data Base.

a Estimates.

Table 5

WORLD TRADE BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1987-1992

Region	*Value of trade in 1987 ($ billion)*	*Percentage increase over previous year*						
		1987	*1988*	*1989*	*1990*	*1991*	*1987-1991* [a]	*1992* [b]
Imports								
World	2 566	16.3	13.8	7.7	13.2	-0.6	8.4	6.6
Developed market-economy countries	1 844	18.5	12.7	8.1	14.7	0.2	8.8	6.0
Countries of Eastern Europe	194	6.4	6.8	-4.2	-1.2	-53.4	-17.1	-1.1
Developing countries	475	14.2	19.5	11.1	15.2	9.9	13.9	8.7
of which:								
Major petroleum exporters	101	-2.8	11.6	4.1	6.9	17.6	9.9	11.0
Other developing countries	374	19.8	21.7	12.8	17.1	8.3	14.9	8.2
Major exporters of manufactures	197	27.9	29.6	14.2	15.4	13.6	18.0	8.2
China	43	0.7	27.9	7.0	-9.8	19.6	10.2	22.0
Memo item:								
Least developed countries	20	3.5	7.8	3.4	10.7	-1.4	5.0	1.2
Exports								
World	2 491	17.2	13.1	7.3	13.1	0.2	8.4	7.0
Developed market-economy countries	1 740	17.1	13.8	7.3	15.0	1.5	9.3	7.9
Countries of Eastern Europe	201	9.4	4.0	-8.8	-9.5	-47.4	-18.0	-5.6
Developing countries	508	20.2	13.8	13.0	13.1	5.8	11.4	6.3
of which:								
Major petroleum exporters	136	10.5	-3.8	22.2	26.8	-2.3	9.9	4.0
Other developing countries	371	24.2	20.2	10.3	8.6	8.9	11.9	7.1
Major exporters of manufactures	236	30.5	23.0	9.0	7.1	10.3	12.2	6.6
China	39	27.5	20.5	10.6	18.2	15.7	16.2	14.2
Memo item:								
Least developed countries	12	10.5	2.2	7.1	-4.1	-1.4	0.9	2.6

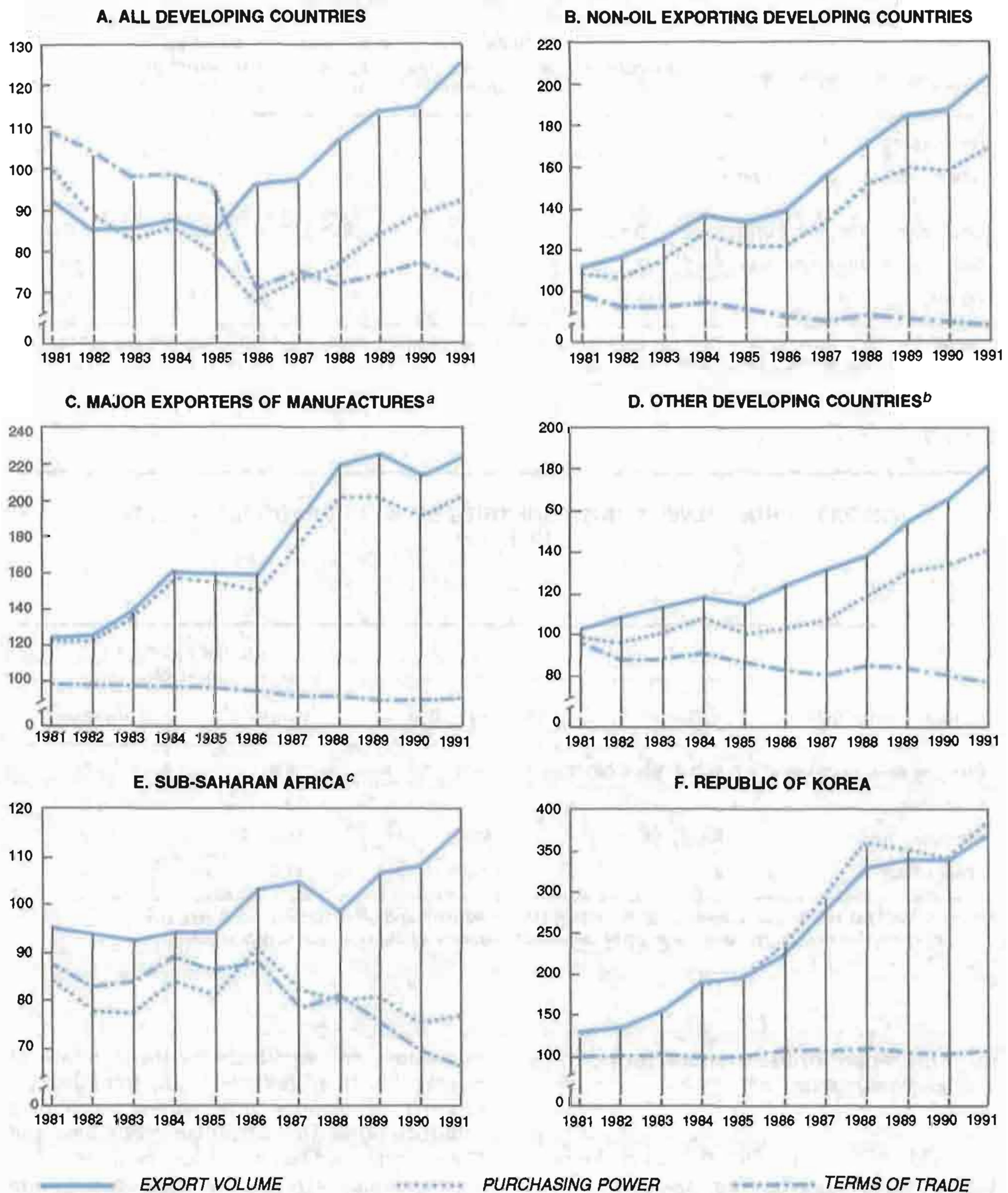
Source: As for table 4.
a Annual average.
b Estimates.

Thanks to a few countries, manufactured exports from developing Africa rose over 17 per cent annually during 1987-1990, halting the earlier decline (1980-1987) in market share (see table 9). Export performance in sub-Saharan countries and those of North Africa was much the same. Because of the small industrial base, manufactured goods account for barely more than 15 per cent of the total exports of developing countries of Africa and 10 per cent of those of sub-Saharan Africa. For the latter, most of the small increase in market share is attributable to three countries (Mauritius, Côte d'Ivoire and Cameroon), which together account for one half of manufactured exports of the region.

Chart 1

DEVELOPING COUNTRIES: INDICES OF EXPORT VOLUME, NET BARTER TERMS OF TRADE AND PURCHASING POWER OF EXPORTS, 1981-1991

(1980 = 100)



Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1992.*

a Brazil, Mexico, Republic of Korea and (former) Yugoslavia.

b D = B-C.

c Excluding oil exporters.

Table 6

NETWORK OF WORLD TRADE: GROWTH OF EXPORTS IN 1990

(Percentage increase over 1987-1989)

	Destination				
Origin	*Developing countries*	*Developed market-economy countries*	*Countries of Eastern Europe*	*Socialist countries of Asia*	*World*
Developing countries	19.2	11.5	11.4	7.3	11.4
Developed market-economy countries	12.4	12.2	8.6	-5.5	12.0
Countries of Eastern Europe	-0.9	18.2	-25.2	-11.8	-9.9
Socialist countries of Asia	17.3	12.5	-17.7	-	11.9
World	11.9	12.2	-11.7	-1.8	10.4

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1991* (United Nations publication, Sales No. E/F.92.II.D.6), table 3.1B.

Table 7

EXPORTS FROM DEVELOPING COUNTRIES BY MAJOR PRODUCT GROUPS, 1987-1991

(Percentage)

			Annual increase 1987-1991	
Product group/SITC		*Share in 1989*	*Value*	*Volume* [a]
Primary commodities	0-1, 2-4, plus 68	20.8	6.9	4.2
Fuel	3	24.6	7.3	6.6
Manufactures	5-8 less 68	53.4	15.6	12.8
Total exports	0-9	100.0	11.2	7.7

Source: UNCTAD secretariat calculations, based on United Nations and other international sources.
a Value deflated by the unit value or price index of exports of the commodity group concerned.

(b) *Upgrading of the manufacturing sector in Asia*

One of the main factors behind the rapid expansion of exports from the eight Asian exporters of manufactures mentioned above has been the upgrading of their industrial exports toward more processed, complex and dynamic products. Table 10 shows the changing structure of exports of this group of countries as a whole, and separately for the Republic of Korea, which in 1987 was the third biggest exporter of manufactures among developing countries (after Taiwan province of China and Hong Kong) and has also been the most active in upgrading. In the table machinery and transport equipment (SITC 7) is taken as an indicator of more sophisticated manufactured and dynamic products in international trade; textiles (SITC 65) are taken as an example of simple manufactured products with an average

Table 8

MAIN EXPORTERS OF MANUFACTURES AMONG THE DEVELOPING COUNTRIES: GROWTH OF EXPORTS, 1987-1990

	Value ($ million)	Share of total exports of developing countries (Per cent)			Annual export growth (Per cent)
Region/country	1987	1980	1987	1990	1987-1990
Latin America	28 405	15.1	11.6	10.8	13.2
Brazil	12 995	7.1	5.3	4.2	7.4
Mexico	7 824	1.2	3.2	3.1	14.6
Argentina	1 996	1.8	0.8	1.0	21.9
Colombia	973	0.7	0.4	0.4	20.4
Uruguay	655	0.4	0.3	0.2	0.2
Venezuela	642	0.3	0.3	0.5	41.0
Chile	440	0.4	0.2	0.2	23.6
Peru	356	0.5	0.1	0.2	19.1
Trinidad and Tobago	342	0.2	0.1	0.1	17.5
Dominican Republic	327	0.2	0.1	0.1	9.6
Bahamas	287	0.1	0.1	0.2	26.6
Costa Rica	270	0.3	0.1	0.1	21.6
Guatemala	213	0.3	0.1	0.1	18.5
Total above	27 320	14.1	11.1	10.3	13.1
Asia	201 692	74.8	82.2	83.1	16.4
Taiwan province of China	48 893	16.6	19.9	16.2	8.3
Hong Kong [a]	44 366	17.1	18.1	19.8	19.5
Republic of Korea	43 537	14.9	17.7	15.8	11.7
Singapore	18 793	7.9	7.7	9.8	25.9
India	8 000	4.2	3.3	3.3	16.1
Malaysia	7 063	2.3	2.9	4.2	31.2
Turkey	6 725	0.7	2.7	2.3	9.3
Thailand	5 996	1.5	2.4	3.8	34.2
Indonesia	3 895	0.5	1.6	2.4	32.4
Pakistan	2 954	1.2	1.2	1.1	13.0
Philippines	2 146	1.2	0.9	0.8	14.1
United Arab Emirates	1 403	0.5	0.6	0.7	25.7
Macao	1 367	0.5	0.6	0.4	6.8
Kuwait	1 186	2.0	0.5	0.2	-7.5
Saudi Arabia	942	0.7	0.4	0.8	47.1
Bangladesh	876	0.5	0.4	0.3	9.2
Qatar	622	0.2	0.3	0.1	-6.9
Sri Lanka	614	0.2	0.3	0.3	17.6
Cyprus	365	0.3	0.1	0.1	-4.9
Jordan	349	0.1	0.1	0.1	10.3
Lebanon	316	0.6	0.1	0.1	-4.8
Syrian Arab Republic	301	0.1	0.1	0.5	79.1
Total above [b]	200 709 (193 984)	73.7 (72.9)	81.8 (79.0)	83.1 (80.8)	16.1 (16.8)

(For source and notes see end of table.)

Table 8 (concluded)

MAIN EXPORTERS OF MANUFACTURES AMONG THE DEVELOPING COUNTRIES: GROWTH OF EXPORTS, 1987-1990

	Value ($ million)	Share of total exports of developing countries [a] (Per cent)			Annual export growth (Per cent)
Region/country	1987	1980	1987	1990	1987-1990
Africa	6 171	3.6	2.5	2.6	17.7
Morocco	1 368	0.5	0.6	0.6	17.4
Tunisia	1 298	0.8	0.5	0.6	23.0
Egypt	699	0.3	0.3	0.2	6.1
Mauritius	501	0.1	0.2	0.2	17.1
Zimbabwe	417	0.4	0.2	0.1	2.8
Côte d'Ivoire	290	0.1	0.1	0.1	19.4
Libyan Arab Jamahiriya	176	-	0.1	0.1	31.5
Cameroon	152	-	0.1	-	26.3 [c]
Senegal	152	0.1	0.1	0.1	5.0
Algeria	136	0.1	0.1	-	6.2
Zaire	117	0.1	0.1	-	12.1
Kenya	115	0.1	0.1	0.1	16.7
Gabon	109	0.1	-	-	-19.0
Total above	5 530	2.1	2.3	2.2	16.5

Source: Data provided by the Statistical Division of the United Nations Secretariat.
a Including re-exports.
b Figures in brackets exclude Turkey.
c 1987-1991.

export growth rate; and iron and steel (SITC 67) are used as an example of "basic" processed manufactured products with sluggish demand.[2]

In the 1980s these countries have been rapidly diversifying not only out of primary commodities into manufactures but also into dynamic products within the manufacturing sector. The share of manufactures in their total exports increased from 53 per cent in 1980 to 79 per cent in 1990. Whereas at the beginning of 1980 light manufactured goods (mainly textiles and clothing) constituted about 40 per cent of total exports and 74 per cent of exports of manufactures, by 1990 the proportions had decreased to 42 per cent and 53 per cent, respectively, and the share of products in SITC 7 shot up to 33 per cent and 42 per cent, respectively. Significant upgrading from textiles to clothing has also taken place in a number of these countries. For the Republic of Korea the diversification in favour of dynamic products in the 1980s has been even more spectacular. The process began later than it did in Taiwan province of China or in Singapore. For example, at the beginning of the 1980s the share of SITC 7 in its total exports of manufactures was 20 per cent (compared with an average for all eight countries of 30 per cent).

Upgrading and diversification have not only contributed to expanding the volume of exports but have by and large also prevented a reduction of export unit values for manufactured goods (see below).

(c) Import penetration

Despite the recession, developing countries have considerably increased their penetration of the markets for manufactured goods of developed countries. Table 11 shows the

[2] This classification follows that used by the GATT secretariat. See GATT, *International Trade, 1990-1991*, vol. 1, Geneva, 1992, table 3.

Table 9

EXPORTS OF MANUFACTURES [a] FROM DEVELOPING COUNTRIES, BY REGION

Region	Value ($ billion)		Percentage share		Annual average growth (Per cent)			
	1987	1990	1987	1990	1980-1987	1987-1990	1989 [b]	1990 [b]
Latin America	28	41	11.6	10.7	8.7	13.2	13.4	0.4
Asia	202	320	82.2	83.6	14.4	16.6	12.8	12.4
MAE [c]	175	279	71.2	72.8	15.1	16.8	12.9	11.1
Others	27	41	11.0	10.8	10.4	15.2	11.8	22.2
Africa	6	10	2.5	2.6	7.1	17.7	12.7	14.2
North Africa	4	6	1.5	1.6	11.2	17.8	4.5	20.3
Sub-Sahara	2	4	1.0	1.1	2.6	17.6	25.8	6.1
All developing countries	245	345	100.0	100.0	12.9	16.0	12.7	10.8
Memo item:								
Least developed countries	2	3	0.7	0.7	2.7	13.1	7.7	12.0

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1992.*
a SITC 5-8 less 68.
b Growth over previous year.
c Major Asian exporters of manufactures: Hong Kong, Indonesia, Malaysia, Philippines, Republic of Korea, Singapore, Taiwan province of China and Thailand.

Table 10

MAJOR ASIAN DEVELOPING COUNTRY EXPORTERS OF MANUFACTURES: CHANGES IN THE COMMODITY STRUCTURE OF EXPORTS, 1973-1990

(Percentage of total exports)

Commodity group	All countries [a]				Republic of Korea			
	1973	1980	1987	1990	1973	1980	1987	1990
Manufactures [b]	52.3	52.8	75.9	78.8	84.0	89.5	92.2	93.2
SITC 5 [c]	2.0	2.3	3.4	4.2	1.5	4.3	2.8	3.9
SITC 7 [d]	11.5	15.9	28.1	33.0	12.0	20.3	35.8	39.3
SITC (6+8)-68 [e]	38.8	34.6	44.4	41.7	70.2	64.9	53.6	50.1
of which:								
Textiles (SITC 65)	7.5	5.5	6.9	6.8	13.5	12.7	8.7	9.3
Clothing (SITC 84)	11.9	9.4	11.9	10.0	23.3	16.9	16.0	12.1
Iron and steel (SITC 67)	1.2	1.9	1.7	1.7	5.9	9.5	5.0	5.5
Primary commodities [f]	46.7	44.9	22.3	20.1	15.8	10.1	7.7	6.5

Source: As for table 9.
a The eight countries listed in footnote *c* to table 9.
b SITC 5-8 less 68.
c Chemical products.
d Machinery and transport equipment.
e Other manufactured goods.
f SITC 0-4 plus 68.

penetration ratios for developing countries in respect of each of the three major OECD markets (North America, Japan and EEC). Since 1984-1985 import penetration has advanced most in Japan and least in North America. Nevertheless, the ratio for the United States in 1989-1990 was still twice that of Japan, and the United States remains the biggest market for exports of developing countries (see table 12). In terms of the growth of total imports from developing countries, EEC countries, particularly Germany and France, have recently been the most dynamic markets, halting the decline in the share of EEC in developed country imports from developing countries that occurred in the 1970s and early 1980s (see table 13).

3. Terms of trade and export purchasing power

The strong growth of export volumes, particularly for manufactures, in developing countries during the recession, together with the weak trade performance of sub-Saharan Africa, raises the question of the impact of volume expansion on export prices and hence on the terms of trade.

Measuring export price movements and the terms of trade, particularly for manufactured exports of developing countries, involves methodological and statistical problems. Export unit value indices for manufactured goods are estimated by the Statistical Division of the United Nations Secretariat at the aggregate level for all developing countries, but the results do not take into account changes in the product composition of these exports. Moreover, since import and export values are expressed in dollar terms, changes in the exchange rates between the dollar and other currencies affect the value of both exports and imports of developing countries, particularly if there has been a change in the geographical distribution of the exports and imports.[3]

The UNCTAD secretariat makes estimates of the terms of trade for individual developing countries and groups thereof. On the basis of this data, chart 1 shows the evolution of the net barter and income terms of trade (or purchasing power of exports) for developing countries as a whole, different subgroups and specifically for the Republic of Korea. It can be seen that while the net barter terms of trade of developing countries as a whole have fluctuated, they do not appear to have worsened in the 1980s in spite of the accelerated growth of export volumes. However, it must be borne in mind that this average is affected by substantial fluctuations in oil prices over the period.

For the non-oil exporting countries, particularly those in sub-Saharan Africa, there has been a steady decline in the net barter terms of trade since 1980. It has been smaller for the major exporters of manufactures, and in the Republic of Korea there was no decline at all. However, with the exception once again of sub-Saharan Africa, there was no decline in the income terms of trade of non-oil exporting countries: declines in the net barter terms of trade were accompanied by an expansion of export volumes. At no time during the 1980s has there been even a significant short-term increase in the income terms of trade of sub-Saharan Africa. From 1980 to 1991 they declined by 22 per cent, and from 1986 to 1991 the decline was around 17 per cent.

4. Price movements of manufactured goods and primary commodities in developing countries relative to those in developed countries

Chart 2 shows how unit value indices for exports of manufactures and of commodities from developing countries as a whole have evolved over the 1980-1991 period, as well as in relation to the movement of corresponding indices for developed market-economy countries. For both primary commodities and, to a lesser extent, manufactures, export unit values of developing countries were on a downward trend relative to those of the developed countries. The decline for commodities was about 50 per cent and for manufactures about 18 per cent. Thus, manufactures for developing countries as a whole have not escaped the decline in net barter terms of trade, although it was smaller than for primary commodities.

Similarly, in both absolute and relative terms, prices of both manufactures and commodities exported by developing countries fluctuated in response to changes in the pace of activity in OECD countries. The direction of change in developing countries' net barter terms of trade was the same as that of the GDP growth rate in OECD in 7 of the 11 years from

3 The World Bank also publishes indices of unit value, but its definition of manufactures includes SITC 9, and hence also gold, the price of which fluctuates considerably.

Table 11

IMPORT PENETRATION RATIOS OF DEVELOPING COUNTRIES' EXPORTS OF MANUFACTURES TO MAJOR OECD MARKETS, 1984-1990

(Percentage)

Exporter/market	Ratio				Increase [a] in ratio
	1984-1985	1986-1987	1988-1989	1989-1990	
All developing countries					
USA/Canada	3.29	3.78	4.21	4.25	0.47
EEC	2.94	2.74	3.14	3.21	0.47
Japan	1.65	1.51	1.96	2.11	0.60
Major exporters of manufactures					
USA/Canada	2.30	2.85	3.13	3.03	0.18
EEC	1.20	1.36	1.62	1.60	0.24
Japan	0.92	0.92	1.21	1.24	0.32

Source: UNCTAD, *Handbook of International Trade Development Statistics, 1991; ibid., 1992, table 7.1.*
a Ratio in 1989-1990 less the ratio in 1986-1987.

Table 12

EXPORTS OF DEVELOPING COUNTRIES TO MAJOR DEVELOPED COUNTRY MARKETS IN 1990

Exporting region	Percentage share in region's total exports				Exports to world
	Europe	United States	Japan	All DMECs	($ billion)
America	24	38	6	70	132
Africa	61	16	2	80	62
West Asia	27	11	32	64	106
South and South-East Asia	18	25	14	61	385
All developing countries	25	24	13	65	702
OPEC members	29	19	22	73	153
Others	23	25	10	63	548
Memo item:					
Socialist countries of Asia	10	8	16	34	66

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1991*, table A-1.

Table 13

IMPORTS OF DEVELOPED MARKET-ECONOMY COUNTRIES FROM DEVELOPING COUNTRIES, 1970-1991

(Percentage)

Country	*Annual average increase*					
	1970-1980	*1980-1987*	*1988*	*1989*	*1990*	*1991*
United States	27.5	3.3	8.2	10.2	6.6	-3.5
EEC	24.3	-6.0	15.0	10.2	18.9	3.3
Germany	22.6	-2.9	10.6	7.6	25.7	9.4
France	24.7	-7.1	7.6	11.1	24.0	2.0
United Kingdom	16.4	-2.5	23.3	5.3	14.3	-0.8
EFTA	22.0	-3.6	12.2	14.4	13.2	-1.8
Japan	29.3	-3.8	20.4	12.5	5.6	3.4
All DMECs	25.5	-2.7	15.2	12.0	7.4	2.1

	Share of total DMEC imports from developing countries						
	1970	*1980*	*1987*	*1988*	*1989*	*1990*	*1991*
United States	22.7	28.5	39.3	38.3	38.0	36.1	34.7
EEC	47.6	43.3	34.1	34.0	33.5	37.0	37.4
Germany	11.2	9.5	8.5	8.5	8.2	9.2	10.1
France	8.9	8.9	5.9	5.7	5.7	6.3	6.4
United Kingdom	10.5	5.3	4.9	5.4	5.1	5.2	5.2
EFTA	4.4	3.3	3.1	3.0	3.1	3.3	3.1
Japan	14.8	19.9	18.4	19.3	19.3	19.0	19.2
All DMECs	100.0	100.0	100.0	100.0	100.0	100.0	100.0

***Source*:** UNCTAD secretariat calculations, based on data (in current prices) of the United Nations data base (COMTRADE).

1980 to 1991 for manufactured goods; during the 12 years from 1980 to 1992 it was the same in 8 years for primary commodities. Nevertheless, the extent of sensitivity is also smaller for manufactures, and changes in unit values sometimes occur with a time lag of one year.[4]

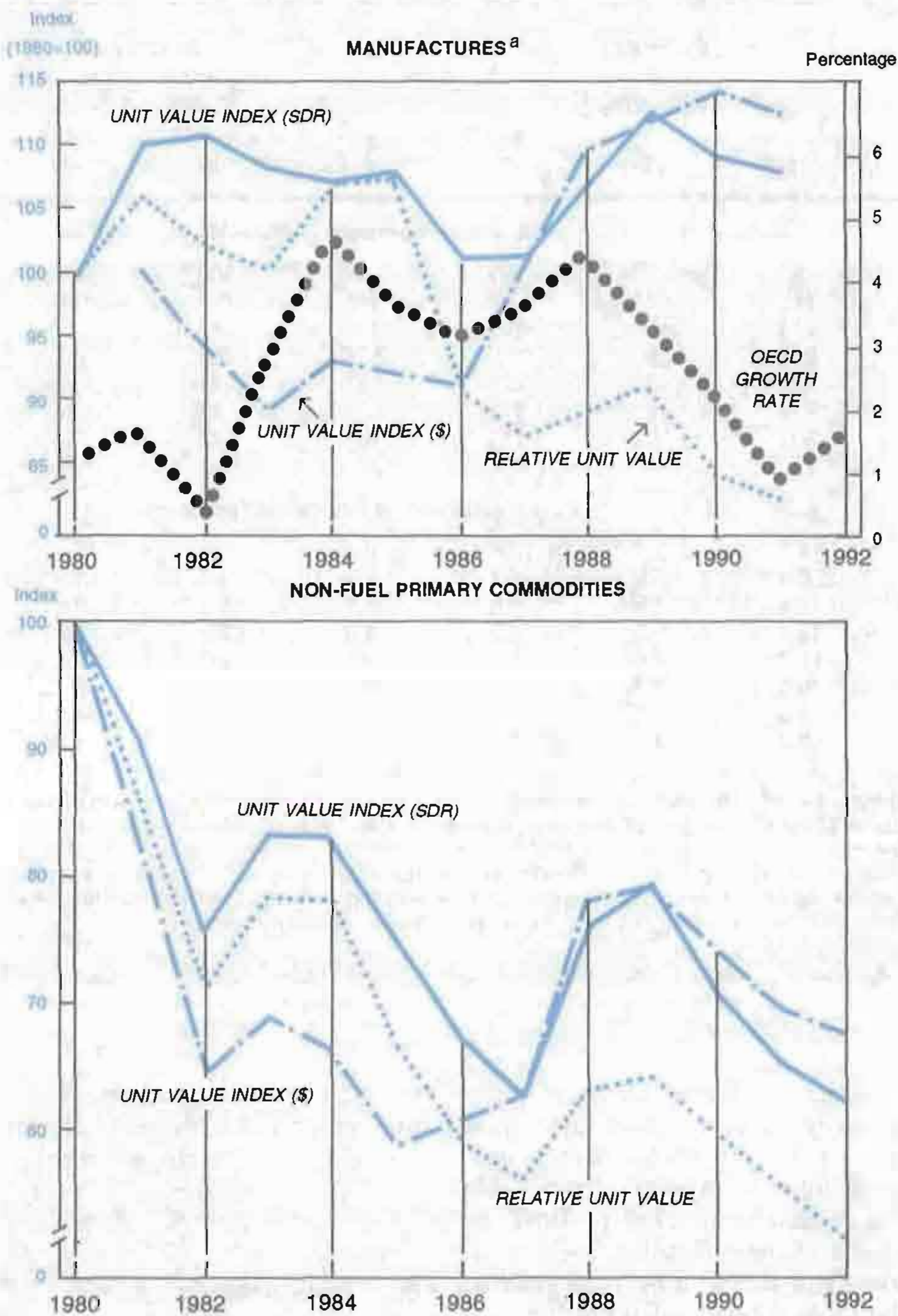
The relatively close association between commodity prices and fluctuations in economic activity is not entirely unexpected. Part of the explanation for the decline in the relative price of manufactured goods exported by developing countries is that the prices of their traditional manufactured exports are primarily demand-determined, much like those of primary commodities. Another factor is that during downswings protectionist pressures increase. In such circumstances, it is likely that the burden of price decline will be on those labour-intensive traditional manufactures exported by low-income developing countries. Because they lack a high degree of product differentiation, such exports are more subject to protectionist policies in developed market-economy countries and exposed to greater price competition in international markets.[5]

4 It should be noted that changes in supply (caused mainly by domestic factors) are also of greater significance for primary commodities than for manufactures.

5 There is evidence that for 1980-1987 basic manufactured goods exported by developing countries, particularly low-income countries, have shown more of a declining tendency in their net barter terms of trade than other manufactured exports (see T. Tesfachew, "Export drive, the behaviour of prices and terms of trade: manufactured exports of developing countries in the 1980s", UNCTAD, Geneva, 1990, mimeo).

Chart 2

MOVEMENT OF EXPORT UNIT VALUE INDICES OF MANUFACTURES AND OF PRIMARY COMMODITIES FOR DEVELOPING COUNTRIES RELATIVE TO DEVELOPED MARKET-ECONOMY COUNTRIES



Source: Real GDP: OECD, *Economic Indicators*, March 1993; manufactures: table 14; primary commodities: UNCTAD, *Monthly Commodity Price Bulletin.*

a SITC 5-8.

b SITC 0-2, 4 and 68.

Table 14

VOLUME, UNIT VALUE AND PURCHASING POWER OF MANUFACTURED EXPORTS [a] OF DEVELOPING COUNTRIES, 1980-1991

	Volume index		Unit value index				
		Relative to developed countries [b]	In terms of:		Relative to developed countries [b]		Index of export purchasing power [c]
			Dollars	SDRs	Dollars	SDRs	(1)x(5)
Year/period	(1)	(2)	(3)	(4)	(5)	(6)	(7)
			A. Index numbers (1980=100)				
1975	53	73	63	67	100	99	53
1985	157	131	92	118	107	106	168
1987	218	170	101	101	87	87	190
1988	249	180	110	107	89	89	222
1989	283	190	112	113	91	90	258
1990	310	199	114	109	84	83	260
1991 [d]	301	192	113	108	82	84	253
			B. Average annual increase (per cent)				
1975-1980	13.5	2.1	9.8	8.3	-	0.2	13.5
1980-1985	9.4	5.5	-1.7	3.3	1.3	1.2	10.9
1985-1987	17.8	13.9	9.8	-7.0	-9.8	-9.4	6.3
1987-1988	14.2	5.9	8.9	4.9	2.3	2.3	16.8
1988-1989	13.7	5.6	1.8	5.6	2.2	1.1	6.2
1989-1990	9.5	4.7	1.8	-3.5	-7.8	-7.7	0.8
1990-1991	-3.0	-3.5	-1.1	-0.9	-2.3	-1.2	-2.7
1980-1990	12.0	7.1	1.3	0.8	-1.7	-1.8	10.0

Source: Calculations by the UNCTAD secretariat, based on data of the Statistical Division of the United Nations Secretariat (*Monthly Bulletin of Statistics*, December 1992, special table E).

a SITC 5-8.

b The index for developing countries divided by the index for developed market-economy countries.

c Index of the value of manufactured exports of developing countries deflated by the index of unit value of their imports of manufactures from developed market-economy countries.

d First nine months.

A loss in the net barter terms of trade does not necessarily imply a welfare loss.[6] It is also necessary to take into account, *inter alia*, changes in the volume of exports. From table 14 it can be seen that from 1980 to 1990 the volume of exports of manufactures from developing countries tripled, resulting in a 1.6-fold increase in the income terms of trade (or purchasing power of exports). However, the situation was not the same in 1990 as in 1991. In 1990 a roughly 10 per cent increase in the export volume was accompanied by a mere 0.8 per cent increase in the income terms of trade. In 1991, however, both the export volume and the net barter terms of trade declined, leading to a fall in the income terms of trade of over 3 per cent, a fall which is likely to continue if recession in the developed world persists.

5. *Conclusions*

Recession has had a moderate impact on world trade, except in 1991. Developing countries have continued to expand their exports faster than world trade, and their growth of imports has played an anticyclical role in the

6 In the extreme case, a country could have a big improvement in the net barter terms of trade with relatively small export growth.

world economy. Manufactures have been the main driving force behind their rapid expansion of exports. However, the sub-Saharan region, with its small industrial base, has become further marginalized. The rapid expansion of manufactured exports from a number of Asian developing countries has, to a large extent, been facilitated by upgrading and product diversification toward more processed, complex and dynamic products. As a result, these countries have achieved a growing penetration of the markets of developed countries. Export expansion has also been helped by market diversification and greater intraregional trade.

While the volume of exports of manufactures from developing countries increased sharply, there was a decline in the net barter terms of trade, though not enough to prevent some improvement in the income terms of trade. The year 1991 was an exception to this general rule, but if the world continues in recession the 1991 experience is likely to be repeated.

C. Commodity markets

1. Introduction

The difficulties faced by commodity exporters in general, and more especially by developing countries heavily dependent on commodity export earnings, have persisted in the 1990s. Commodity-dependent developing countries suffered from an enormous setback during the 1980s, caused by the very depressed level of commodity prices, especially in real terms - i.e. in relation to world prices of manufactures. Prices have continued to fall in real terms for most commodities, and in nominal terms for many. For a large number of commodities, export volumes have not expanded significantly. The purchasing power of commodity exports thus remains low. Supply continues to surpass demand for most commodities and there are important stock overhangs.

Over the last two decades, the traditional structural problems faced by commodity producers and exporters, such as price and earnings instability and relatively slow growth in demand, have been exacerbated by rapidly increasing supplies. The latter stem from increased productivity and the emergence of new and efficient producers, coupled with the inability of inefficient ones to diversify into other economic activities. This has been the case, in particular, for cocoa, vegetable oils and bauxite. For a wide range of commodities exported by developing countries, the expansion in supply has also reflected the pressure to increase exports resulting from the need to service large foreign debts. Moreover, for several commodities, such as cereals, sugar, vegetable oils, meat and most dairy products, high levels of producer support in developed countries have been the main factor behind excess supplies.

The continuing recession in the main consuming countries and changes in the formerly centrally planned economies have also had a restrictive effect on commodity demand, but the latter factor has also led to increased supplies on world markets, in particular of aluminium. The economic reforms introduced in developing countries have had mixed results on the commodity supply and export earnings. While many inefficiencies have been corrected by these reforms, in several cases established export structures have been destroyed and new difficulties have emerged in commodity exports. Devaluations have contributed to reducing real wages in many developing countries, permitting lower prices for commodity exports.

2. Commodity markets in the 1990s

(a) An overview and a regional perspective

1992 was the fourth consecutive year in which the combined price index of non-fuel commodities exported by developing countries fell in nominal as well as in real terms. This has also been the case for most individual commodities. The only major group that proved

an exception was oilseeds and oils (see table 15).[7] The weakness of commodity markets is thus widespread and affects all commodity exporters in all regions.

Table 16 provides a regional picture of the impact of price movements on commodity export earnings. It shows the estimated change in commodity export earnings by region assuming that the volume of exports remained constant at the 1990 level (and that the product composition was identical to that used for calculating the price indices).[8] Over the last two years, the cumulative loss in export earnings of developing countries due to price declines amounted to 15 per cent of their 1990 earnings, which is substantially greater than the 5 per cent loss suffered by the developed market-economy countries.

Among the developing regions, the biggest losses have been experienced by Africa and Latin America. The reason is that the prices of commodities such as tropical beverages, which have a relatively larger weight in the commodity exports of those regions, declined more than those of commodities such as natural rubber, vegetable oils and timber, which are relatively more important export items for Asia. Products such as wheat and vegetable oilseeds and oils, whose prices were rising in the recent period, are proportionately much more important for developed countries and have led to a relatively better performance of the price index of their commodity exports.

(b) Main commodity groups and selected commodities

This subsection reviews recent developments in world commodity markets, focusing on price movements, for the main non-fuel export commodities of developing countries. (A summary of recent developments relating to international commodity agreements and arrangements is given in annex 1.)

(i) Basic food products

In 1992 the prices of basic food products, which are important export items for developing countries, continued to decline. However, the decline was less pronounced than in the previous two years.

The slight recovery in ***sugar*** prices in 1992, following a big decline in 1991, was a major factor explaining this result. In early 1993, prices were around their 1992 averages. Lower production forecasts for the current crop year in large Asian countries such as India and China, uncertainties regarding Cuban sugar supplies, and the possibility of larger import demand by countries of the former Soviet Union have helped prop up prices despite the prospect of record exports from Brazil and Thailand and depressed demand in Central and Eastern Europe. From a longer-term point of view, there has been a turnaround in the decline of sugar consumption in the industrialized countries, and there is much potential for an increase in consumption in developing Asia.

Another product which helped to contain the decline in the price index of basic foods is ***soybean meal***. In spite of a decline in livestock production in most regions, and particularly in the former USSR and other European countries in transition, soybean meal prices have moved up recently owing to excessive rainfall in Brazil and too little in Argentina. Also, the oil content of United States crop was below normal.

In respect of ***rice***, the emergence of Viet Nam as an exporter of more than 1 million tons of rice per year (about 10 per cent of world trade) has had a major influence on the market. The recent good crops in Indonesia and Thailand, as well as reduced imports in the former Soviet Union, have also depressed the market. Rice prices, in real terms, are at an unprecedentedly low level. As only a relatively small proportion of world rice production (about 4 per cent) enters world markets, the market situation is strongly affected by even small changes in world supply or demand.

Prices for ***bananas*** have also been declining. Export supplies remain abundant despite a strong increase in consumption. Recently, consumption has benefited from promotional campaigns, the increase of imports into Germany following unification, and expanded demand by countries such as Turkey and the Republic of Korea, which have liberalized market access.

Beef prices have also continued to decline. The growth of bovine meat production has been slow, but the level of consumption has been stagnant.

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7 This group has the smallest weight among all the groups appearing in the table. Prices of these products are still very low level when viewed against the longer-term trend.

8 The percentage change in export earnings is thus assumed to be the same as that in the price index of the region's exports.

Table 15

FREE MARKET PRICE INDICES FOR PRINCIPAL GROUPS OF COMMODITIES [a] EXPORTED BY DEVELOPING COUNTRIES, 1990-1992

(1985 = 100)

	Nominal			Real [b]		
Commodity group	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
All food	117	110	107	82	77	71
Basic food	151	141	138	106	98	91
Tropical beverages	62	57	49	43	40	32
Vegetable oilseeds/oils	74	80	86	52	55	57
Agricultural raw materials	137	128	125	95	89	83
Minerals, ores, metals	148	134	129	103	93	86
Total [a]	127	119	115	89	83	76

Source: UNCTAD, *Monthly Commodity Price Bulletin*, vol. XIII, No. 4, April 1993.

a Excluding fuels.

b Nominal prices deflated by the United Nations unit value index of manufactured goods exported by developed market-economy countries.

Wheat production has fallen from its record level in 1990. Coupled with strong import demand, this has caused a significant drop in world wheat stocks and an increase in prices.

(ii) Tropical beverages

The sharp downward trend in prices for tropical beverages has continued. The 1992 average, in nominal terms, was about 20 per cent below the already very low level of 1990, and less than one half that of 1985. Real prices are down from 1985 by about two thirds. The collapse of the price-stabilizing mechanisms of the international coffee and cocoa agreements has been a major factor precipitating these price declines.

The ***coffee*** market continues to be characterized by excess supply. A high level of production and rather modest increase in consumption caused prices to reach in August 1992 their lowest level ever recorded in real terms, and one of the lowest levels in nominal terms since 1970. World demand has increasingly favoured the arabica group of coffees and demand for robustas has declined, affecting in particular African producers such as Cameroon, Côte d'Ivoire and Uganda. The very low prices have encouraged importers to accumulate substantial stocks. In the 1991/92 crop year, world coffee exports increased in volume by 4.4 per cent, but declined in value by 15.2 per cent. Current prices are widely believed to be below the normal variable costs for a large number of coffee growers.

During the past 10 years, the world ***cocoa*** economy has also been characterized by persistent oversupply, resulting in unprecedentedly high stock levels and the collapse of prices in both real and nominal terms. The impact on the market of seven years[9] of persistent overproduction, when annual output rose by 4.6 per cent but consumption only by 3.7 per cent, has been such that, despite a production deficit in 1991/92 and expectations of a further deficit in 1992/93, cocoa prices have continued to fall. For the calendar year 1992, average prices were the lowest in nominal terms since 1972 and the lowest ever in real terms since records began to be kept in 1854.

As a result of increasing output and stagnating demand, ***tea*** prices have been on a declining trend. After falling steadily for more

[9] 1984/85 - 1990/91.

Table 16

ESTIMATED LOSS OF COMMODITY [a] EXPORT EARNINGS BY REGION, 1990-1992, DUE TO PRICE CHANGES

	Commodity export earnings ($ billion)	Loss due to price change ($ billion) [b]			Cumulative loss 1991-1992
Region	1990	1991	1992	1991-1992 (cumulative)	Per cent of commodity earnings
Developing countries	128.53	7.30	11.66	18.94	14.8
of which in:					
America	55.66	4.68	7.24	11.91	21.4
Africa	18.12	1.74	2.61	4.35	24.0
Asia	54.75	0.88	1.81	2.68	4.9
Developed market-economy countries	359.09	11.13	5.75	16.88	4.7

Source: UNCTAD, *Commodity Yearbook, 1992* (United Nations publication, Sales No.E/F.92 II.D.8). Price indices are from UNCTAD, *Monthly Commodity Price Bulletin* and United Nations, *Monthly Bulletin of Statistics.*

a Primary commodities excluding fuels.

b In 1990 prices (see text).

than two years to reach in 1991 the lowest real levels ever recorded, they have somewhat improved thanks to drought in almost all the main exporting countries, causing production failures.

(iii) Vegetable oilseeds and oils

As noted above, this is the only group of commodities whose price index rose during the last three years, although from extremely low levels. ***Palm oil***, the most important vegetable oil in terms of exports for developing countries, showed the strongest increase in prices. Output in the Far East has yet to fully recover from the lagged effects of the drought last year which, combined with relatively low stock levels, stimulated a price rise. However, prices have remained considerably below pre-1990 levels in both nominal and real terms.

Prices of ***soybean oil*** remain steady in spite of the expected large bean crop in Latin America, because of the low oil output in the United States (due to the low oil content of beans referred to above) which caused a reduction in stocks from the record levels reached last year. There has also been a significant rise in consumption and world trade.

(iv) Agricultural raw materials

Prices for agricultural raw materials, as a group, have fallen in the 1990s. The decline from 1990 to 1993 was particularly pronounced for cotton and jute, while prices rose for timber, both tropical and temperate.

Cotton prices have been generally influenced by supply variations in the face of stable demand. For example, after ample production and very low prices in 1992, estimates that cotton production in the 1992/93 crop would be about 11 per cent lower than in the previous year have led to a slight recovery in prices.

In the ***natural rubber*** market, demand and supply have been relatively steady. However, the abundance of supplies in relation to demand has kept prices low for most of the period since 1990.

Prices for ***tropical timber*** remained relatively steady in spite of the slowdown in the construction industry in the industrialized countries. Demand was strong in producing countries, and prices for temperate zone hardwood increased rapidly, providing a stimulus to tropical hardwood prices as well.

(v) Minerals, ores and metals

The decline in prices for this commodity group has been steady and general in the 1990s. World stocks of non-ferrous metals have reached very high levels, in particular for aluminium and nickel but also for tin, zinc, copper and lead. Average production costs of several metals, including platinum and lead, are estimated to be considerably higher than market prices.

Aluminium prices, which had fallen almost continuously since the end of 1990, recovered somewhat in early 1992 but fell again towards the end of the year, reaching very low levels in the first quarter of 1993. Prices have been strongly influenced by the supply situation, including the emergence of supplies from the Russian Federation, and by announcements, in 1992, of closures and cutbacks in operating rates of aluminium smelters in North America and Western Europe.

Bauxite prices, which are usually determined by formulas contained in long-term contracts, appear to have been relatively little affected by the downturn in aluminium prices, although there is a growing tendency to link prices of bauxite to the world aluminium price. This link may influence the price obtained by some bauxite producers, such as Brazil, exporting bauxite rather than aluminium.

Since 1990 ***copper*** prices have been gradually declining, mainly affected by the slowdown of economic activity in the major industrialized countries and a constant increase in mine production. The impact of this slowdown, however, was attenuated by continuous minor supply disruptions, mainly in Africa, Chile and Poland, and by the rising imports of China, where consumption has been increasing faster than production. Furthermore, demand in the United States has recently begun to pick up. However, because of heavy selling by several suppliers, including countries of the former USSR and China (the latter previously having been a substantial importer), prices have recently plummeted to a five-year low.

The price of ***tin*** declined considerably from 1990 to 1991. It then remained within a fairly narrow band throughout the year, but at a level low by historical standards. World tin mine output declined as continued low tin prices brought about numerous mine closures. Demand fell because of recession in the industrialized countries and economic difficulties in the former Soviet Union. In the United States there was continued interest in the recycling of used tin cans, largely due to the rising costs of producing the primary metal, especially in the late 1980s, and the limited space available for landfills. In 1992, the price of tin recovered somewhat, particularly in the middle of the year. However, this seems to have been largely due to some supply disruptions, and to speculation associated with them. By the end of 1992 prices had resumed their declining trend, which has continued into 1993.

After three years of recovery ***iron ore*** prices started to fall in 1992 as a result of weakening demand and high stocks. As the imbalance of world supply and demand worsened, price negotiations between the major exporters and importers for 1993 resulted in a further drop of 11 per cent, eroding the gains obtained by the iron ore industry in 1989/90 and 1990/91. These two consecutive years of price decline reflected not only the impact of the world recession, but also the fierce competition among suppliers in a shrinking market. In addition, most suppliers seem to consider it more important to obtain long-term contracts for assured quantities rather than short-lived price advantages. Steelmakers continued to press strongly for further cuts in ore prices in order to counteract the effects of growing tensions in steel trade and low steel prices.

3. Special features of the current commodity market situation

Several longer-term structural factors have contributed to the emergence of depressed commodity markets. On the demand side these include the increased importance in developed countries of sectors that are relatively less commodity-intensive; the substitution of traditional materials by synthetics and composites; and the saturation point reached in per capita consumption of many foods in developed countries.[10] This subsection focuses on two issues of current importance: the link between commodity demand and the current recession in the industrialized world and the impact on commodity markets of the changes taking place in the formerly centrally planned economies. It also discusses some changes in trading policies and practices which affect commodity markets (box 2) and the impact on them of growing environmental concerns (box 3).

[10] See *UNCTAD VIII. Analytical Report by the UNCTAD Secretariat to the Conference* (TD/358), United Nations publication, Sales No. E.92.II.D.3, chap. V.

Box 2

IMPACT OF CHANGES IN TRADING POLICIES AND PRACTICES ON WORLD MARKETS FOR BANANAS, SUGAR AND RUBBER

Bananas

As a result of its policy of trade liberalization, Turkey's imports of bananas in 1991 reached 80,000 tons, representing a five-fold increase in two years. Similarly, in the Republic of Korea, the volume of banana purchases during 1991 increased to over 310,000 tons, from 24,000 tons in the previous season. Partly as a result of these developments, developing countries increased their share of world banana imports to 10.6 per cent, compared to 7.6 per cent in 1990. The market for bananas will be significantly affected by changes in the EEC import regime. In February 1993, the EC Council accepted a market organization in the banana sector and an action plan to assist Community producers and the ACP countries, which entered into force on 1 July 1993. [1]

Sugar

An important development in the world sugar economy has been the break-up of preferential markets. The share of the free market in world sugar trade went up from 69 per cent in 1989 to 87 per cent in 1992. In the past, short-term supply and demand variations used to cause very large price fluctuations because their impact was felt exclusively on this portion of the market. Thus, a significant result of the enlarged role for market-based trade in sugar is likely to be to reduce the excessive price volatility traditionally observed. Sugar traded under preferential agreements used to include some 4-5 million tons (almost one quarter of world trade) between Cuba and the former Soviet Union. It is now basically confined to trade between EEC and its ACP partners, quota imports of the United States and barter arrangements between Cuba and China.

Rubber

A factor which has contributed to relative stability in the rubber market has been the broader geographical spread of the tyre industry over the last 10 years, embracing countries such as China, Indonesia, Malaysia, Mexico, Thailand and Turkey, where production increased considerably. Economic conditions in a single market consequently have a smaller impact on prices than earlier. So far, for example, the slowdown in the Japanese car industry has not yet had any strong repercussions in the rubber market.

1 For a more detailed discussion of trade policy with respect to world trade in bananas see box 4.

(a) The recession and the commodity sector

The recession in the industrialized countries, which remain the principal markets for commodities, has been a major factor depressing commodity prices, particularly those of most metals, minerals, and timber, which enter into the production of consumer durables and investment goods. However, the fact that the downturns in different industrialized countries did not occur simultaneously has prevented world demand from falling to catastrophically low levels, while demand in developing countries has held up relatively well. Moreover, occasional supply disruptions (for example, for copper and cotton) and in some cases environmental factors, such as in the aluminium and timber markets, have provided some support to prices.

Recessionary periods generally cause significant restructurings in the metals and minerals industry. While such developments are indeed taking place, their magnitude is comparatively small because either the industries have recently completed major restructurings (e.g. copper and aluminium) or they are in the midst of one initiated earlier (e.g. iron and steel).

As already noted in the previous subsection, in 1992 demand for iron ore was particularly strongly affected by the economic slowdown. Iron ore is one of the few major commodities entirely dependent on a single end-use, namely the iron and steel industry. Weak world demand has resulted in large cutbacks in iron and steel production, particularly

Box 3

ENVIRONMENTAL CONCERNS AND COMMODITY MARKETS

Commodity production, processing and trade are being increasingly affected by various kinds of measures already undertaken or being considered for dealing with global or local environmental problems.

Restrictions on trade

The first type of effect stems from regulations and restrictions based on environmental concerns but imposed directly on trade. Some of these regulations, such as those included in the Basel Convention which affects, for example, the trade in metal scrap, stem from international agreements. Others, such as the possible restrictions by European countries on imports of tropical timber, are a matter of unilateral action. Although it is too early to assess the actual impact of these regulations on commodity exports of developing countries, or on environmental protection, it is clear that they change the parameters of international commodity trade and limit the options open to exporters and importers.

Tropical timber is likely to be the commodity which will face the most important commercial restrictions, or threats thereof, based on environmental grounds. Global tropical forest loss as a result of logging, however, is a relatively minor part of total deforestation, close to two thirds of which is attributable to the conversion of forest land to agriculture. The more profitable is the exploitation of timber, the more important becomes sustainability and preservation of the resource base and the less likely is conversion of the land to other uses.

Recycling and recyclability requirements also affect the commodity sector, although they are not, strictly speaking, restrictions on commodity trade. Manufacturers are being required by law to recycle increasing proportions of the raw materials used, and exporters are being required to take back the "waste" produced by their products. While the demand for virgin material is reduced as a result of recycling, hurting exporters of several commodities, developing countries may find new opportunities in the international division of labour which will result from increased global recycling activities.

Regulations on production processes

The second type of effect stems from national and international measures implemented to safeguard or rehabilitate the environment. These measures, which can be market-oriented or regulatory, affect production processes directly and impose additional costs on producers.

In agriculture, such measures may seek the prevention of excessive or misapplied use of chemical inputs and the depletion of natural resources as a result of erosion or the degradation of the soil. While excessive chemical inputs create environmental problems in developed countries, in the developing world a far more relevant problem is generally low application rates and the consequent depletion of soil nutrients.

After some decades of the green revolution and the "chemicalization" and "industrialization" of agriculture, environmental issues have gained considerable importance on the agronomical research agenda. At the frontier of agricultural technology many traditional techniques for sustainable agriculture are being re-evaluated and supplemented by innovative elements. The intention is to replace chemical technology with management skills. It is important, however, that producers, particularly in developing countries, have access to the necessary finance and technical support if they are to adopt the desirable practices.

In the production of metals and minerals as well, environmental regulations are adding to costs of production. It has been estimated that increasingly stricter environmental regulations may add up to 15 per cent, in real terms, to the cost of copper production and 12 per cent to that of aluminium production by 1995. Stricter environmental regulations also act as a barrier to entry into industry. This effect is important for local firms in developing countries and for small firms in general. By contrast, big transnational corporations operating in countries with tight regulations often already have the technology which meets new standards. The cost effect is likely to be greater for existing installations than for new ones.

Box 3 (concluded)

However, environmental protection does not always have to be accompanied by higher costs. Productive efficiency often leads to environmental efficiency also. Some cost-saving innovations are environmentally favourable. For example, recently installed bacterial leaching in Chile prevents acid water pollution and at the same time allows lower grade ores to be used. Similarly, cost savings have been realized in the aluminium industry as a result of measures to reduce fluoride emissions.

Potential for environmentally preferable products

The third type of effect is a potential increase in demand for those natural products which have environmental advantages, such as biodegradability and recyclability. While many such products originating from developing countries can be identified, their market potential is not fully exploited because of lack of information, supply difficulties, and unfavourable market and industry structures. In this respect, the environmental advantages of some agricultural commodities, such as jute, coir and other fibres, are well known, although their potential may not be fully appreciated. For others, such as organic pesticides/insecticides, vegetable oil-based products, and products made of waste in agriculture, forestry and fisheries, they are less widely recognized. In some cases local technologies employed in commodity production and processing also provide scope for better management of natural resources and advantages in export promotion.

Environmental concerns and the pricing of commodities

An underlying cause of environmental degradation is that the environment, including biodiversity resources, has been used as a free input into production. Environmental and resource costs (or benefits) are not adequately (if at all) included in the prices of commodities. Thus, the main thrust of policies must be a better internalization of these costs and benefits. Whether the environmental factor is dealt with as a regulatory or pricing issue, there will be repercussions on the prices of products. The user of a good should pay for preventing harm to the environment or for repairing harm caused during its production.

Although the principle of the inclusion of environmental and resource costs into prices is a well accepted one, its implementation, whether through regulation or the market, is fraught with difficulties. It amounts to no less than establishing a new value system through international consensus. There are practical problems, such as the specific characteristics of the many externalities to be considered, difficulties in accounting, the physical, legal and institutional framework in which production of and trade in the specific commodity take place, and the choice of a time horizon. Moreover, the new value system could radically alter the competitive positions of specific commodities and countries.

in Japan and Germany, the two major markets for traded iron ore. The market contraction has had a greater impact on trade, mainly due to the sharp drop of iron ore imports into Japan (11 per cent) and EEC. World iron ore exports fell by about 8 per cent in 1992, affecting all ten major exporters.

Ten years after the difficult period of oversupply in 1982-1983, the iron and steel industry is back in crisis. Since that period the industry, particularly in developed market-economy countries, has embarked on a restructuring process which has not yet been completed. Modernization and stricter environmental regulations are leading to the elimination of old ironmaking capacity, particularly in industrialized countries. In contrast, new directly reduced iron capacity continues to be built, mainly in countries well endowed with natural gas and/or iron ore reserves, as in Venezuela. The search for cleaner and environment-friendly technologies has been favouring the acceptance of gas-based direct reduction methods, as well as the development of new ironmaking processes designed to bypass the coke oven/blast furnace traditional steelmaking route.

Recession has also curtailed aluminium demand, but there have been various offsetting factors. In some countries (mainly the United States) technological development has continued to stimulate aluminium consumption. Moreover, some important consuming sectors, such as packaging (mostly aluminium cans), have been relatively little affected by the recession because it has hardly affected beverage consumption. It should be noted, however, that more than half of the raw material needs

of the two sectors mentioned above are covered by secondary metal, and consequently the positive development of consumption in these sectors has a limited impact on primary metal demand, which is particularly important for bauxite producing countries.

Despite the recession, operating rates for aluminium smelters have remained high; cutbacks made by the end of 1992 and those announced in early 1993 correspond to less than 5 per cent of capacity. This contrasts with the massive closures of smelter capacity in 1985-1986, which resulted in the present "leaner" industry structure. An important reason for the more restrained response, apart from the relatively small impact of the recession on demand, is the reduced degree of concentration in the industry and the diminished market power of the major producers, whereby it has become more difficult to achieve an orderly reduction in operating rates. Furthermore, the present flatter shape of the industry cost curve, combined with rapidly changing exchange rates, have made the identification of marginal capacity more difficult. A number of aluminium smelters have also succeeded in insulating themselves from the effects of price falls by linking the prices of inputs, such as electric power and alumina, to the aluminium price, and this is likely to have made it less necessary to reduce operating rates in response to downward pressure on output prices. Finally, the costs of closing down smelters are probably quite high since many have long-term contracts for aluminium and power contracts which involve a significant fixed charge.

Among food commodities, beef and veal consumption has been significantly affected by recession. While developing countries are not important exporters of meat to the developed countries, the latter's decrease in beef consumption has also led to a decline in demand for feedstuffs, some of which are important export products for several developing countries. Moreover, the availability of exportable surpluses from the developed suppliers of meat has intensified the competition facing those developing countries which are exporters of these products.

In the case of copper, the recession had little effect on output. World mine production has risen almost continuously since the mid-1980s, assisted by both expansion of existing capacity and new projects that have come onstream in recent years, notably in Chile, Indonesia and the United States. This trend has not been affected even by recession, since prospects for the copper market over the medium term are considered good. Production of refined copper followed a similar trend, a reduction in the world total taking place only in 1991, which was accounted for by the difficulties in the transition economies. Prices of refined copper have recently declined, but the new technologies introduced in the 1980s have made possible a considerable reduction in production costs.

(b) Effects of changes in the transition economies on commodity markets

The changes taking place in the European countries that are in transition to a market economy have led to unusual fluctuations in domestic demand for and/or supply of commodities. First, because of declining incomes and foreign exchange shortages, these countries have reduced their imports of commodities in spite of generally falling world prices. Second, because of the pressing need to earn foreign exchange at a time of sharply declining domestic demand due to reduced industrial activity, they have been able to increase greatly their exports of commodities. Table 17 provides estimates of the changes in import and export volumes of the former Soviet Union and countries of Central and Eastern Europe for selected products.

(i) Reduced import demand

The reduction in import demand has been important for a wide range of products. As may be seen from table 17 (limited to commodities for which relatively reliable data are available), cocoa and tea are two items of special importance to developing countries where imports have declined sharply. The USSR formerly accounted for close to 10 per cent of world imports of cocoa.

In the Russian Federation and other former republics of the USSR, basic foodstuffs are given priority in the allocation of foreign exchange resources over less essential items such as cocoa, coffee and tea. For example, the bulk of coffee is imported into Russia from India under an intergovernmental agreement and thus is crucially affected by the Government's decisions. There is also a small but lucrative private trade in these products. Per capita consumption of coffee in the former USSR, which was never very high, has fallen by about 20-30 per cent since 1991.

Imports of cocoa beans into the region and the consumption of cocoa products fell by about 60 per cent and there was a similar, though smaller, fall in most countries of Cen-

Table 17

CHANGES IN EXPORT AND IMPORT VOLUMES OF COUNTRIES IN TRANSITION FOR SELECTED PRODUCTS

Commodity	Country	Period	Percentage change [a]
Imports			
Cocoa	Russian Federation	1989/90-1991/92 [b]	-83
	Bulgaria	"	-21
	Former Czechoslovakia	"	60
	Romania	"	-10
	Hungary	"	-11
Tea	Former USSR [c]	1991-1992	-50
Bananas	Former USSR	1990-1991	45
	Former Czechoslovakia	"	-1
	Hungary	"	-12
	Romania	"	9
Meat	Former USSR	1989-1992	430
Iron ore			
	Former Czechoslovakia	1990-1991	-15
	Poland	"	-33
	Romania	"	-35
	Hungary	"	-7
	Bulgaria	"	-70
Tin	Former USSR	1990-1992	-37
Exports			
Iron ore	Former USSR	1990-1992	-25
Aluminium	Former USSR	"	300-400 [d]
Lead	Former USSR	1991-1992	100
Timber	Former USSR	"	20

Source: UNCTAD secretariat estimates.
a From beginning to end of period shown.
b Crop year.
c From India.
d Net exports (to developed market-economy countries and developing countries).

tral and Eastern Europe. These countries together used to account for about 17 per cent of world imports of cocoa beans, and the impact of their reduced consumption on the world market has been considerable. Imports of tea also declined considerably. Sales to the former republics of the USSR by India alone fell in 1992 to half the previous year's level, contributing to arresting the rise in tea prices that might otherwise have occurred. Nevertheless, stocks are being depleted and there is potentially a large demand which would have to be filled through increased imports.

Declining production in the industrial sector has sharply reduced the demand for, and curtailed imports of, industrial raw materials such as lead, tin and zinc, in all these countries. Consumption of iron ore, which was mostly satisfied from within the region, has also declined, enabling exports to other markets to expand. Imports of natural rubber also fell as defence expenditure was scaled down.

The ability to import bulk commodities, in particular, food products, from the industrialized countries is crucially affected by the availability of suppliers' credits. For example, there was a spectacular rise in meat imports into the region in 1990-1992 on account of special credits and food aid programmes.

(ii) Increased exports

Declining production in heavy industry, including defence, has been the main factor in

increasing export availabilities from the former republics of the Soviet Union for such products as aluminium, nickel and copper. A further factor has been the dismantling of the central trading structures and the freedom to export granted to enterprises. In some cases even larger exports would have been possible, but they were hindered by lack of essential inputs such as energy, inadequate transport infrastructure and weak marketing institutions.

The most evident impact of increased exports has been on the aluminium market. World demand for aluminium grew in 1991 and 1992, albeit slowly, but supply increased much more as a result of the increased capacity and capacity utilization (noted above) compared to earlier recessions. This tendency has recently been reversed. Another important factor has been the increase in exports from the former republics of the USSR. At the beginning of 1992 there was a general belief reinforced by delays in shipments from Russia, that these exports could not remain for very long at the level reached in 1991. However, net exports turned out to be much the same as in 1991, and world stocks continued to rise. While net exports in 1993 are expected to remain more or less unchanged, they are expected to decline as domestic demand increases in the long run.

In the case of copper, consumption in Central and Eastern Europe also fell steadily, with the biggest decline in the former Soviet Union. For the region as a whole consumption in 1991 was 35 per cent below the 1987 level. However, since production also fell, exportable surpluses rose much less. Net exports of tropical timber also rose.

For cotton, there was a temporary decline in production largely because land formerly used for cotton was diverted to the cultivation of grains in many of the Central Asian republics, with a consequent sharp decline in exports. There were also marketing problems immediately following the break-up of the Soviet Union, as the control of cotton exports shifted from Moscow to the inexperienced Central Asian republics. However, exports recovered quickly and are expected to surpass the 1989/90 level in 1992/93.

D. Major developments in trade policy

In recent years trade policies have exhibited three main trends: (a) trade liberalization in developing countries and in Central and Eastern Europe; (b) the persistence of protectionist threats and managed trade in developed countries; and (c) moves toward regional and subregional integration in various parts of the world. This chapter examines the first two of these trends.[11]

The process of trade liberalization in developing countries, which started in the mid-1980s, continued in 1991 and 1992.[12] Many countries took further steps to open up their economies and to foster their integration into world markets. Many further reduced their tariff rates or simplified or bound most of their tariffs, often in the context of wide-ranging economic reforms. Considerable import liberalization measures in the non-tariff area have also been implemented in a number of countries, with the declared intention of achieving full liberalization around the middle of the decade.[13] Moreover, several developing countries have decided to no longer invoke section B of GATT article XVIII, which permits import restrictions for balance of payments reasons. Countries in Central and Eastern Europe, too, have embarked on fundamental economic reforms embracing liberal trade policies. Several of the newly independent States of CIS have declared their intention of adopting outward-

11 Issues in regional integration are extensively dealt with in a report by the UNCTAD secretariat submitted to the Trade and Development Board at the first part of its fortieth session (September 1993). See "Evolution and consequences of economic spaces and regional integration processes" (TD/B/40(1)/7).

12 For a summary of salient measures taken by different countries see annex 2.

13 For a list of actions in this direction previously taken by developing countries see *TDR 1991*. An assessment of trade policy reforms in developing countries examined in the context of the major policy issues for the 1990s is contained in *UNCTAD VIII. Analytical Report by the UNCTAD Secretariat to the Conference* (TD/358), United Nations publication, Sales No. E.92.II.D.3, chap. II, sect. C. The dramatic changes achieved by developing countries in their trade regimes since their inception are described in *Issues and Developments in International Trade Policy* (Washington, D.C.: IMF World Economic and Financial Surveys, August 1992), pp. 40-49, tables 11-13.

oriented policies, in spite of the disruption of trade which accompanied the serious economic difficulties of the transition process. It is, however, worth noting that the abandonment of quantitative restrictions, import licensing and price measures in developing countries has been accompanied by the adoption of anti-dumping and anti-subsidy legislation to counter surges of dumped or subsidized imports.

By contrast, there has been only modest trade liberalization in developed countries (see section B of annex 2). Some have made liberalization contingent upon the attainment of their objectives in international trade negotiations while others have provisionally implemented tariff reductions pending a satisfactory outcome of the Uruguay Round. Only a few have reduced trade restrictions on a MFN basis. Australia decided to reduce import tariffs, tariff quotas and industry assistance as part of a plan aimed at making the Australian economy more competitive. New Zealand announced the continuation of reforms of its tariff structure and the removal of the remaining import licence controls on certain apparel items. Sweden removed all quantitative restrictions on textile imports as from August 1991. Otherwise, where liberalization has occurred, it has been selective.

The average level of MFN tariffs in developed countries has been lowered significantly from near 40 per cent in the years following World War II to an average of around 5 per cent at present. This trend indicates the downgrading of tariffs as an instrument of trade policy in favour of other means of protection. Nevertheless, high tariffs and tariff escalation remain serious problems for products in which developing countries have a competitive edge. High MFN tariffs are applied on agricultural products (in particular tropical ones), textiles, clothing, footwear, ceramics and glass. Tariff escalation often results in high effective rates of protection for semi-processed and processed products, thus discouraging exporting countries from further processing their raw materials and so increasing the value added of their final exports. It affects their exports of food and beverages, leather, textiles and petrochemicals.

Besides, non-tariff measures have increasingly been used to protect domestic industries in decline, such as steel, and more recently even high-technology industries such as electronics. Such trade policy actions, which have become increasingly widespread in recent years, consist mainly of measures falling outside the framework of the GATT safeguard mechanism, such as "voluntary" export restraints (VERs) as well as other "grey-area" measures, and of measures affording administrative protection, such as anti-dumping and countervailing duty actions. By their very nature they are applied selectively to products originating in certain countries, thus eluding the strict constraints imposed for the application of multilaterally accepted safeguard measures. Moreover, in many instances emergency measures under GATT article XIX have been taken or have remained in force, although their use has declined with the increased recourse to "grey-area" measures.

The move towards regional and subregional integration has been accelerated in recent years.[14] Among the numerous integration schemes are: the North American Free Trade Agreement (NAFTA); the MERCOSUR Treaty, aimed at the economic integration of Argentina, Brazil, Paraguay and Uruguay; the agreements reached in the framework of the Initiative for the Americas, aimed at ultimately creating a free trade area in the western hemisphere; several bilateral and subregional agreements in Latin America; the completion of the Single European Market and its extension through the European Economic Area; the integration of Eastern and Central European economies into Western Europe; the attempts at integration in Asia and the Pacific through the upgrading of the Asian and Pacific Economic Co-operation (APEC) group and other initiatives; and the steps taken towards an integration of the countries members of the Organization of African Unity.

1. Persistent use of non-tariff measures in developed countries

Calculations of the use of non-tariff measures (NTMs) in eight developed countries and EEC over the period 1981-1991, shown in table 18,[15] indicate that despite continued growth in world trade since 1983 and the ongoing Uruguay Round negotiations, the use of

14 See *TDR 1991*, Part One, chap. III.

15 The figures up to 1981 were calculated using 1986 trade weights, while those for 1988-1991 have 1988 trade weights. For a more detailed description of the methodology used and an explanation of the underlying measures which determined these trends, see the various annual reports by the UNCTAD secretariat to the Trade and Development Board on "Problems of protectionism and structural adjustment" (TD/B/1126, TD/B/1160, TD/B/1196, TD/B/1240 and TD/B/1282), and "Selected issues on restrictions to trade" (UNCTAD/ITP/24).

Table 18

FREQUENCY RATIOS AND IMPORT COVERAGE RATIOS [a] OF SELECTED NON-TARIFF MEASURES [b] APPLIED BY SELECTED DEVELOPED MARKET-ECONOMY COUNTRIES [c] IN THE PERIOD 1981-1991

(Percentage)

SITC	Product group	Trade flows (thousands)	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
						FREQUENCY RATIO: all selected NTMs							
0-9	All products	1 099	15.1	15.4	15.5	15.6	16.8	16.9	17.0	15.5	15.2	15.0	14.8
0-9 less 3	All non-fuel products	1 092	15.1	15.3	15.5	15.6	16.8	17.0	17.0	15.5	15.3	15.0	14.8
0+1+22+4	Food	98	34.6	34.9	35.0	35.0	35.3	35.3	35.3	34.9	34.8	34.7	34.5
2 less (22+27+28)	Agricultural raw materials	36	9.2	9.2	9.2	9.0	9.3	9.4	9.4	9.2	9.2	9.1	9.0
27+28+67+68	Ores and metals	66	18.6	19.1	18.9	19.7	21.5	23.2	22.8	21.1	20.8	19.9	19.7
3	Fuels	6	18.0	21.4	21.4	11.3	12.6	12.6	13.2	12.4	12.4	11.9	11.6
5	Chemicals	110	7.4	7.7	7.8	7.9	9.1	9.3	9.2	7.7	7.3	7.2	7.0
6-8 less (67+68)	Other manufactures	783	13.7	13.9	14.1	14.2	15.5	15.5	15.6	14.0	13.7	13.5	13.3
		Imports ($ billion)				IMPORT COVERAGE RATIO: all selected NTMs							
0-9	All products	1 400	20.2	20.6	20.8	17.0	17.4	17.9	18.7	18.3	19.1	19.0	18.3
0-9 less 3	All non-fuel products	1 220	16.2	16.6	16.9	17.1	17.5	18.1	18.6	18.2	19.1	19.0	18.3
0+1+22+4	Food	123	35.4	36.0	36.5	38.2	38.7	36.3	36.3	35.6	35.7	36.0	35.6
2 less (22+27+28)	Agricultural raw materials	61	3.4	7.2	7.2	3.6	3.8	7.7	7.7	3.8	3.8	3.8	3.7
27+28+67+68	Ores and metals	112	14.4	15.7	15.4	17.5	17.0	18.7	18.5	18.5	18.5	17.4	17.3
3	Fuels	180	47.4	47.7	47.7	16.9	16.8	16.8	19.0	18.9	18.9	18.9	18.8
5	Chemicals	92	9.1	9.2	9.3	9.4	9.6	10.1	10.2	9.7	9.6	9.8	9.8
6-8 less (67+68)	Other manufactures	832	15.4	15.3	15.7	15.7	16.4	17.0	17.7	17.6	19.0	19.9	17.8
						IMPORT COVERAGE RATIO: "narrow" definition of NTMs							
0-9	All products	1 400	13.0	13.1	13.1	13.4	13.3	13.3	13.4	13.5	13.4	13.2	13.3
0-9 less 3	All non-fuel products	1 220	12.6	12.8	12.8	13.1	13.0	13.0	13.1	13.2	13.1	12.9	13.0
0+1+22+4	Food	123	30.5	31.4	31.5	30.8	30.7	30.1	30.6	32.3	32.3	31.2	30.8
2 less (22+27+28)	Agricultural raw materials	61	2.3	2.4	2.4	2.3	2.3	2.3	2.3	2.4	2.4	2.4	2.4
27+28+67+68	Ores and metals	112	11.8	12.4	9.8	13.9	14.5	14.9	14.9	14.6	14.5	13.5	13.4
3	Fuels	180	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3	15.3
5	Chemicals	92	6.0	6.1	6.1	6.1	6.1	6.2	6.0	6.0	6.0	5.9	5.9
6-8 less (67+68)	Other manufactures	833	11.6	11.6	12.0	11.9	11.8	11.7	11.9	11.8	11.6	11.7	11.9

Source: UNCTAD Data Base on Trade Control Measures.

a Ratios have been computed using 1988 trade weights, except for the United States (1989 weights). For the definition of these ratios and of (the number of) trade flows, see footnote 16 to the text of this chapter.

b The group "all selected NTMs" comprises certain para-tariff measures, surcharges, variable levies, anti-dumping and countervailing actions, quantitative restrictions (including prohibitions, quotas, non-automatic licensing, "voluntary" export restraints and restraints under MFA and similar textile arrangements and State monopolies), automatic licensing and import surveillance, advance payment of duties and import deposits, and price control measures (including minimum, reference or basic import price systems, price surveillance and voluntary export price restraints), additional customs formalities and other entry control measures, and local content requirements. The "narrow" group of NTMs excludes para-tariff measures, automatic licensing and import surveillance, advance payment of duties and import deposits, and anti-dumping and countervailing actions.

c Austria, Canada, EEC (12), Finland, Japan, New Zealand, Norway, Switzerland and the United States. (Time series were not available for Australia and Sweden.)

NTMs has not generally declined.[16] Only a few countries are making significantly less use of overt border NTMs. New Zealand introduced the most far-reaching liberalization process, eliminating some 80 per cent of such measures in existence in 1981. By contrast, the trade coverage of NTMs, using fixed trade weights, increased in EEC and in the United States. Although the *frequency ratio* fell from 15.1 per cent in 1981 to 14.8 per cent in 1991, the *import coverage ratio* (excluding fuels) increased over the whole period from 16.2 per cent to 18.3 per cent if all NTMs are considered, or from 12.6 per cent to 13.0 per cent if anti-dumping and countervailing duty actions as well as surveillance measures are excluded. This means that the incidence of NTMs on imports by developed countries, based on 1988-1989 trade statistics, increased by $26 billion, to $223 billion in the first instance, or by $5 billion, to $159 billion, in the second.

Most of the declines in the frequency ratio took place after 1987, suggesting that the stand-still commitment of the Punta del Este Declaration has contributed to a certain extent to preventing non-tariff measures from spreading. However, this may also reflect, at least in part, a shift to measures applied selectively, and targeted on certain suppliers of specific products, which makes it possible for the value of imports "covered" by these non-tariff measures to remain relatively stable (and may explain the limited movement in the import coverage ratio if the "narrow" definition of NTMs is used). Indeed, there has not been any significant reduction in the use of NTMs; most of the quantitative restrictions or measures with similar effect that existed before the launching of the Uruguay Round are still in force, indicating that the roll-back commitment has not generally been honoured.

The overall increase in the use of NTMs may appear relatively small, but it should nevertheless be observed that most NTMs are part of a stock of protective measures which tend to remain in force for a long time without significant modifications. The observed increase is largely due to resort to "grey area" measures, especially VERs, as well as to anti-dumping and countervailing duty actions. The use of VERs with regard to trade in steel, automobiles and consumer electronics increased significantly. Trade in footwear was liberalized in the early 1980s, but new restrictions were introduced at the end of the decade. Anti-dumping and countervailing (anti-subsidy) measures were taken on a wide range of products, mainly by Australia, Canada, EEC and the United States. A large number of actions by the United States were terminated around the middle of the last decade, when a number of countries agreed to VERs for exports of steel products to the United States market.

The incidence of the various types of NTMs applied in 1992 in major OECD countries on their total imports and their imports from developing countries and China, for different product groups, can be seen in table 19. Some $237 billion of OECD imports from all sources, or nearly 18 per cent, were affected by NTMs, of which $158 billion (12 per cent) were affected by volume-restraining measures (quotas, non-automatic licensing, VERs, State monopolies and textile restraints) and $75 billion (6 per cent) by measures primarily intended to control the price of imported goods (minimum or reference price mechanisms, variable levies, anti-dumping and countervailing measures). Border NTMs in agriculture, MFA-type restrictions and "grey area" measures together affected some $152 billion worth of trade. Thus nearly 13 per cent of developed countries' non-fuel imports were covered by non-tariff measures which, to a very large extent, are applied outside the GATT framework.[17] The Agreement on Safeguards contained in the Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations[18] contemplates the eventual elimination of these measures or their being brought into conformity with the General Agreement within a transitional period of four to eight years. It also provides for the conversion of border non-tariff measures in the agricultural sector into tariffs.[19] Tariffication and progressive reduction of duties would cover all border measures other than ordinary customs duties, thus including quantitative import restrictions, vari-

16 This assessment is based on two indicators: the trade or import coverage ratio and the frequency ratio. The former measures the value of imports affected by selected NTMs as a share of all imports and the latter expresses the number of trade flows covered by NTMs as a share of the total number of trade flows. The number of trade flows for each importing country is the number of national tariff lines multiplied by the number of trading partners in which imports originated at each tariff line during a given base year.

17 The figures do not reflect, however, the end of voluntary agreements restraining exports of steel to the United States in March 1992, which would lower considerably the NTM incidence. It should be recalled, nevertheless, that anti-dumping and countervailing actions were initiated shortly afterwards as an alternative means of restricting steel imports into the United States (see box 5).

18 GATT document MTN.TNC/W/FA, 20 December 1991.

19 Such proposals would cover HS chapters 1-24 less fish and fish products, as well as certain raw materials contained in HS chapters 29-53, such as hides and skins, wool and cotton.

Table 19

IMPORT COVERAGE RATIOS OF SELECTED NON-TARIFF MEASURES APPLIED IN 1992 BY DEVELOPED MARKET-ECONOMY COUNTRIES [a] ON IMPORTS FROM ALL SOURCES AND FROM DEVELOPING COUNTRIES AND CHINA, BY PRINCIPAL TYPE OF MEASURE

(Imports in $ billion; ratios in per cent)

Product group definition	Product group	Imports [b] from		Trade coverage ratios of: All selected NTMs [c]		"Narrow" definition of NTMs [c]		QRs [d]		"Grey area" [e]		Price measures [f]	
		World	DCs [g]	World	DCs [g]	World	DCs [g]	World	DCs [g]	World	DCs [g]	World	DCs [g]
SITC 0-9	All products (incl. fuels)	1 335.6	434.8	17.7	20.9	13.1	17.6	11.8	16.8	8.0	7.1	5.6	3.5
SITC 3	Fuels	159.3	106.5	17.8	13.1	14.3	10.0	13.4	10.0	1.8	0.7	0.0	0.0
SITC 0-9 less 3	All products (excl. fuels)	1 176.3	328.3	17.7	23.5	12.9	20.1	11.6	19.0	8.8	9.2	6.4	4.6
--	Agriculture [h]	118.2	50.8	26.2	20.8	22.9	18.0	17.4	14.3	13.5	13.5	11.5	11.4
--	Textiles and clothing [h]	91.8	59.6	52.2	70.7	47.1	67.0	47.1	67.0	7.9	9.3	3.2	4.7
--	All other products	966.3	217.9	13.4	11.2	8.4	7.7	7.6	7.0	8.3	8.1	6.0	3.0
	of which:												
--	Fish and fish products [h]	24.9	13.7	51.4	54.8	49.2	54.4	46.0	51.2	46.4	49.3	3.7	3.3
SITC 67	Iron and steel	33.2	8.5	50.5	40.4	37.3	31.5	30.5	18.1	48.6	37.9	20.4	20.8
SITC 85	Footwear	15.0	10.7	35.0	42.5	22.4	31.2	22.4	31.2	32.5	40.0	1.4	1.8
SITC 781	Vehicles	84.0	4.8	41.7	0.6	36.9	0.6	32.5	0.1	37.2	0.0	27.6	0.0
--	Consumer electronics [h]	60.4	24.2	16.1	10.3	7.2	5.4	7.0	5.4	5.2	3.6	11.7	5.6
--	Other	748.7	156.0	7.2	6.5	2.8	3.2	2.6	3.2	2.4	4.1	2.7	1.8

Source: UNCTAD Data Base on Trade Control Measures.

a Australia, Austria, Canada, EEC, Finland, Japan, New Zealand, Norway, Sweden, Switzerland and the United States.

b 1988, except for the United States (1989).

c For definitions see table 18, footnote *b*.

d Prohibitions, quotas, non-automatic licensing, State monopolies, "voluntary" export restraints and restraints under MFA and similar textile arrangements.

e Non-automatic licensing, "voluntary" export restraints, import surveillance, minimum prices and price surveillance.

f Price controls, minimum prices, price surveillance, anti-dumping and countervailing actions.

g Including China.

h The group "Agriculture" covers HS chapters 1-24, less fish and fish products, plus some industrial products (certain chemicals and chemical products, textile fibres, essential oils, albuminoidal substances, modified starches, glues and hides and skins), as specified in annex 1 to the Agreement on Agriculture included in the Draft Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations (GATT document MTN.TNC/W/FA, 20 December 1991). The group "Textiles and clothing" is defined according to the list of products identified by HS codes in the annex to the Agreement on Textiles and Clothing of the Draft Final Act. The group "Fish and fish products" comprises unprocessed, semi-processed and processed fish (HS codes 0301-0307, 1603-1605 and 2301). The group "Consumer electronics" comprises audio and video equipment and parts and components thereof; photographic and cinematographic cameras and equipment and parts thereof; personal computers; watches, clocks and electro-magnetic, electrostatic, electronic and similar musical instruments.

able import levies, minimum import prices, discretionary import licensing, non-tariff measures maintained through State trading enterprises, voluntary export restraints and other similar measures, whether or not maintained under country-specific derogations.

Border non-tariff measures in the agricultural sector for which tariffication is envisaged affect some 23 per cent of the developed market-economy countries' imports of agricultural products (worth some $27 billion on the basis of trade in 1988-1989). These involved mainly border trade measures in EEC, resulting from the application of its Common Agricultural Policy through the common organization of markets in a number of products which govern imports from third countries (using variable levies and variable components, reference prices, licences and VERs), and in Japan through the use of import authorizations, quotas[20] and State import monopolies.

To a lesser extent, the trade coverage ratio for agriculture (narrowly defined) of 23 per cent also reflects NTMs applied on imports of agricultural products in the United States, Sweden and Switzerland. In the United States they reflect the provisions of section 22 of the Agricultural Adjustment Act, which restrict imports through quotas (and/or increased duties) of certain products to prevent them from interfering with the Department of Agriculture's price support programmes. These quotas are covered by a GATT waiver since 1955. In Switzerland the use of NTMs affects mainly agricultural products. Various border measures and import schemes are applied to regulate its agricultural market, including licensing schemes, quantitative restrictions, variable levies, minimum prices and obligatory purchases of competing domestic products. In Sweden, NTMs in agriculture are applied through import licensing and through variable levies on a wide range of products. Some seasonal restrictions and import monopolies also affect imports of agricultural products.

Bilateral restraint agreements concluded under the MFA govern developed countries' imports of textiles and clothing, The UNCTAD secretariat has calculated that such restraints, mainly in the United States and EEC, and to a lesser extent in Canada, affect 60 per cent of developed countries' imports of textile products from developing countries and China, with a value of $35.8 billion. Some EFTA countries have reduced considerably MFA restrictions on textile imports or (as in Sweden) eliminated them completely. Switzerland, although a signatory of MFA, has a liberal regime for textile imports and Japan does not apply restraints under the Arrangement.

With regard to safeguard measures, proposals are also being considered to re-establish multilateral control over them and to eliminate measures that escape such control by prohibiting the use of "grey area" measures. Existing measures would be phased out or brought into conformity with the General Agreement within an agreed period. In addition to VERs and orderly marketing arrangements (OMAs), the proposed Safeguard Agreement covers a wide range of similar measures, such as export moderation, export price or import price monitoring systems, and export or import surveillance. The annual trade covered by this group of non-tariff measures applied by developed countries on imports from all sources amounted in 1988-1989 to $106.8 billion, affecting mainly motor vehicles ($31.2 billion), steel ($16.1 billion), agriculture ($15.9 billion) and fish and fishery products ($11.5 billion).

Non-tariff measures applied by developed market-economy countries have a greater incidence on their imports from developing countries than on their trade with each other, both in general and specifically as regards manufactures (see table 20). One fifth of non-fuel imports from developing countries (and China) are affected by NTMs "narrowly" defined, while for trade among developed countries the proportion is one tenth. Comparing these ratios with the incidence of the application of measures "broadly" defined, it can be seen that here too developing countries' exports are more affected than exports from developed countries, but that the difference in treatment is smaller. As for specific sectors, a high proportion of imports of textiles, clothing and footwear face non-tariff measures, in particular in the major markets. The trade coverage ratios shown in the table reflect the incidence of bilateral restraint agreements for textile exports to the United States (76 per cent on textile yarns and fabrics and 84 per cent on clothing), EEC (60 and 63 per cent), Canada (31 and 70 per cent), and Austria (16 and 41 per cent), as well as VERs on footwear to the United States (33 per cent) and EEC (53 per cent). Since the share of these three categories in selected developed market-economy countries' total imports of

[20] Quotas on a number of agricultural products have been removed since 1989 as part of Japan's market-opening measures which were taken partly in response to external pressures to reduce the trade and current account surpluses accumulated during the 1980s. The virtual ban on imports of rice remains, however, a highly contentious issue of Japan's trade policy. See GATT, *Trade Policy Review. Japan 1992* (Geneva, January 1993), vol. I, pp. 156-160, and vol. II, pp. 3-9.

Table 20

IMPORT COVERAGE RATIOS [a] OF SELECTED NON-TARIFF MEASURES APPLIED IN 1992 BY SELECTED DEVELOPED MARKET-ECONOMY COUNTRIES [b] TO THEIR IMPORTS FROM MAJOR COUNTRY GROUPS

(Percentage)

		NTM coverage of imports from:					
		World		*DMECs*		*Developing countries and China*	
Product group definition (SITC)	*Product group*	*Broad*	*Narrow*	*Broad*	*Narrow*	*Broad*	*Narrow*
0+1+22+4	**All food items**	34.4	31.2	37.6	33.2	29.5	27.5
0	Food and live animals	38.6	35.1	44.1	38.8	32.1	30.0
2	Oilseeds and nuts	3.5	2.1	2.9	1.4	3.9	3.0
4	Animal/vegetable oils	10.6	7.6	15.9	9.8	7.0	6.2
2 less (22+27+28)	**Agricultural raw materials**	4.0	2.8	3.2	2.4	6.2	4.0
27+28+67+68	**Ores and metals**	16.9	12.1	18.9	13.2	11.8	8.9
67	Iron and steel	50.5	37.3	53.5	38.2	40.4	31.5
68	Non-ferrous metals	1.2	0.1	1.1	0.0	0.4	0.0
3	**Fuels**	17.9	14.3	23.1	18.4	13.0	10.0
5	**Chemicals**	10.0	6.3	9.7	6.6	10.6	4.3
6-8 less (67+68)	**Other manufactures**	17.2	11.7	1 4.2	8.0	25.6	21.8
61	Leather	11.4	1.0	3.9	1.5	16.2	0.7
65	Textile yarn and fabrics	36.3	33.0	13.6	10.3	61.1	57.6
84	Clothing	60.8	55.4	20.8	5.3	71.0	68.1
85	Footwear	35.0	22.4	13.8	0.0	42.5	31.2
0-9 less 3	**All items, excluding fuels**	17.7	12.9	15.3	9.8	23.5	20.1
0-9	**All items**	17.7	13.1	15.7	10.2	20.9	17.6

Source: UNCTAD Data Base on Trade Control Measures.
Note: For the definition of the "broad" and "narrow" groups of NTMs see table 18, footnote *b*.
a Ratios have been computed using 1988 trade weights, except for the United States (1989 weights). For the concept of import coverage ratio see footnote 16 to the text of this chapter.
b Australia, Austria, Canada, EEC, Finland, Japan, New Zealand, Norway, Sweden, Switzerland and the United States.

manufactures is much bigger for developing countries than for developed countries (33 per cent, against 5 per cent), the incidence of NTMs on imports of manufactured products as a whole is also much higher.

2. *Continued deterioration of the trading environment*

The trading environment in the past few years has not been favourable to the success of the liberalization efforts of developing countries. For one thing, protectionism has not declined significantly in developed countries. For another, while most trade conflicts have concerned mainly trade relations among the major trading countries, they have also had adverse repercussions on developing countries, as well as on countries in transition.

A major source of concern is the persistence of unilateral retaliatory action, or the threat of such action, outside the GATT framework, to remedy alleged "unfair" trade practices, particularly in the United States, where the commitment to "free trade" is being abandoned in favour of "fair trade", which many claim is euphemism for protectionism. Concerns have been raised over the use of unilateralism as a means of prying open foreign markets, forcing trading partners to remove

what are considered unfair practices.[21] Attempts to revive "Super 301" legislation in the United States have given rise to anxiety regarding the commitment of the United States to multilateralism,[22] especially in the light of statements that its present trade policy should focus on results. Under the "Special 301" provisions of the 1988 Trade Act, China, India and Thailand were named in 1991 as the "most egregious" offenders of the protection of intellectual property rights (IPRs) and market access, making them subject to possible retaliatory action. An agreement was reached with China on protection of IPRs which averted the threats of retaliation. Retaliatory action for the alleged lack of patent protection in India was indefinitely delayed owing to improved IPR protection in other areas. Australia, Brazil and EEC were placed on a "priority watch list" as not all the criteria were met for their designation as "priority" countries. A "secondary watch list" included 23 further countries. In 1992, India and Thailand were for the second time named "priority foreign countries", together with Taiwan province of China. An agreement on the protection of copyrights, patents and trademarks was reached with the latter, together with other commitments which averted retaliation. Seven other countries (Australia, Hungary, Philippines, Turkey, Brazil, Egypt, Poland and Republic of Korea) and EEC were placed on a "priority watch list". Practices relating to the protection of IPRs in these countries were to be monitored so as to determine whether other action under the Special 301 provisions would be taken. The "secondary watch list" included 22 other countries which the United States considered deserved special attention for maintaining intellectual property practices or market access barriers of particular concern to its interests.

Bilateral trade issues between the United States and Japan have continued to have a prominent place in the trade scene, both on issues involving bilateral market access problems and, more general, on issues relating to the conduct of economic policies and private sector practices in both countries. Salient sectoral trade issues in the past two years relate to automobiles and parts,[23] the unresolved dispute on semiconductors, for which a new five-year bilateral agreement came into effect in August 1991,[24] the extension of VERs on machine tools (to be phased out by the end of 1993) and a number of disputes in the agricultural sector, the most prominent being Japan's restrictions on imports of rice (one of the most sensitive issues in the Uruguay Round negotiations on tariffication of restrictions in agriculture).

Trade policies in EEC were greatly influenced by the agreement to reach a unified market at the end of 1992, which implied, *inter alia*, the adoption of Community-wide regulations leading to the removal or harmonization of national trade restrictions and intra-Community hindrances to the free circulation of goods. Two developments in this regard illustrate the difficulties facing the Community in reconciling its trade, industrial and employment objectives with its international obligations and commitments. One is the regulation on the common organization of the market for bananas, which replaced the different regimes previously in force (see box 4). The second is the agreement reached on imports of automobiles from Japan, aimed at fully liberalizing imports by the end of 1999 and calling for the elimination of national quantitative restrictions in some of the member States by the end of 1992. The restrictions would be replaced by a monitoring system by Japan allowing a smooth transition to unrestricted exports at the target date. Until then imports would be limited according to forecasts for the Community's automobile market as provided in the agreement. However, in March 1993 the two parties still differed on the outlook for demand and hence the extent to which imports of Japanese automobiles would be cut.

Tensions also have arisen in other areas, illustrating the need for clear rules and disciplines with regard to the GATT instruments negotiated in the past. These areas include the dispute over subsidies granted to the Airbus consortium by some European Governments, the consistency of which with the GATT Subsidies Code was challenged by the United

21 See, for instance, Jagdish N. Bhagwati, *The World Trading System at Risk* (Princeton, New Jersey: Princeton University Press, 1991), pp. 48-57.

22 For an analysis of the events that determined a turning point in the United States trade policy, see Jagdish N. Bhagwati, "United States trade policy at the crossroads", *The World Economy*, vol. 12, No. 4, December 1989.

23 Recent developments in this context have included self-limitation by Japan of its car exports to the United States, discussion in the United States of the possibility of raising tariffs on minivans and allegations that such vehicles were being dumped in its market, promotion of the sales of United States cars in Japan, and the purchase of components made in the United States by Japanese car manufacturers.

24 The five-year agreement reached in 1986, which aimed at ending dumping of Japanese chips in the United States and in third-country markets, provided for an increase of access of foreign semiconductors to the Japanese market. The United States, claiming that its share remained far below the 20 per cent target of the 1986 agreement, engaged negotiations for a new agreement.

Box 4

THE NEW EEC REGIME FOR BANANAS

Until June 1993 import regimes in EEC for bananas differed among countries. France, Greece, Italy, Portugal, Spain and the United Kingdom virtually banned or considerably restricted imports from Latin America, reserving their markets for domestic producers (including those in their overseas territories) and for ACP countries, where production costs are higher. In February 1993 a GATT panel found that some of these quantitative restrictions were inconsistent with the relevant GATT articles and were not justified by other provisions or clauses and recommended that the Community bring these restrictions into conformity with the General Agreement.

A new EEC regulation came into effect on 1 July 1993 aiming at completing the single market in respect of bananas by establishing a common import regime to replace the various national regimes. It allows duty-free access for traditional ACP suppliers. An annual tariff quota of 2 million tons applies to all imports from non-ACP countries and from "non-traditional" ACP suppliers, with a reduced duty of ECU 100 ($125) per ton and a duty of ECU 850 per ton for imports above that level (ECU 750 ($1,070) for non-traditional ACP imports). The price of bananas in March 1993 was around $560 per ton.

The new regulation confronts the Community with a dilemma, both internally and externally. On the one hand, the Protocols of Accession of Portugal and Spain allow these countries to maintain quantitative restrictions on bananas, and the Banana Protocol annexed to the Treaty of Rome allows duty-free entry of bananas into Germany. On the other hand, EEC is bound by GATT obligations and by obligations arising both from the Lomé Convention granting duty-free and unrestricted preferential access to ACP countries and from its Protocol on bananas specifying that the Community was not to place ACP producers in a less favourable situation than in the past or present. Germany, supported by Belgium, Luxembourg and the Netherlands, strongly objected to the new restrictions and brought the case before the European Court of Justice. In late June 1993 the Court handed down an interim ruling upholding the new regime. For their part, Latin American exporters have initiated action in GATT. According to the Union of Banana Exporting Countries (UPEB), Latin American countries exported 2.8 million tons of bananas to the Community in 1992, which is much higher than the 2 million-ton annual quota set by EEC in its new regulation. Latin American countries have complained that restrictions would cause annual losses of around $350 million and would entail in the next three years the suppression of more than 170,000 jobs and of nearly 35,000 hectares of banana plantations. They would also loose considerable fiscal revenues and would be deprived of the benefits from investments already made in expectation of expanding banana production and exports.

There is not yet a clear picture of the outcome of this conflict. Much debate on this issue is expected within the GATT dispute settlement mechanism, with regard to the consistency of the new regime with the General Agreement. Furthermore, the Community is confronted with its responsibilities with regard to its commitments to support economic and social progress in developing countries. The proposal made by the EC Commission in February 1993 [1] (still under consideration by the Council) that the Community should introduce a diversification and development programme for certain banana-producing countries of Latin America is an acknowledgement of the harm that would be done to the economies of those countries.

1 See *Official Journal of the European Communities*, No. C 50, 20 February 1993.

States, a challenge which provoked the response by EEC that the United States aircraft industry was being subsidized indirectly through defence contracts. After several years of negotiations, an agreement was signed in July 1992 which put an end to this conflict. The implications for other countries derive from the provisions in the agreement that the United States and EEC would seek to extend multilaterally the improved disciplines over subsidies on large aircraft (of more than 100 seats) by reviewing the Agreement on Trade in Civil Aircraft of GATT and to adapt them to smaller planes and aircraft components.

A helpful development which contributed to reduce tensions was the decision by EEC in May 1992 to reform its Common Agricultural Policy, with the aim, *inter alia*, of replacing many trade-distorting subsidies, such as

guaranteed prices to producers and export subsidies, by direct income payments to farmers.

3. *Increased use of anti-dumping and anti-subsidy measures*

As already mentioned, a feature of recent trade policy regarding import control is the shift from measures of a more general application to ones targeted on imports of selected products from selected suppliers. Anti-dumping and countervailing (anti-subsidy) measures fall within this category. Although they have long been applied, mainly in industrialized countries, as a means of countering "predatory" pricing and trade-distorting subsidies, increased recourse to this type of measure has been observed since 1990.

Moreover, the use of anti-dumping measures and countervailing duties has now spread to developing countries. A number of them have enacted new legislation in this regard in the wake of their trade liberalization programmes. Previously, developing countries had never, or only rarely, used such measures as they could have recourse to other means of restricting imports, such as quotas, licences or minimum price schemes or foreign exchange control. Their main concern in adopting new legislation in this area has been to prevent surges in imports of dumped or subsidized products from jeopardizing their liberalization objectives.

Anti-dumping and countervailing measures can be used to prevent distortive and anti-competitive practices by trading partners. The relevant GATT articles are intended to regulate the use of such measures; the Codes which supplement and interpret these articles aim at preventing abusive use of the measures. However, it has often been argued that the practical effect of anti-dumping and countervailing laws, especially those of industrialized countries, is to protect domestic industries from import competition rather than from "unfair" trade practices of an exporting country.[25] The recent measures taken by the United States in the steel sector on expiry of the voluntary restraint agreements illustrates this argument (see box 5). Misuse of anti-dumping and countervailing measures may be favoured by loopholes in the General Agreement and the GATT Codes, in particular with regard to the methodology used to determine the dumping or subsidy margins and injury (which is often biased in favour of the domestic producer) as well as to the definitions of dumping and subsidies.[26] In the absence of stricter disciplines, countries may continue to prefer resorting to anti-dumping or countervailing measures rather than to normal safeguard actions, the latter being subject to more stringent requirements for injury determination. This would explain in part the increase in the number of anti-dumping procedures opened in recent years (see table 21).

Most of the anti-dumping actions have been initiated by Australia, Canada, EEC and the United States. Among developing countries, Mexico and, to a lesser extent, the Republic of Korea, have made use of this measure since the mid-1980s. There has been a sharp increase in actions initiated by Australia and the United States since July 1990, and a more moderate increase by EEC and Canada in 1991/92. The relatively large number of EEC actions between July 1987 and June 1990 was partly due to the numerous investigations undertaken into imports in the textile sector. The decline in United States actions initiated from 1986/87 to 1989/90 reflects an easing of pressures for this type of protective action in the iron and steel sector, as VERs covered most imports of the products involved. A great number of cases were terminated in Australia in 1986/87 and 1987/88, following the introduction of a sunset clause in the Australian anti-dumping legislation. By June 1990 the number of outstanding cases had reached a low point, but subsequently their number started to rise.[27] The number of outstanding cases for Canada declined steadily during the period 1986-1992, mainly as a result of review investigations under the sunset clause of its legislation. The number of outstanding cases in EEC remained approximately stable during this period. Nev-

25 For instance, Bhagwati claims that, however legitimate their roles in a free trade regime, anti-dumping and countervailing duty laws have been captured and misused by the forces of protectionism and examines how this happened. See N. David Palmeter's review of J.N. Bhagwati's *Protectionism* (Cambridge: MIT Press, 1988) in *Yale Journal of International Law*, vol. 14:182, 1989.

26 The Agreement on Anti-dumping Practices and the Agreement on Subsidies and Countervailing Measures included in the Draft Final Act of the Uruguay Round take into account these difficulties and seek to clarify the interpretation of the current Codes and to establish stricter disciplines with regard to their operation.

27 Many anti-dumping (or countervailing duty) procedures initiated do not result in definitive duties or price undertakings. These procedures have been included among the outstanding cases in table 21 as it can be argued that the fact that a firm is involved in an investigation implies a harassment effect, not to mention the cost implications and the uncertainties created.

Box 5

PROTECTION OF THE STEEL INDUSTRY IN THE UNITED STATES

From October 1984 until end-March 1992 the iron and steel sector in the United States was protected by the Steel Import Programme, implemented following a finding by the United States International Trade Commission (USITC) that the domestic steel industry was being threatened by increased imports of certain categories of steel. Instead of granting relief through quotas or higher import duties, the United States opted for a programme of "voluntary" restraint agreements (VRAs) to help the domestic steel industry compete with imports. Bilateral VRAs were negotiated for the period 1 October 1984-30 September 1989 with countries whose steel exports to the United States had increased significantly as part of an alleged "unfair surge in imports"; at the same time, all pending anti-dumping and countervailing investigations on steel products were withdrawn and duties were suspended. The VRAs were extended in June 1989 until the end of March 1992, and their coverage extended to include specialty steel products that had so far been subject to quotas and increased duties. [1] At the same time, the United States negotiated bilateral consensus agreements with major steel trading countries to remove "unfair" trade practices.

Since September 1991 steel imports into the United States have again been the object of anti-dumping and countervailing investigations or threats of such actions. As no multilateral agreement could be concluded before the date of expiration of VRAs in March 1992, United States steel producers took recourse to trade remedy laws. Numerous unfair trading complaints were filed, notwithstanding the fact that steel exports had increased and imports fallen, as a result of a policy by foreign exporters not to flood the United States market after the end of the VRAs.

The investigations proceeded after a preliminary finding by USITC in August 1992 of reasonable evidence of material injury to the domestic steel industry due to imports from 20 countries. The Department of Commerce made a preliminary determination, in November 1992, that steel products exported from 12 countries [2] were subsidized with rates of up to 90 per cent, and in January 1993 that 19 countries [3] were dumping steel products with margins of up to more than 100 per cent. Subsequently, countervailing and anti-dumping duties were imposed.

Countries involved in the investigations indicated their intention of bringing the cases before the GATT. [4] Some countries also reacted by taking retaliatory action, for instance by making use of their own anti-dumping and countervailing legislation (Canada, Mexico) or by limiting purchases of United States products, as in the case of steel firms in Brazil, which decided to stop buying coal from the United States. Exporters argued that the high levels of duties were determined arbitrarily, with criteria and methodology which often favoured the domestic industry, and that the fall in import prices reflected the strengthening of the dollar.

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1 Extended VRAs were negotiated with Australia, Austria, Brazil, China, former Czechoslovakia, EEC, Finland, former German Democratic Republic, Hungary, Japan, Mexico, Poland, Republic of Korea, Romania, Trinidad and Tobago, Venezuela and (former) Yugoslavia. The intent of these bilateral agreements was to limit total imports from these countries to about 20 per cent of the United States market.

2 Austria, Belgium, Brazil, France, Germany, Italy, Mexico, New Zealand, Republic of Korea, Spain, Sweden and the United Kingdom.

3 Argentina, Australia, Austria, Belgium, Brazil, Canada, Finland, France, Germany, Italy, Japan, Mexico, Netherlands, Poland, Republic of Korea, Romania, Spain, Sweden and the United Kingdom.

4 Upon request from Brazil, the GATT Council discussed the anti-dumping and countervailing actions at its meeting of 9 February 1993. After bilateral consultations which failed to arrive at a mutually agreed solution to the countervailing duty determinations, EEC requested conciliation under the Subsidies Code. It subsequently requested, in May 1993, the establishment of a panel to examine the definitive countervailing duties imposed by the United States in January 1993 in relation to an earlier case.

ertheless, many cases were terminated between July 1987 and June 1990, in particular those involving exports from Central and Eastern Europe. In the United States, the number of outstanding cases has risen steadily in recent years as the number of investigations initiated also increased sharply and relatively fewer actions were terminated.

Countervailing duty actions have been resorted to most often by the United States and to a lesser extent Australia, and in both coun-

Table 21

ANTI-DUMPING AND COUNTERVAILING ACTIONS INITIATED SINCE 1986/87 AND THEIR SUBSEQUENT STATUS IN EACH YEAR UNTIL 1992

(Number of cases)

A. Actions involving imports from all sources

	Cases initiated [a] from 1 July to 30 June						*Cases revoked/terminated from 1 July to 30 June*						*Outstanding cases [b] at the end of June*						
Initiating country	*86/87*	*87/88*	*88/89*	*89/90*	*90/91*	*91/92*	*86/87*	*87/88*	*88/89*	*89/90*	*90/91*	*91/92*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Anti-dumping																			
Australia	40	20	20	23	47	73	102	111	49	25	4	29	212	150	59	30	28	71	115
Austria	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	4
Brazil	-	1	1	-	2	9	-	-	-	-	-	-	-	-	1	2	2	4	13
Canada	22	21	14	15	11	16	10	31	26	42	55	19	149	161	151	139	112	68	65
EEC	27	43	42	37	22	26	25	56	36	38	25	15	208	210	197	203	202	199	210
Finland	4	5	2	-	1	-	-	1	3	1	-	-	1	5	9	8	7	8	8
India	-	-	-	-	-	5	-	-	-	-	-	-	-	-	-	-	-	-	5
Japan	-	-	-	-	-	3	-	-	-	-	-	-	-	-	-	-	-	-	3
Mexico	2	17	17	10	13	25	-	3	7	7	-	8	-	2	16	26	29	42	59
New Zealand	3	6	5	2	6	13	-	-	2	6	3	5	-	3	9	12	8	11	19
Poland	-	-	-	-	24	-	-	-	-	-	24	-	-	-	-	-	-	-	-
Republic of Korea	1	-	1	3	2	-	1	1	-	-	3	-	3	3	2	3	6	5	5
Sweden	-	-	2	4	2	1	-	-	-	6	-	-	2	2	2	4	2	4	5
United States	41	31	25	24	51	62	36	14	17	19	36	25	159	164	181	189	194	209	246
Total	140	144	129	118	181	237	174	217	140	144	150	101	734	700	627	616	590	621	757
Countervailing																			
Australia	3	-	2	7	7	8	1	7	3	5	2	3	9	11	4	3	5	10	15
Brazil	-	-	-	-	-	8	-	-	-	-	-	-	-	-	-	-	-	-	8
Canada	2	-	1	2	-	-	-	-	-	-	2	1	6	8	8	9	11	9	8
Chile	-	-	-	-	1	2	-	-	-	-	-	-	-	-	-	-	-	1	3
EEC	-	1	2	-	-	-	-	-	2	-	-	-	3	3	4	4	4	4	4
New Zealand	-	4	-	-	1	-	-	-	3	-	2	-	-	-	4	1	1	-	-
United States	10	13	8	6	8	19	11	13	10	14	18	12	102	101	101	99	91	81	88
Total	15	18	13	15	17	37	12	20	18	19	24	16	120	123	121	116	112	105	126
All actions	155	162	142	133	198	274	186	237	158	163	174	117	854	823	748	732	702	726	883

(For source and notes see end of table.)

Table 21 (concluded)

ANTI-DUMPING AND COUNTERVAILING ACTIONS INITIATED SINCE 1986/87 AND THEIR SUBSEQUENT STATUS IN EACH YEAR UNTIL 1992

(Number of cases)

B. Actions involving imports from developing countries

Initiating country	Cases initiated [a] from 1 July to 30 June						Cases revoked/terminated from 1 July to 30 June						Outstanding cases [b] at the end of June						
	86/87	87/88	88/89	89/90	90/91	91/92	86/87	87/88	88/89	89/90	90/91	91/92	1986	1987	1988	1989	1990	1991	1992
Anti-dumping																			
Australia	11	11	8	10	22	35	28	33	23	15	-	15	68	51	29	14	9	31	51
Austria	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Brazil	-	-	1	-	2	5	-	-	-	-	-	-	-	-	-	1	1	3	8
Canada	6	9	4	8	7	2	3	6	8	6	13	3	43	46	49	45	47	41	40
EEC	17	25	26	28	13	20	8	7	12	13	12	13	53	62	80	94	109	110	117
Finland	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
India	-	-	-	-	-	4	-	-	-	-	-	-	-	-	-	-	-	-	4
Japan	-	-	-	-	-	1	-	-	-	-	-	-	-	-	-	-	-	-	1
Mexico	-	6	4	4	3	17	-	2	2	1	-	2	-	-	4	6	9	12	27
New Zealand	-	3	1	1	6	12	-	-	1	-	-	4	-	-	3	3	4	10	18
Poland	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Republic of Korea	-	-	-	-	-	-	-	-	-	-	-	-	1	1	1	1	1	1	1
Sweden	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
United States	14	7	14	12	25	22	8	7	7	7	16	10	57	63	63	70	75	84	96
Total	48	61	58	63	78	118	47	55	53	42	41	47	222	223	229	234	255	292	363
Countervailing																			
Australia	2	-	-	3	4	3	1	1	-	3	2	3	1	2	1	1	1	3	3
Brazil	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Canada	-	-	1	2	-	-	-	-	-	-	-	-	1	1	1	2	4	4	4
Chile	-	-	-	-	1	2	-	-	-	-	-	-	-	-	-	-	-	1	3
EEC	-	1	2	-	-	-	-	-	2	-	-	-	3	3	4	4	4	4	4
New Zealand	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
United States	5	12	6	4	8	13	7	8	6	13	16	9	78	76	80	80	71	63	67
Total	7	13	9	9	13	18	8	9	8	16	18	12	83	82	86	87	80	75	81
All actions	55	74	67	72	91	136	55	64	61	58	59	59	305	305	315	321	335	367	444

Source: Compiled by the UNCTAD secretariat, on the basis of reports to the GATT Committee on Anti-dumping Practices and Committee on Subsidies and Countervailing Measures and of other officially published information.

a New cases only (i.e. excluding cases reviewed).

b Covers orders, price undertakings and pending investigations.

tries there has been an increase since 1986/87 in the number of procedures initiated as well as in the number of outstanding measures. In most cases, especially in the United States, countervailing actions involve products and suppliers which are also under anti-dumping investigations.

4. Textiles and clothing

Textiles and clothing is one of the most heavily protected sectors in developed countries; for example, tariffs average 20.4 per cent in Canada, 18.3 per cent in the United States, 23.4 per cent in Austria and 26 per cent in Finland, and for some items they exceed 38 per cent in the United States. Non-tariff restrictions on imports, mostly of products originating in developing countries and Central and Eastern Europe, also afford a protective shield. Quantitative restraints, mostly quotas negotiated in bilateral agreements, affect 67 per cent of imports ($60 billion) of textiles and clothing from developing countries and China, while a mere 7 per cent of trade among developed countries in this sector is subject to quantitative restrictions. Calculations by the UNCTAD secretariat indicate that the import coverage ratio of restraints applied to textile imports from developing countries under bilateral agreements is 60 per cent. Trade among developed countries is scarcely affected by quotas under bilateral agreements, since they apply only to exports to the United States of certain textile products from Japan. (More precisely, they are voluntary export restraints.)

Some notable efforts to liberalize trade in textiles have recently taken place in importing developed countries, in particular in Norway, which has introduced a policy of gradual liberalization of quantitative restrictions, reducing the number of product categories involved to four for all suppliers (except for Hong Kong, where there are five), and in Sweden, which removed all quantitative restrictions as from 1 August 1991 and abolished all bilateral restraint agreements that were still in force. However, in global terms liberalization in the world textile trade remains uneven; the textile market of the Nordic countries is small and liberalization measures in the major markets have been selective (in general, in favour of Central and Eastern European countries, for which market access was increased). Other supplying countries, by contrast, experienced a reduction in quota amounts - for instance, as a result of the extension of the bilateral agreements between the United States and the Republic of Korea and Hong Kong.

Under the cover of a quasi-permanent derogation from GATT rules, discriminatory restrictions on trade in textiles and clothing have been augmented by developed countries, in spite of the provisions on standstill and rollback in the Punta del Este Declaration to the effect that no new import restrictions would be introduced during the Uruguay Round. For the fifth time since its entry into force, the Multi-Fibre Arrangement was extended in December 1992, with no changes made to its provisions,[28] until the end of December 1993, in view of the fact that the Uruguay Round had not been completed. For many developing countries the phasing out of MFA and the integration of trade in the textile and clothing sector into the GATT is considered a high priority issue in the Uruguay Round and a prerequisite for the success of the Round. Although there has been agreement on the objective of a gradual and progressive integration of textile trade into GATT over a transition period, the negotiations in this area have been among the most difficult. Developing countries have been concerned mainly with the transition time span and the modalities of the staged integration (which could lead to the continuation, with regard to important exports, of the MFA restrictive system for another decade), the low growth rates of quotas, and the criteria for the application of safeguards, which would open the way to discrimination against developing countries.■

[28] The decision to extend the Arrangement was taken, however, on the understanding that bilateral agreements for 1993 would provide increased market access. Participants also reiterated that special consideration should be provided for small suppliers and least developed countries. See *GATT Activities in 1992* (Geneva: GATT, June 1993), p. 99.

Chapter III

INTERNATIONAL CAPITAL MARKETS

A. Recent trends in external financing

As in 1991, changes in major categories of international lending presented a far from uniform picture during 1992. For example, as shown in table 22, external bond issues continued to expand fairly rapidly, while syndicated bank credits stagnated. Within the total volume of financing from the international capital markets the share of developing countries remained small, although the recent rise in external bond issues by certain borrowers from Latin America continued. Thus, overall movements in the different categories of financing continued to be dominated by conditions in OECD countries. These conditions included low economic growth, the attempts by banks (especially those in Japan) to improve their capital positions, lower interest rates, and other factors causing shifts in the relative recourse by borrowers to different financial instruments.

As shown in table 23, the growth in exposure to all borrowers of banks reporting to the Bank for International Settlements (BIS) contracted for the second consecutive year. Once again, an important influence was exerted by reductions in Japanese banks' international interbank lending. Contributing to the buoyancy of external bond issues were lower interest rates for major currencies (shown in table 24), the large sums released for reinvestment by, and the high refinancing requirements resulting from, exceptionally high levels of redemptions of outstanding issues, and recourse by Japanese banks to issues of subordinated and perpetual floating rate notes as a means of achieving the targets for their capital prescribed by the Basle Agreement on International Convergence of Capital Measurement and Capital Standards.[29] By contrast, issues of equity-related international bonds (i.e. bonds with equity warrants attached and convertible bonds) were depressed by low prices on the Japanese stock markets.

The conjunction of buoyant flows of external equity investment to a number of Latin American countries with their increased bond issues is associated with growing interest in parts of the developing world as a destination for international portfolio investment. However, although this interest now extends beyond South and South-East Asia and includes some countries seriously affected by the outbreak of the debt crisis in the 1980s, only a minority of developing countries are in question. Indeed, there continues to be a segmentation of developing countries into one group now benefiting from easy or greatly improved access to external financing from the international capital markets, and another for which there has been only limited relaxation of their long-standing external financial stringency.

There was concentration on a relatively small number of developing country recipients for each of the categories of external financing shown in table 22. For example, 55 per cent of the external bond issues by developing countries were accounted for by only four Latin American countries (Argentina, Brazil, Mexico and Venezuela) and 35 per cent by only three countries of South and South-East Asia

[29] Concerning this Agreement see *TDR 1992*, Part Two, annex I, sect. B.4.

Table 22

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES THEREIN, 1988-1992

Category	*1988*	*1989*	*1990*	*1991*	*1992*
External bond offerings					
Total ($ billion)	227.1	255.7	229.9	297.6	333.7
Percentage share of:					
Developing countries	1.5	0.9	2.0	2.7	3.8
Central and Eastern Europe	0.5	0.7	0.7	0.5	0.4
Syndicated credits					
Total ($ billion)	125.5	121.1	124.5	116.0	117.9
Percentage share of:					
Developing countries [a]	10.2	12.1	14.7	21.0	11.7
	(6.1)	(12.1)	(12.3)	(20.9)	(11.7)
Central and Eastern Europe	2.2	2.0	2.5	0.1	0.2
Eurocommercial paper programmes					
Total ($ billion)	57.1	54.1	48.3	35.9	28.9
Share of developing countries (per cent)	1.2	2.4	1.9	2.8	11.8
Committed borrowing facilities [b]					
Total ($ billion)	16.6	8.4	7.0	7.7	6.7
Share of developing countries (per cent)	7.8	10.7	30.0	58.4	25.4
Other non-underwritten facilities [c]					
Total ($ billion)	19.5	19.1	17.9	44.3	99.0
Share of developing countries (per cent)	3.1	3.7	1.7	1.6	4.5

Source: OECD, *Financial Market Trends*, 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.

c Non-underwritten syndicated borrowing facilities, including medium-term note (MTN) programmes but excluding Eurocommercial paper.

(Indonesia, Republic of Korea, and Thailand).[30] Although there has recently been a limited revival of international bank lending to countries in Latin America, as shown in table 23, the growth in the exposure to this region of BIS-reporting banks in 1992 remained far below the levels of the early 1980s, depressed in part by debt reduction resulting from restructuring agreements and recently, for Mexico, by rules limiting banks' borrowing in foreign currencies (see Part Two, chapter III). Larger increases in exposure were recorded for South and South-East Asia and West Asia. As in the case of bond issues, flows to the former region

[30] Figures for announced and completed international bond issues published by BIS (*International Banking and Financial Market Developments*, table 13A), which are assembled on a different basis from those of OECD in its *Financial Market Trends* (the source for table 22), show a still greater concentration of such issues on Latin American borrowers.

Table 23

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA [a] VIS-À-VIS DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES, [b] 1985-1992

	1985	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*Stock (end of 1992)*
	Percentage rate of increase [c]								*$ billion*
All developing countries [d]	4.9	4.2	6.5	-2.6	-2.0	0.3	1.5	8.3	562
Of which in:									
America	3.0	0.8	1.4	-3.0	-6.7	-10.6	1.3	4.3	222
Africa	14.8	10.3	8.8	-7.6	-3.3	4.1	-7.3	-7.6	48
West Asia	-	4.6	17.0	3.9	10.1	4.6	-7.7	24.4	112
South and South-East Asia [e]	8.3	6.4	10.9	-3.5	0.8	17.3	12.8	11.1	173
Europe [f]	7.6	-2.1	0.4	-9.7	-13.6	-2.5	-15.8	-15.2	6
Central and Eastern Europe [b]	25.9	18.7	17.3	3.4	12.2	-3.7	1.2	-0.6	95
Memo items:									
All borrowers [g]	19.1	27.0	28.5	7.8	18.5	17.1	-0.8	-0.4	6 198
14 highly indebted countries [h]	2.7	3.1	1.7	-4.3	-7.6	-11.2	0.2	2.1	228

Source: Bank for International Settlements, *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.
b Including the former USSR.
c Based on data for end-December.
d 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.
e Including Oceania.
f Malta and former Yugoslavia.
g Including multilateral financial institutions.
h Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay and Venezuela.

were highly concentrated. Indeed, in the case of figures for increases in the exposure of BIS-reporting banks to this region adjusted for the effects of movements in exchange rates five countries (Indonesia, Republic of Korea, Malaysia, Taiwan province of China and Thailand) received 90 per cent, and lending to these countries together with India amounted to 107 per cent of the total (a figure implying a negative growth in exposure to the rest of the region). The same six countries accounted for more than one half of syndicated international bank credits to developing countries agreed in 1992.[31] The substantial expansion in the exposure of BIS-reporting banks to West Asia during 1992, after the contraction in 1991, reflected partly drawings on syndicated facilities arranged in 1991.

[31] BIS figures for announced new international syndicated credit facilities (*ibid.*, table 8), which are estimated on basis different from those discussed in the text, indicate a rather higher level of concentration on these six South and South-East Asian countries than do the data in the OECD source.

Table 24

SELECTED INTERNATIONAL INTEREST RATES

A. LONDON INTER-BANK OFFERED RATE (LIBOR) ON SIX-MONTH DEPOSITS IN SELECTED CURRENCIES

(Period averages in per cent per annum)

Currency	1990	1991	1992	1993 (Jan-Feb)
United States dollar	8.35	6.08	3.90	3.41
French franc	10.29	9.61	10.37	12.14
Deutsche mark	8.51	9.31	9.52	8.46
Japanese yen	7.76	7.38	4.46	3.53
Pound sterling	14.79	11.67	9.70	6.64

B. COMMERCIAL INTEREST REFERENCE RATES [a]

Currency		1992		1993 (until mid-June)	
		High	Low	High	Low
Australian dollar		10.42	8.05	9.48	7.70
Austrian schilling		9.66	8.65	8.65	7.81
Belgian franc		10.20	9.02	9.02	8.09
Canadian dollar	(1) [b]	9.48	6.80	8.20	7.55
	(2) [c]	9.60	7.48	8.45	7.90
	(3) [d]	9.80	7.88	8.85	8.30
Danish krone		11.80	10.20	11.40	9.10
Finnish markkaa		13.20	11.20	11.95	9.95
French franc		10.54	9.33	9.44	8.24
Deutsche mark		9.68	8.18	8.18	7.35
Irish punt		11.33	10.02	11.75	9.08
Italian lira		14.54	11.93	13.31	12.17
Japanese yen		6.70	5.30	5.50	4.70
Netherlands guilder	(1) [b]	9.90 [e]	8.30	8.30	7.30
	(2) [c]	9.90 [e]	8.30	8.30	7.50
	(3) [d]	9.90 [e]	8.45	8.45	7.85
New Zealand dollar		9.54	8.12	8.57	8.12
Norwegian krone		11.78	10.37	11.26	7.97
Spanish peseta		14.61	12.21	14.02	12.58
Swedish krona		12.97	10.70	11.82	9.99
Swiss franc		8.55 [f]	7.18 [f]	7.18	5.88
Pound sterling		10.89	8.10	8.30	7.70
United States dollar	(1) [b]	7.52	5.42	6.21	5.30
	(2) [c]	7.92 [g]	6.38 [g]	7.08	6.13
	(3) [d]	8.26 [g]	6.96 [g]	7.49	6.59
ECU		9.89	9.15	9.18	8.07
SDR [h]		8.10	8.10	7.55	7.55

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

a Minimum interest rate for officially supported export credits denominated in specified currencies or weighted averages of currencies advanced by participants in the OECD Arrangement on Guidelines for Officially Supported Export Credits.

b Maturity of less than five years.

c Maturity of between five years and eight and a half years.

d Maturity of more than eight and a half years.

e Until mid-February 1992 there was only one Commercial Interest Reference Rate for the guilder.

f Until mid-March 1992 there were two Commercial Interest Reference Rates for the Swiss franc (one for maturities of up to eight years and one for maturities of more than eight years).

g Until mid-February 1992 there were two Commercial Interest Reference Rates for the United States dollar (one for maturities of up to five years and one for maturities of more than five years).

h Since mid-February 1992 a minimum interest rate equal to that of the weighted average of rates included in the SDR may be used for loans to countries in category III, i.e. whose GNP per capita does not exceed that of those eligible for IDA credits.

As indicated by table 22, developing countries' share of Eurocommercial paper programmes, committed borrowing facilities and other non-underwritten facilities has recently increased. Terminology under these headings is somewhat fluid. Eurocommercial paper programmes are a relatively short-term financing instrument generally available at a lower cost than short-term bank credit and may have the advantage for borrowers of not always requiring rating by major credit-rating agencies. The financing made available under committed borrowing facilities differs from Eurocommercial paper primarily on the basis of the mechanisms used to sell it to investors; those for the latter, for example, are more flexible than for note issuance facilities or revolving underwriting facilities (both categories of committed borrowing facilities) but all three of them involve highly similar contractual instruments. Other non-underwritten facilities consist of longer-term financing than Eurocommercial paper which (unlike bonds) is sold by dealers on an agency basis rather than underwritten by banks. Medium-term notes, a major category under this heading, have maturities varying from as little as nine months to several years.[32] Increased participation by developing countries in the markets for financing instruments included under Eurocommercial paper programmes, committed borrowing facilities, and other non-underwritten facilities is, like the other financing instruments already discussed, limited to a few borrowers. Three countries (Indonesia, Republic of Korea, and Mexico) accounted for almost one half of committed borrowing facilities in 1992, and Latin American countries (mainly Argentina, Brazil and Mexico)[33] for more than 70 per cent of Eurocommercial paper programmes and more than 80 per cent of other non-underwritten facilities, respectively. (The categories of borrowing described in this paragraph do not include Eurocurrency certificates of deposit, an instrument issued by banks and resembling those under Eurocommercial paper programmes, note issuance facilities and revolving underwriting facilities which, as discussed below in section D, has recently been an important vehicle for the external financing of Mexican entities.)

The remarks above concerning the concentration of lending from the international capital markets on a limited number of developing countries suggest that the pattern of recent external financing for South and South-East Asian countries mentioned above is more diversified than that for the Latin American countries. These differences are further brought out by the figures in table 25, which put these patterns in a longer perspective.

Many countries in South and South-East Asia (including all of those in table 25) largely or completely avoided being affected by the debt crisis.[34] Recourse to borrowing from banks by such countries reflected changes in their balance of payments on current account and policies towards external payments positions. For all but one of the sample of countries in table 25 continued borrowing from this source led to increases between 1983 and 1991 in the share of bank claims in total external debt. The increases were substantial for the Republic of Korea and Thailand, but for all the countries in the group except Indonesia they were accompanied by falls in the ratio of total debt to exports of goods and services. Three of the countries shown (Indonesia, Malaysia and Thailand) were recipients of large amounts of net foreign direct investment, which was a more important source of external financing than international bond issues and foreign equity investment. A substantial proportion of these flows originated within Asia, much of them in Japan but part also in Taiwan province of China which, for example, has become a significant source of such investment for Thailand. The Republic of Korea was an exception to this pattern, receiving only a limited flow of net direct investment and having greater recourse to external bond issues (which account for most of its inflow of portfolio investment).

A different pattern of external financing has characterized most of the group of Latin American countries, which in recent years have achieved a relaxation of the restriction of their access to the international capital markets originally associated with the debt crisis.[35] For the countries in table 25 FDI was mostly less im-

[32] The account of different lending instruments in this paragraph is based on M. Stigum, *The Money Market*, 3rd edition (Homewood, Illinois: Dow Jones-Irwin, 1990), chaps 20, 22 and 24; F. Graaf, *Euromarket Finance: Issues of Euromarket Securities and Syndicated Eurocurrency Loans* (The Netherlands: Kluwer Law and Taxation Publishers, 1991), chap. 2 (a) and (h); and R. Tennekoon, *The Law and Regulation of International Finance* (London, etc.: Butterworths, 1991), Part VI.

[33] Figures in BIS, *op. cit.*, for Euronotes, a financing category including Eurocommercial paper programmes and medium-term notes, show that approximately two thirds of announced facilities were for these three borrowers.

[34] The account in this paragraph is largely based on the survey in BIS, *International Banking and Financial Market Developments*, August 1992, pp. 16-28.

[35] The account in this paragraph makes extensive use of the survey in BIS, *International Banking and Financial Market Developments*, November 1992, pp. 16-28.

Table 25

FEATURES OF THE BALANCE OF PAYMENTS AND EXTERNAL FINANCING OF SELECTED COUNTRIES IN SOUTH AND SOUTH-EAST ASIA AND LATIN AMERICA SINCE 1980

($ billion, unless otherwise specified)

Region/country	Current account balance	Net foreign direct investment [a]	Portfolio investment [b]	Bank claims as proportion of total external debt (per cent) [c]
South and South-East Asia				
Indonesia				
1981-1985 [d]	-16.0	1.2	0.7	
1986-1989 [d]	-8.5	1.9	-0.1	
1990	-3.2	1.1	-0.1	
1991	-4.5	1.5	-	
1983				45.8
1991				47.2
Republic of Korea				
1981-1985 [d]	-11.2	0.2	1.6	
1986-1989 [d]	33.7	1.9	-0.3	
1990	-2.2	-0.1	0.8	
1991	-8.8	-0.1	3.1	
1983				72.5
1991				93.2
Malaysia				
1981-1985 [d]	-11.9	5.4	5.5	
1986-1989 [d]	4.1	3.3	-0.4	
1990	-1.7	2.5	-0.3	
1991	-4.4	3.5	0.2	
1983				64.3
1991				61.3
Taiwan province of China				
1981-1985 [d]	23.4	0.7	0.2	
1986-1989 [d]	55.8	-8.2	-2.9	
1990	10.8	-3.9	-1.0	
1991	12.0	-0.6	-	
1983				63.6
1991				65.6
Thailand				
1981-1985 [d]	-10.1	1.4	1.3	
1986-1989 [d]	-4.3	3.3	2.3	
1990	-7.1	2.3	-	
1991	-7.8	1.8	-0.1	
1983				49.5
1991				82.7

(For source and notes see end of table.)

Table 25 (concluded)

FEATURES OF THE BALANCE OF PAYMENTS AND EXTERNAL FINANCING OF SELECTED COUNTRIES IN SOUTH AND SOUTH-EAST ASIA AND LATIN AMERICA SINCE 1980

($ billion, unless otherwise specified)

	Current account balance	Net foreign direct investment	Other net long-term capital flows [e]	Bank claims as proportion of total external debt (per cent) [c]
Latin America				
Argentina				
1980-1981 [f]	-4.7	0.9	6.4	
1982-1985 [f]	-2.1	0.4	2.1	
1986-1989 [f]	-2.5	0.7	2.0	
1990	1.9	2.0	-0.8	
1991	-2.7	2.4	1.2	
1983				59.6
1991				48.6
Brazil				
1980-1981 [f]	-12.3	1.9	7.5	
1982-1985 [f]	-5.8	1.7	5.3	
1986-1989 [f]	-0.4	1.2	-1.9	
1990	-3.8	0.2	-4.6	
1991	-1.4	-	-1.3	
1983				72.5
1991				52.7
Chile				
1980-1981 [f]	-3.4	0.3	2.6	
1982-1985 [f]	-1.7	0.2	1.4	
1986-1989 [f]	-0.7	0.2	0.6	
1990	-0.6	0.2	1.9	
1991	0.1	0.6	0.5	
1983				73.0
1991				45.1
Mexico				
1980-1981 [f]	-13.4	2.5	12.2	
1982-1985 [f]	1.1	0.7	5.4	
1986-1989 [f]	-1.0	2.6	-1.1	
1990	-7.1	2.6	3.0	
1991	-13.3	4.8	13.0	
1983				77.5
1991				61.3
Venezuela				
1980-1981 [f]	4.4	0.1	1.3	
1982-1985 [f]	2.0	0.1	0.4	
1986-1989 [f]	-1.8	-0.1	-1.3	
1990	8.3	0.4	-1.3	
1991	1.7	1.9	0.8	
1983				73.9
1991				51.4

Source: Bank for International Settlements, *International Banking and Financial Market Developments*, August 1992 and November 1992, and IMF, *Balance of Payments Statistics Yearbook, 1992*, Part 1.

a Partly estimated.
b Net financial flows in the form of bonds and equities.
c End of year.
d Cumulative amounts.
e Net financial flows in the form of bonds and equities, and other long-term capital of the resident official sector, deposit money banks and other sectors.
f Annual average.

portant than other net long-term capital inflows in the 1980s. Such investment rose in all the countries except Brazil at the beginning of the 1990s - in the case of Argentina and Venezuela to levels substantially higher than other net long-term capital inflows but in the case of Mexico to one much lower. An important feature of the external financing of Argentina, Brazil and Mexico at the beginning of the 1990s was their increased use of external bond issues which, as discussed further below in sections C and D, continued to expand in 1992 and was accompanied by increased foreign participation in their equity markets. In contrast to the countries of South and South-East Asia shown in table 25, those of Latin America all substantially decreased their dependence on bank debt. As noted above, recently there has been a modest rise in the exposure of BIS-reporting banks to Latin America, positive exchange rate adjusted changes, for example, being registered for Argentina and Mexico in 1991. More recently increases in short-term trade-related credits to, and interbank borrowing by, entities in Chile and Mexico point to the achievement of more normal relations between these countries and their external creditors.

As discussed in section D and also in Part Two, chapter III, the recent rise in financial flows to certain Latin American countries has relaxed their external financial constraint, but its scale has created problems for monetary and fiscal policy and exchange rate management. The recent experience of these Latin American countries serves to highlight issues which can be expected to become increasingly prominent as greater attention is given to developing countries by international portfolio investors and the volume of their placements in such countries expands.

Except for Asian and a limited number of Latin American borrowers, access to international capital markets remained restricted and perceptions of creditworthiness unfavourable for the great majority of developing countries. For example, the exposure of BIS-reporting banks to Africa continued to contract. As is documented in detail in section E, most developing countries have to pay high premiums and face restrictive conditions on official insurance for financing and payments arrangements for their imports. Lending to developing countries in the form of export credits has continued to be low, and the revival in 1989 and 1990 has not been sustained (see tables 26 and 27). More than 50 per cent of all developing countries repaid more than they received in new financing in this form. Fluctuations of medium- and long-term export credits have been more marked than for total export credits, presumably reflecting their link to variations in the investment demand of particular recipients.

B. Renegotiation and reduction of bank debt

A number of agreements on the reduction of debt and debt service between debtor countries and their creditor banks have been reached since the spring of 1992. These countries included two of the largest Latin American debtors, Argentina and Brazil. In April 1993 final agreement was achieved regarding the rescheduling of Argentina's bank debt, on whose terms preliminary agreement had been reached in June 1992. An agreement in principle was reached on Brazil's debt in July 1992. Once this agreement has been finalized, major restructurings will have been undertaken since the beginning of the 1990s for the three largest debtor countries in this region (the third being Mexico). As already noted above, Argentina, Brazil and Mexico have all recovered their access to the international capital markets and, subject to continuing achievement by them of sustainable positions in their balance of payments on current account, their creditors may now face respite from pressures on their balance sheets due to disruptions in the receipt of debt-service payments from these three borrowers.

However, for other developing countries, with smaller amounts of outstanding debt, restructurings remain frequent. Signings were completed for an agreement on such a restructuring for Gabon in May 1992 and for the Philippines in July 1992. Bolivia reached preliminary agreement on the terms of a restructuring in July 1992, Guyana in August 1992, and the Dominican Republic in May 1993. Moreover, several other debt renegotiations are currently at various stages, the countries in question including Bulgaria, Congo, Côte

Table 26

TOTAL EXPORT CREDITS [a] TO DEVELOPING COUNTRIES, BY REGION

A. PREVALENCE OF NEGATIVE NET FLOWS

(Unless otherwise specified, percentage of the number of countries in the region or grouping) [b]

	1987		1988		1989		1990		1991		1992
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half
All developing countries	50	47	43	42	35	45	33	39	52	40	52
Of which in:											
Africa	56	54	38	40	28	42	28	48	58	32	50
America	39	35	38	38	32	54	27	32	51	41	62
West Asia	60	67	60	53	50	43	36	36	64	36	57
South and South-East Asia [c]	52	38	45	45	45	41	48	34	31	55	38
Memo item: [d]											
14 highly indebted countries [e]	9	9	8	9	5	7	4	4	5	7	7
Central and Eastern Europe [f]	6	5	4	6	4	5	4	5	0	4	3

B. NET FLOWS AND STOCK IN MID-1992

(Millions of dollars)

	1987	1988	1989	1990	1991	1992 (1st half)	Stock (end of June 1992)
All developing countries	-5 146	-5 754	5 857	6 734	2 487	825	182 774
Of which in:							
Africa	916	-1 500	3 664	-5 018	828	-984	56 263
America	-959	1 572	93	4 563	3 205	1 613	54 897
West Asia	531	-3 422	1 634	4 660	2 024	-748	35 531
South and South-East Asia [c]	-5 498	-1 745	209	2 662	-3 024	1 153	32 345
Memo item: [d]							
14 highly indebted countries [e]	-1 686	296	1 659	3 681	3 353	1 018	66 115
Central and Eastern Europe [f]	-3 141	-3 581	404	4 610	9 732	2 290	42 726

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 Excluding countries for which data are not available.
c Including Oceania.
d Number of countries.
e Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay and Venezuela.
f Including the former USSR.

Table 27

NET FLOW OF MEDIUM-TERM AND LONG-TERM EXPORT CREDITS TO DEVELOPING COUNTRIES, 1985-1991

(Millions of dollars)

Net flow to:	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
All developing countries							
Total	552	-3 308	-7 045	-5 160	3 729	-957	5 067
Private	1 005	-1 985	-4 271	-3 480	4 134	-1 815	2 539
***By region*:**							
Africa							
Total	422	-980	-2 939	-2 764	1 442	-1 568	1 942
Private	541	-281	-2 244	-2 200	1 272	-1 642	1 226
America							
Total	-220	-758	-896	261	1 307	278	1 318
Private	-241	-993	-1 042	260	1 460	-4	206
West Asia							
Total	402	-303	183	739	1 324	214	821
Private	477	-243	217	1 071	1 560	-191	542
South and South-East Asia [b]							
Total	206	-754	-2 909	-2 004	398	106	867
Private	338	-101	-821	-1 345	514	-19	453

Source: Estimates by the UNCTAD secretariat, based on OECD figures.
a Provisional.
b Including Oceania.

d'Ivoire, Ecuador, Jordan, Nicaragua, Panama, Poland, and Uganda. Movement in these negotiations will be affected by the extent of the concessions banks are prepared to make now that a substantially reduced importance among their problems is attributed to developing countries' debts.

The main features of Argentina's agreement with its creditor banks were described in *TDR 1992*,[36] namely the substitution of discount and par reduced-interest-rate bonds for outstanding debt together with arrangements for settling past arrears on interest by means of cash payments and the issue of government bonds. Delay in completing the agreement was due to the need for additional negotiations necessitated by an initial offer on the part of banks to convert only 13 per cent of their debts into discount bonds. This proportion fell far short of the target of the Argentine Government, which was concerned at the level of collateral it would have to provide for the principal of the new bonds. Under the distribution eventually achieved 35 per cent of eligible debt was converted into discount bonds, and 65 per cent into par bonds. As a result of the agreement there will be an increase in interest payments by Argentina as it removes the ceiling it previously applied to such payments and begins to meet in full its contractual obligations.

Brazil's preliminary agreement, which covers $41 billion of debt,[37] offers a much wider range of rescheduling options to its creditor banks than in the case of Argentina. In addition to discount bonds (option 1) and par bonds at a reduced interest rate rising by stages from 4 per cent in the first year to 6 per cent in years 7 to 30 (option 2), the options include the following: par bonds with an interest rate during the first six years lower than under option 2 but linked to LIBOR thereafter and with a shorter maturity and grace period for the repayment of principal (option 3); new money

36 Part Two, chap. I, sect. C.

37 The amount of debt covered by the restructuring has declined from $44 billion to $41 billion since the preliminary agreement, owing to repayments and to purchases of debt titles by Brazilian banks (*Financial Times*, 29 May 1993).

together with conversion bonds in a ratio of 1 to 5.5, both at a rate of interest linked to LIBOR and with maturities and grace periods less than under options 1 and 2 (option 4); par bonds with reduced interest rates rising according to the same schedule as under option 3 but with the difference between these rates and one linked to LIBOR capitalized, a longer maturity and grace period, and rising repayments of principal (option 5); and par bonds at reduced interest rates also following the same schedule as under option 3 but with the capitalization of the difference between these rates and a fixed rate of 8 per cent (option 6). As for Argentina, difficulties have arisen owing to the relatively low proportion of debt (18 per cent) which, in their initial response, banks have chosen to convert into discount bonds under option 1. The Brazilian Government's target for this option is 40 per cent of debt, and further negotiations have resulted in an agreement that banks will convert at least 35 per cent into discount bonds. In the meantime Brazil's financing costs (for example, those associated with export credits for its imports) continue to be unfavourably affected by uncertainty over the final outcome of its debt renegotiation.

The main features of the agreement of the Philippines were described in *TDR 1992*.[38] The agreement also comprised a buy-back operation, completed in May 1992, which resulted in the retirement of $1.3 billion of debt at an average price of 52 per cent of face value. Gabon's agreement covers most of the country's outstanding bank debt and reschedules principal payments due in 1989-1992. The options under Bolivia's agreement in principle are a buy-back of outstanding debt at 16 per cent of face value, the exchange of old claims for new par bonds bearing a zero rate of interest, and the exchange of principal claims for short-term discount bonds, also bearing a zero rate of interest. Guyana's preliminary agreement was for a buy-back of outstanding debt at about 11 per cent of face value, the cost being financed by a grant under the IDA debt reduction facility.[39] The agreement in principle of the Dominican Republic covers outstanding debt and arrears, and provides for the exchange of two types of bond at concessional terms, one of them a discount bond, for existing obligations.

Although no agreement has yet been reached on debt and debt-service reduction for any country of Central and Eastern Europe or the former Soviet Union, creditor banks have granted to the latter a succession of deferrals of selected payments of principal on its debt, and a number of discussions concerning debt restructurings are under way following the agreement at the Paris Club covering the payments due on official debt in 1993 (see Part Three, box 16). The negotiations of Poland with commercial banks have been protracted because the country is pressing for an agreement offering terms similar to those agreed earlier with its creditors at the Paris Club. Poland has resumed limited interest payments as a result of recent talks, and has offered to buy back a third of its debt to banks and issue 30-year par and discount bonds for the remainder. Bulgaria has put forward a proposal under which it would buy back 50 per cent of its outstanding debt at 10 per cent of face value and exchange the remainder for par or discount bonds. Smaller creditor banks have already sold their Bulgarian debt on the secondary market at prices of around 16-20 per cent of face value but it is not clear whether other banks would also be prepared to accept such a large discount.

C. Latin American bond financing

As noted in section A, recent issues of external bonds by developing countries have been concentrated principally among a limited group of countries in Latin America and South and South-East Asia. For the countries of the latter region access to such financing was not

38 See Part Two, chap. I, sect. C.

39 Under the IDA debt reduction facility, established in 1989 and funded with $100 million from net income from the World Bank's operations, money is made available to low-income countries for the reduction of their external debt in the form of obligations to commercial banks and suppliers through buy-backs at large discounts on face value. Support is contingent on programmes acceptable to IDA for medium-term adjustment and the management of external debt.

disrupted in the 1980s by the debt crisis but bonds have not dominated their external capital inflows.[40] For the Latin American countries bond issues have been of greater relative importance as a source of external financing and closely related to their achievement of improved creditworthiness. In view of the critical role of bonds to the latter group of countries special interest attaches to the terms of their issues and to the ease with which they have been absorbed by international investors.

The costs associated with bond finance consist of interest, of those due to the special terms and conditions of an issue (enhancements),[41] and of fees paid to the issuing banks.[42] The first two of these costs are strongly influenced by borrowers' perceived creditworthiness. This in turn is affected by the ratings of agencies such as Moody's, Standard and Poor's, Fitch, and Duff and Phelps or of the National Association of Insurance Commissioners (NAIC).[43] In general, a rating is a pre-condition for access to the bond market.[44] Recently, the ratings of entities from Argentina, Mexico and Venezuela have been tending to improve; Argentina's sovereign debt, for example, was upgraded in July 1992. Moreover, the debt of certain entities from Chile and Mexico, which is denominated in local currencies, has been more highly rated by Standard and Poor's than that denominated in foreign currencies. However, with the exception of Chilean ones, entities from Latin American countries which have been the recipients of the recent increase in bond financing for the region have not yet received investment-grade ratings[45] for debt denominated in foreign currencies from the two major rating agencies, Moody's and Standard and Poor's. None the less, in a small number of cases Fitch, NAIC and Duff and Phelps have accorded investment grade to debt issued as private placements by certain Brazilian, Mexican and Venezuelan entities, and in May 1993 Duff and Phelps raised its rating of Mexican sovereign bonds to investment grade.

The costs of bond finance depend not only on such ratings but also on the balance at particular times between the scale of new issues and the markets' willingness to absorb them. Thus, for example, the improvements in creditworthiness just mentioned were reflected during the first half of 1992 in reductions of the spread for new issues without enhancements between their yield at launch and that on comparable bonds of OECD Governments in the same currency (their yield spread). But these reductions in cost were also due to the increased interest of retail investors (including holders of flight capital) and institutions in bonds offering high returns at a time when interest rates for many major currencies had fallen. The movement came to an end later in the year as a result of an oversupply of issues (including those of a number of newcomers to the markets, many of them Latin American banks). The reversal was manifested in higher than expected yield spreads for a number of Mexican issuers and yield spreads ranging from 575 to 745 basis points for certain Brazilian banks.[46]

A major stimulus to external bond issues by many Latin American borrowers during the recent period has been higher interest rates in their domestic financial markets than in international ones, a phenomenon further discussed below in section D. The resulting incentive for interest rate arbitrage has been particularly important for Latin American banks, which have found that onward lending to domestic customers of funds raised from this source can be highly profitable since interest rate differentials have not been offset by depreciation of their domestic currencies.

Perceptions of the creditworthiness of Latin American borrowers may not prove robust in the event of unfavourable developments affecting their external payments, although the evaluations by rating agencies suggest that investors would be likely to differentiate carefully between countries in such circumstances.

40 Among Central and Eastern European countries Hungary has regularly raised money through external bond issues since the mid-1980s. Even when its external financial position became difficult, it experienced no restrictions on its access to the bond markets owing to its avoidance of debt restructurings.

41 Examples of such enhancements were given in *TDR 1992*, Part Two, chap. 1, sect. D.

42 Despite intense competition among banks for mandates for the bond issues of Latin American countries, fees do not appear to have changed significantly, typically amounting to about 1 per cent of the face value of issues.

43 The latter is an association of United States insurance regulators whose evaluation of financial assets determines the size of the reserves to be set aside against the risk of loss on them.

44 On occasion borrowers have obtained ratings only after their first bond issues, a recent example being a Colombian public sector oil company.

45 Bonds rated Baa or higher by Moody's and BBB or higher by Standard and Poor's are regarded as being of "investment grade". There is frequently a bar on investment in assets of less than investment grade by institutional investors. The other agencies use similar rating systems but, except for Fitch, with a less fine grading of speculative issues.

46 See, for example, *International Insider*, 9 November 1992, and N. Peagam, "Unchastened borrowers restart the flood", *Euromoney*, March 1993, pp. 146 and 148.

Moreover, investors' willingness to hold paper originating in this region is clearly subject to limits which are not precisely defined but can quickly be reflected in substantial rises in the costs associated with new issues. If a country has recently been the recipient of large amounts of short-term or speculative external financing (a subject discussed in section D), the sustainability of its external payments position and the effectiveness of macroeconomic management (and thus the country's creditworthiness as far as the bond markets are concerned) is especially vulnerable to unfavourable developments or shifts in perceptions.

D. External financial flows: some consequences and policy responses in Latin America

The large increase in financial flows to certain Latin American countries, combined with debt restructurings, has significantly relaxed the external financial constraint on policy making and has been accompanied by a limited revival of domestic investment. However, the scale of these flows and the potential volatility of large parts of them have also posed sometimes difficult challenges to policy makers, as is discussed in greater detail in Part Two, chapter III, section C. Certain features of this situation, already evident last year, have continued to apply, and more recent experience has further underlined their importance.

Total net external financial flows to Latin America are estimated to have increased from a little less than $40 billion in 1991 to about $57 billion in 1992.[47] Five countries, namely Argentina, Brazil, Chile, Mexico and Venezuela, accounted for about two thirds of this figure. The categories of external financing included here comprise borrowing in the form of international bank loans and external bonds (discussed in earlier sections), direct investment, portfolio investment in equities, and other, principally short-term, financing (e.g. the purchase of various instruments other than equities available in these countries' domestic financial markets). Of Argentina's net external financial inflow, estimated to be some $9-11 billion, an amount of $2.5 billion consisted of direct investment (of which almost $2 billion were flows associated with privatization). Of Brazil's net inflow of $10-11 billion, $1.3-2.0 billion consisted of direct investment, $1.7 billion of net inflows into the country's domestic financial markets, and $7.9 billion of various other kinds of borrowing. For Chile, $0.6-1.0 billion of the total net inflow of $2.7 billion consisted of direct investment. The total net inflow into Mexico was more than $23.3 billion, of which $5-6 billion was direct investment and more than $15 billion was absorbed by the country's domestic financial markets (including $10 billion of equity investment); the balance consisted of borrowing in the form of bank loans and external bonds. Of Venezuela's total net inflow of $2.1 billion (a figure which may not include all that associated with single large privatization),[48] $0.8-1.0 billion consisted of direct investment.

The substantial inflows into Argentina, Brazil, Chile and Mexico consisted not only of external financing from non-residents but also of substantial amounts of repatriated flight capital. An important influence on these inflows was exerted by interest rate arbitrage between United States dollar rates and generally substantially higher ones in these countries' domestic financial markets, as illustrated for

[47] These estimates (which include long- and short-term capital, unrequited official transfers, and errors and omissions in balance of payments statistics) are those of CEPAL, in its "Preliminary Overview of the Latin American and Caribbean Economy 1992", *Notas sobre la Economia y el Desarollo*, No. 537/538, December 1992, table 16. The figures for individual countries in this paragraph are based on the estimates in the same source, together with higher ones for Argentina and Brazil published in *Latin American Weekly Report*, 1 April 1993. The estimates for direct investment are based on The World Bank Debt and International Finance Division's publication, *Financial Flows to Developing Countries. Quarterly Review*, April 1993, table 17, the issue of *Latin American Weekly Report* cited above, and *Latin American Economy and Business*, various issues. The last two publications are also the source for the estimates of the other categories of external financial inflow mentioned in the text.

[48] According to *Latin American Economy and Business*, February 1993, p. 7, if account is taken of the inflows during December 1992 of $1.3 billion associated with the second instalment of the privatization of the telephone utility, CANTV, then the total 1992 inflow into Venezuela of foreign investment alone, direct and portfolio, amounted to more than $2 billion.

selected monthly rates of interest in table 28. The nature of this arbitrage process varied over time and among countries. For example, in Chile an important role has been played by banks which borrowed in international markets for the purpose of onward lending domestically. In Brazil both non-financial corporations and banks have reduced their cost of financing by external borrowing, but much of the money raised in this way was used for onward lending in the form of purchases of government debt instruments rather than for capital formation. For Mexico borrowing abroad by its commercial banks has been particularly important, one of the instruments used to attract the inflow being Eurocurrency certificates of deposit (Euro-CDs), instruments mostly denominated in dollars and generally having maturities of up to one year (most frequently of up to six months). Already in April 1992 the stock of outstanding Mexican Euro-CDs, at $12.4 billion,[49] exceeded the total value of the country's external bond issues since 1989. More recently, in early 1993, external investors have switched funds from equities into short-term government bills (Certificados de Tesoreria (CETES)), as prices fell on the Mexican stock exchange.

The other major vehicle for short-term or speculative, and thus potentially volatile, external financial inflows into this group of Latin American countries has been portfolio equity investment. Inflows in this form can take place through the purchase of various instruments: American Depository Receipts (ADRs) and Global Depository Receipts (GDRs), which permit the shares of the issuing entity to be traded in the stock markets of the United States and other OECD countries (and which have been especially important for Mexican entities but have also been used by those of other countries in the group); shares in country and regional investment funds; and shares directly available in domestic markets. Large profits have been possible for equity investors in these countries in recent years. For example, IFC's index of stock prices in dollars rose more than 570 per cent for Venezuela in 1990, and almost 400 per cent for Argentina in 1991. Moreover, increases in this index of more than 90 per cent were registered in 1991 for Chile, Mexico and Brazil.

1992 was marked by less buoyancy in these countries' equity markets; IFC indices for Argentina and Venezuela fell 25 per cent and 43 per cent, respectively, that for Brazil changed little, and those of Chile and Mexico rose in the range of 10-20 per cent.[50] Nevertheless, the markets continued to attract substantial sums from abroad. However, the inflows were often accompanied by large outflows; the estimated net inflow of $1.7 billion into Brazil's financial markets (much of it portfolio equity investment), for example, consisted of an inflow of $3.9 billion balanced by an outflow of $2.2 billion.[51]

Of the major categories of external financing only direct investment, external bond issues, and significant parts of equity investment associated with privatization are in general likely to be linked closely to fixed capital formation. For short-term lending and remaining purchases of equities such a connection can be expected to be at best more indirect. Information on the proportion of investment financed in recent years through equity issues is available for only a few developing countries, and only for Mexico in Latin America.[52] Even if this proportion is high, the bulk of such issues will be sold through and to financial institutions, the importance of stock exchanges consisting mainly of improving the liquidity of equity investments (a function likely to be unfavourably affected by large price volatility).

Furthermore, while the external financial inflows discussed in this section have been associated with reductions of financing costs, they have also complicated monetary, fiscal and trade policy (as discussed at greater length in Part Two, chapter III). Such inflows exert upward pressure on the exchange rate, with unfavourable consequences for the country's competitiveness and its capacity to attract FDI in sectors producing tradable goods. Offsetting actions in the form of purchases of foreign currency by the monetary authority will generally be accompanied either by increases in the money supply (which may be unwanted) or by increased sales of government debt (which will have an adverse effect on its fiscal balance) (see Part Two, chapter III, sections B, C.3 and C.4). The alternative is other, more direct, measures to control or restrain the inflows. To the extent

49 C. Collyns *et al.*, *Private Market Financing for Developing Countries* (Washington, D.C.: IMF, World Economic and Financial Surveys, December 1992), p. 24.

50 *Latin American Economy and Business*, March 1993, p. 15.

51 *Latin American Weekly Report*, 1 April 1993.

52 For a summary of recent research on this question see A. Singh, "The stock-market and economic development: should developing countries encourage stock-markets?", *UNCTAD Discussion Paper No. 49*, pp. 36-41. The proportion of corporate growth financed through external equity was 76 per cent in the case of Mexico, the highest for the samples of firms in nine countries during the 1980s covered in Singh's study.

Table 28

REPRESENTATIVE EXCHANGE-RATE ADJUSTED LENDING OR MONEY-MARKET RATES OF INTEREST IN SELECTED LATIN AMERICAN COUNTRIES AND EXCESS RETURNS AS COMPARED WITH UNITED STATES RATES

(Returns, and excess returns, in percentage points after adjustment for changes in exchange rates for the United States dollar) [a]

	Argentina [b]		Brazil [c]		Chile [d]		Mexico [e]	
	Return	Excess return [f]	Return	Excess return [f]	Return	Excess return [f]	Return	Excess return [f]
1991								
January	-13.66	-14.17	-5.39	-5.90	-2.09	-2.60	1.57	1.06
February	-23.03	-23.51	-8.02	-8.50	1.27	0.79	1.51	1.03
March	1.11	0.63	12.88	12.40	0.27	-0.21	1.45	0.97
April	-2.02	-2.48	6.08	5.62	1.94	1.38	1.37	0.91
May	0.75	0.30	10.95	10.50	2.54	2.09	1.31	0.86
June	0.87	0.41	6.03	5.57	1.44	0.98	1.25	0.79
July	2.06	2.61	5.41	4.96	1.39	0.94	1.20	0.75
August	1.34	0.90	7.46	7.02	1.74	1.30	1.14	0.70
September	1.80	1.37	9.58	9.15	0.65	0.22	1.25	0.82
October	1.41	1.00	-4.64	-5.05	1.26	0.85	1.22	0.81
November	1.44	1.06	12.69	12.31	1.60	1.22	1.24	0.86
December	1.38	1.04	13.85	13.51	-0.38	-0.72	1.43	1.09
Monthly average	-2.21	-2.57	5.57	5.13	0.97	0.52	1.32	0.88
Annual equivalent	-22.72	-26.83	91.64	82.32	12.27	6.42	17.04	11.19
1992								
January	2.16	1.85	8.38	8.07	2.39	2.08	1.63	1.32
February	1.08	0.77	11.91	11.60	7.84	7.53	1.57	1.26
March	0.97	0.64	10.91	10.60	0.68	0.35	0.54	0.21
April	1.39	1.08	10.30	9.99	1.95	1.64	1.38	1.07
May	1.19	0.88	9.95	9.65	1.83	1.53	0.10	-0.20
June	1.00	0.70	9.74	9.44	-0.68	-0.98	0.95	0.65
July	1.27	1.00	7.76	7.49	-0.24	-0.51	1.53	0.26
August	1.20	0.94	9.00	8.74	-0.30	-0.56	2.37	2.11
September	1.20	0.96	9.44	9.20	0.30	0.06	0.20	-0.04
October	1.20	0.97	8.70	8.47	3.47	3.24	0.98	0.75
November	1.78	1.52	7.98	7.72	1.00	0.74	1.93	1.67
December	2.05	1.78	7.09	6.82	1.19	0.92	1.34	1.07
Monthly average	1.37	1.09	9.26	8.98	1.62	1.34	1.21	0.93
Annual equivalent	17.80	13.89	189.53	180.73	21.30	17.32	15.33	11.75

Source: UNCTAD secretariat estimates, based on data of the Centro Español de Estudios de América Latina (CEDEAL), ECLAC, IMF and the Central Bank of Chile.

a Exchange rate adjustments on the basis of end-of-month exchange rates between the dollar and the respective currency.
b 30-day time deposits (period average).
c "Hot money" (period average).
d Non-indexed bank loan from 30 to 89 days (period average).
e Average rate of interest to borrowers (period average) until June 1992. Thereafter implicit monthly returns on 28-day Certificados de Tesoreria (CETES).
f Excess return as compared with United States Treasury bills.

that the flows take volatile forms, the possibility of their reversal represents a threat to economic stability (see Part Two, chapter III, sections D.1 and D.2). The threat results from the vulnerability of the country's exchange rate and external financial position to such a reversal. If a worsening of the external accounts forces a depreciation of the currency, there is a risk of a further deterioration through financial outflows as arbitrage profits, dependent in part on a high exchange rate, are eliminated. In these circumstances the Government may find that it is losing its control over key economic variables such as exchange and interest rates, and may also be confronted with a devastating loss of international creditworthiness.

In fact, the changes in the pace of gross domestic investment in the Latin American countries chiefly affected by recent inflows have not so far matched the scale of the turn-about in their external financial positions (see Part Two, chapter III, sections B, C.1 and D.2). Indeed, in Brazil a contraction of such investment has continued.

In view of the problems posed to certain Governments in Latin America by recent financial inflows, considerable interest attaches to their policy responses.[53] These have varied (see Part Two, chapter III, section C.4). At one end of the spectrum is the largely passive reaction of Argentina, while elsewhere Governments have tended to be more interventionist, most notably in Chile, which adopted a wide range of measures to control the capital inflow. As experience accumulates regarding the problems which can result from developing countries' exposure to the flood-tide and ebb-tide of external financing which results from progressive incorporation in the global network of financial markets, debate is likely to continue as to the appropriate policies to be followed in these circumstances. The result may be wider recourse to the more interventionist approaches already tried in Latin America.

E. Terms of export credits and alternative financing arrangements

As noted in section A, lending in the form of export credits[54] to developing countries, to those of Central and Eastern Europe and to the former USSR continues to be sluggish. This outcome results partly from demand conditions, in particular the absence of a sustained rise in investment in these countries which could be expected to generate substantial imports of capital goods that are frequently financed with export credits. But, as in other recent years, the sluggishness is also due to the prevalence of high costs and restrictive conditions applying to insurance from export credit agencies (ECAs) for the financing and payments arrangements for imports. These costs and conditions, like their analogues in the private insurance market, are of interest because of the way in which they reflect perceptions of countries' creditworthiness (and thus, as explained below, their costs of doing business). As indicators for this purpose they reinforce the picture in earlier sections of improved external financial positions for certain developing countries accompanied by the continuation of stringency for the great majority and for economies in transition.

The costs of private export credits consist of interest, premiums on official insurance, and other transaction costs associated with the restrictive conditions on which such insurance cover is made available. These conditions include the proportion and amount of credit for which cover is available, the limit on the amount of financing below which the exporter

53 For a review of initial responses see *TDR 1992*, Part Two, annex II.

54 The export credits in tables 26 and 27 include not only the private lending carrying insurance or guarantees from an export credit agency (ECA) which is discussed in the present section, but also direct lending by OECD Governments whose determinants are not discussed in this Report. It is customary to define a "private export credit" as one carrying "official" insurance or guarantees (even in cases where the institutions with officially recognized mandates for this purpose are privately owned). However, the sale of the short-term credit insurance operations of the United Kingdom's Export Credits Guarantee Department (ECGD) to the Nederlandsche Credietverzekering Maatschappij (NCM), the consortium of banks and insurance companies which serves as a vehicle for providing export credits in the Netherlands, may presage further blurring of the distinction between official and private insurance in trade financing and payments.

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 (which may consist of a guarantee from a national public entity in the importing country or a letter of credit issued by a bank in the importing country and frequently also confirmed by one from an OECD country). The interest rates charged on financing for the imports of developing countries and economies in transition are linked to international rates or to the minimum rates under the OECD Arrangement on Guidelines for Officially Supported Export Credits (the Consensus referred to in footnote *a* to table 24), and sometimes to other national rates. They generally also include a premium inversely related to perceptions of the borrower's creditworthiness. Minimum interest rates under the OECD Consensus used to be determined principally by a matrix under which rates varied according to the classification of the borrowing country into one of three categories (I or "relatively rich", II or "intermediate", and III or "relatively poor"), and according to the maturity of the loan (but not its currency denomination). Since early 1992 the matrix has been replaced by the "Commercial Interest Reference Rates" for different currencies or composite currency units shown in table 24. These rates are calculated by the addition of 100 basis points to the yield on government bonds and are subject to adjustment at regular intervals. To developing countries belonging to Category III (i.e. with a level of GNP per capita making them eligible for IDA credits) loans may be made at an interest rate consisting of the SDR rate plus 50 basis points.

The influence of perceptions of creditworthiness extends beyond the costs of private export credits to those of other financing and payments arrangements for imports. The latter include charges on banks' letters of credit and margins over inter-bank interest rates for *a forfait* financing[55] as well as the premiums on private insurance for such arrangements. As a result, there tends to be an approximate correlation between movements in the costs of all the different financing and payments arrangements available to developing countries and economies in transition.

As indicated by tables 29 and 30, there has recently been considerable inertia in the terms on official insurance cover from EXIM in the United States and NCM (registered in the United Kingdom). But table 29 also brings out the continuing prevalence for both developing countries and economies in transition of instances[56] where credit insurance cover from ECAs is available only on restrictive conditions or not at all. Indeed, only for countries of South and South-East Asia is there a large proportion of instances (33 per cent for short-term credits and more than 40 per cent for medium- and long-term credits) where such insurance cover is available from the ECAs without restrictive conditions, i.e. on normal terms. Moreover, it is noteworthy that none of the countries of Central and Eastern Europe shown in tables 29 and 30 receives export credit insurance from the two ECAs without such restrictions. Table 31 provides more detail concerning the unfavourable position regarding the availability of official credit insurance cover currently facing countries of Central and Eastern Europe and the former Soviet Union. Only the German ECA, Hermes, makes available cover to the great majority of these countries, its policy in this respect being in sharp contrast to that applied by NCM and ECGD.[57]

The prevalence of restrictive terms on official credit insurance cover since the outbreak of the debt crisis has been due not only to perceptions of creditworthiness but also to the cash flow deficits in recent years for the majority of ECAs of OECD countries (see table 32). The consequent contribution to the tightening of ECAs' terms results from their long-run obligation to be self-supporting on their commercial operations, an objective difficult to achieve in conditions widely characterized by disruptions of developing countries' debt service. This restrictiveness on the part of ECAs led to increased interest during the 1980s in private credit insurance for financing and payments arrangements for countries' imports.[58] Terms on private insurance are sometimes more flexible than those available from ECAs and more responsive to changes in perceptions of

[55] *A forfait* financing (or forfaiting) is an arrangement under which the debt instruments associated with a trade transaction are sold at a discount in financial markets without recourse to previous holders.

[56] The concept, "instance", is explained in footnote *c* to table 29.

[57] It should be noted that much of the package of financial aid recently agreed for the Russian Federation consists of export credits, but a good deal of these export credits is in the form of direct lending by Governments. Moreover, this agreed financial aid is not reflected in the tables showing actual lending in this chapter.

[58] N. Budd (*Credit Enhancement in International Trade Transactions* (London, etc.: Lloyds of London Press, 1992)) points out that only in the 1980s were banks accepted by the Committee of Lloyds insurance market as named insureds or assignees. Previously, political risk insurance could be purchased only by parties to commercial, as opposed to financial, transactions (*op cit.*, p. 2).

Table 29

TERMS [a] OF INSURANCE COVER AVAILABLE TO SELECTED REGIONS FROM SELECTED EXPORT CREDIT AGENCIES [b]

(Number of instances [c] in which EXIM, ECGD or NCM applied specified terms)

Region/period	Normal terms [a]		No cover [a]		Restrictive conditions [a]	
	Short-term [d]	Medium- and long-term [e]	Short-term [d]	Medium- and long-term [e]	Short-term [d]	Medium- and long-term [e]
Africa						
Late 1988/early 1989	9	8	18	21	43	41
Late 1989/early 1990	9	8	18	18	43	44
Late 1990/early 1991	9	8	18	19	43	43
Late 1991/early 1992	9	8 (8) [c]	18	19 (16) [c]	43	44 (11) [c]
Late 1992/early 1993	9	(8) [c]	20	(16) [c]	41	(11) [c]
Latin America						
Late 1988	7	7	6	9	39	36
Late 1989	7	7	6	8	39	37
Early 1991	15	8	5	21	32	23
Early 1992	7	7 (5) [c]	5	17 (6) [c]	40	28 (15) [c]
Early 1993	6	(5) [c]	5	(6) [c]	41	(15) [c]
South and South-East Asia [f]						
Early 1989	16	16	3	3	29	29
Early 1990	16	16	3	3	29	29
Early 1991	16	16	3	3	29	29
Early 1992	16	16 (10) [c]	3	3 (3) [c]	29	29 (11) [c]
Early 1993	16	(10) [c]	3	(3) [c]	29	(11) [c]
Central and Eastern Europe [g]						
Early 1989	3	1	4	4	5	7
Early 1990	3	1	4	4	5	7
Early 1991	2	1	5	4	5	7
Early 1992	1	1 (0) [c]	5	4 (3) [c]	7	7 (3) [c]
Early 1993	0	(0) [c]	4	(3) [c]	8	(3) [c]
Memo item:						
Highly indebted countries [h]						
Late 1988/early 1989	3	3	4	5	21	20
Late 1989/early 1990	3	3	4	4	21	21
Late 1990/early 1991	9	4	3	9	16	15
Late 1991/early 1992	3	3 (3) [c]	3	7 (3) [c]	22	19 (8) [c]
Late 1992/early 1993	3	(3) [c]	3	(3) [c]	22	(8) [c]

Source: Exporter's regional guides in *Euromoney Trade Finance Report*, *Trade Finance*, *Trade Finance and Banker International*, and *Project and Trade Finance*, 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 mainly the perceived riskiness of the provision of financing to the borrower in question. The number and stringency of the conditions vary. For some borrowers cover is not available on any terms.

b The Export-Import Bank (EXIM) of the United States, and until late 1991/early 1992 the Export Credits Guarantee Department (ECGD) of the United Kingdom; since that date also the Nederlandsche Credietverzekering Maatschappij (NCM).

c Until late 1991/early 1992 each country for which information was 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. However, for late 1992/early 1993 data is available only for the cover on short-term credits provided by NCM. Figures for cover on medium- and long-term credits from EXIM for this date are given in parentheses, as are figures for EXIM only for late 1991/early 1992.

d 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.

e Insurance cover for credits other than short-term.

f Including Oceania.

g Including the former USSR.

h See footnote *h* to table 23.

Table 30

CHANGES IN TERMS [a] ON INSURANCE COVER AVAILABLE TO SELECTED REGIONS FROM SELECTED EXPORT CREDIT AGENCIES [b]

(Number of instances)

Region	*More favourable terms* [a]				*Less favourable terms* [a]			
	Late 1988/ early 1989- Late 1989/ early 1990	Late 1989/ early 1990- Late 1990/ early 1991	Late 1990/ early 1991 Late 1991/ early 1992	Late 1991/ early 1992- Late 1992/ early 1993 [c]	Late 1988/ early 1989- Late 1989/ early 1990	Late 1989/ early 1990- Late 1990/ early 1991	Late 1990/ early 1991- Late 1991/ early 1992	Late 1991/ early 1992- Late 1992/ early 1993 [c]
Africa	3	-	1	-	-	1	-	2
Latin America	1	10 [d]	4	-	-	13 [d]	9	1
South and South-East Asia [e]	-	-	-	-	-	-	-	-
Central and Eastern Europe [f]	-	-	5	-	-	1	5	1
Memo item:								
Highly indebted countries [g]	1	9	4	-	-	5	8	-

Source: Exporter's regional guides in *Euromoney Trade Finance Report*, *Trade Finance*, *Trade Finance and Banker International*, and *Project and Trade Finance*, 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, ECGD or NCM between the categories "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see table 29.) Such changes are recorded separately for short-term and for medium- and long-term credits.

b The Export-Import Bank (EXIM) of the United States, and until late 1991/early 1992 the Export Credits Guarantee Department (ECGD) of the United Kingdom; since that date also the Nederlandsche Credietverzekering Maatschappij (NCM).

c Changes refer to insurance cover for short-term credits only in the case of ECGD/NCM in the absence of data concerning the terms on cover for medium- and long-term credits from ECGD in late 1992/early 1993 (see footnote ***b*** to table 29).

d Including the case of two borrowers for which favourable changes in the terms of insurance cover for short-term credits were accompanied by unfavourable changes in the terms for long-term credits.

e Including Oceania.

f Including the former USSR.

g See footnote ***h*** to table 23.

creditworthiness (although the cost is typically higher). During the most recent period for the countries covered in tables 29 and 30 (namely late 1991/early 1992-late 1992/early 1993) there was slightly more movement in the terms for private credit insurance than in those for official cover, but here too changes were infrequent. Of the countries in Africa, one experienced a favourable change in terms and two unfavourable changes; of the countries in Latin America and the Caribbean, three, all belonging to the category of "highly indebted", experienced favourable changes in terms and one an unfavourable change; and of the countries in South and South-East Asia, four, one of which belongs to the category "highly indebted", experienced favourable changes and none unfavourable ones.[59] Uncertainties in many countries of Central and Eastern Europe and the former USSR act as an impediment to the availability of private credit insurance. For example, owing to the process of privatization, the status of borrowers sometimes changes during the period covered by an insurance policy, government risk becoming commercial risk.

Long-term as well as short-term cover is available for Hungarian imports at premium rates beginning at under 2 per cent per annum. Short-term cover is available for imports into Poland and the Czech Republic, but longer-term cover for these countries is more difficult to obtain. For other countries availability is

[59] This information is based on the same source as tables 29 and 30.

Table 31

AVAILABILITY OF CREDIT INSURANCE COVER FOR COUNTRIES OF CENTRAL AND EASTERN EUROPE AND FORMER REPUBLICS OF YUGOSLAVIA FROM SELECTED EXPORT CREDIT AGENCIES [a]

(As of beginning 1993)

Country	*Cover available from:*	*Cover not available from:*
Albania	-	NCM, Hermes, ECGD
Armenia	Hermes	NCM, ECGD
Azerbaijan	-	NCM, Hermes, ECGD
Belarus	Hermes	NCM, ECGD
Bulgaria	Hermes [b]	NCM, ECGD
Croatia	Hermes	NCM, ECGD
Czech Republic	NCM, Hermes, ECGD	-
Estonia	Hermes	NCM, ECGD
Georgia	Hermes	NCM, ECGD
Hungary	NCM, Hermes, ECGD	-
Kazakhstan	Hermes	NCM, ECGD
Kyrgyzstan	Hermes	NCM, ECGD
Latvia	Hermes	NCM, ECGD
Lithuania	Hermes	NCM, ECGD
Moldova	Hermes	NCM, ECGD
Poland	Hermes	NCM, ECGD
Romania	NCM, Hermes	ECGD
Russian Federation	Hermes, ECGD	NCM
Slovakia	NCM, Hermes	ECGD
Slovenia	Hermes	NCM, ECGD
Tajikistan	Hermes	NCM, ECGD
Turkmenistan	Hermes, ECGD	NCM
Ukraine	Hermes	NCM, ECGD
Uzbekistan	-	NCM, Hermes, ECGD

Source: *Business Eastern Europe, Project and Trade Finance* (various issues).

a Hermes of Germany; Nederlandsche Credietverzekering Maatschappij (NCM) of the Netherlands; and Export Credits Guarantee Department (ECGD) of the United Kingdom.

b For short-term credits only.

Table 32

PROPORTION OF EXPORT CREDIT AGENCIES [a] IN SELECTED OECD COUNTRIES THAT INCURRED CASH-FLOW DEFICITS, 1982-1991

(Percentage)

	1982	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*
Proportion:	74	83	65	74	70	83	65	65	71	83

Source: Information supplied by the the Berne Union.

a 1982-1989: 23 agencies in 19 countries; 1990-1991: 25 agencies in 20 countries.

more limited and costs are higher. For example, for Romanian imports cover is available only under restrictive conditions at premium rates of 6 per cent per annum for periods of up to six months. Cover may be available for certain countertrade transactions for Bulgaria, Estonia, Latvia, Lithuania, Russian Federation and Ukraine. However, it is likely to be unobtainable for imports into Albania and the constituents of former Yugoslavia.[60]

[60] This characterization of the availability of private credit insurance cover is based on the Exporters Guide to Eastern Europe in *Trade Finance*, December 1992, and the address, "The current market and available cover in East European/CIS risk", by Angus McCallum, Managing Director, Sedgwick Financial and Political Risk, to the conference on political risk insurance in London, March 1993.

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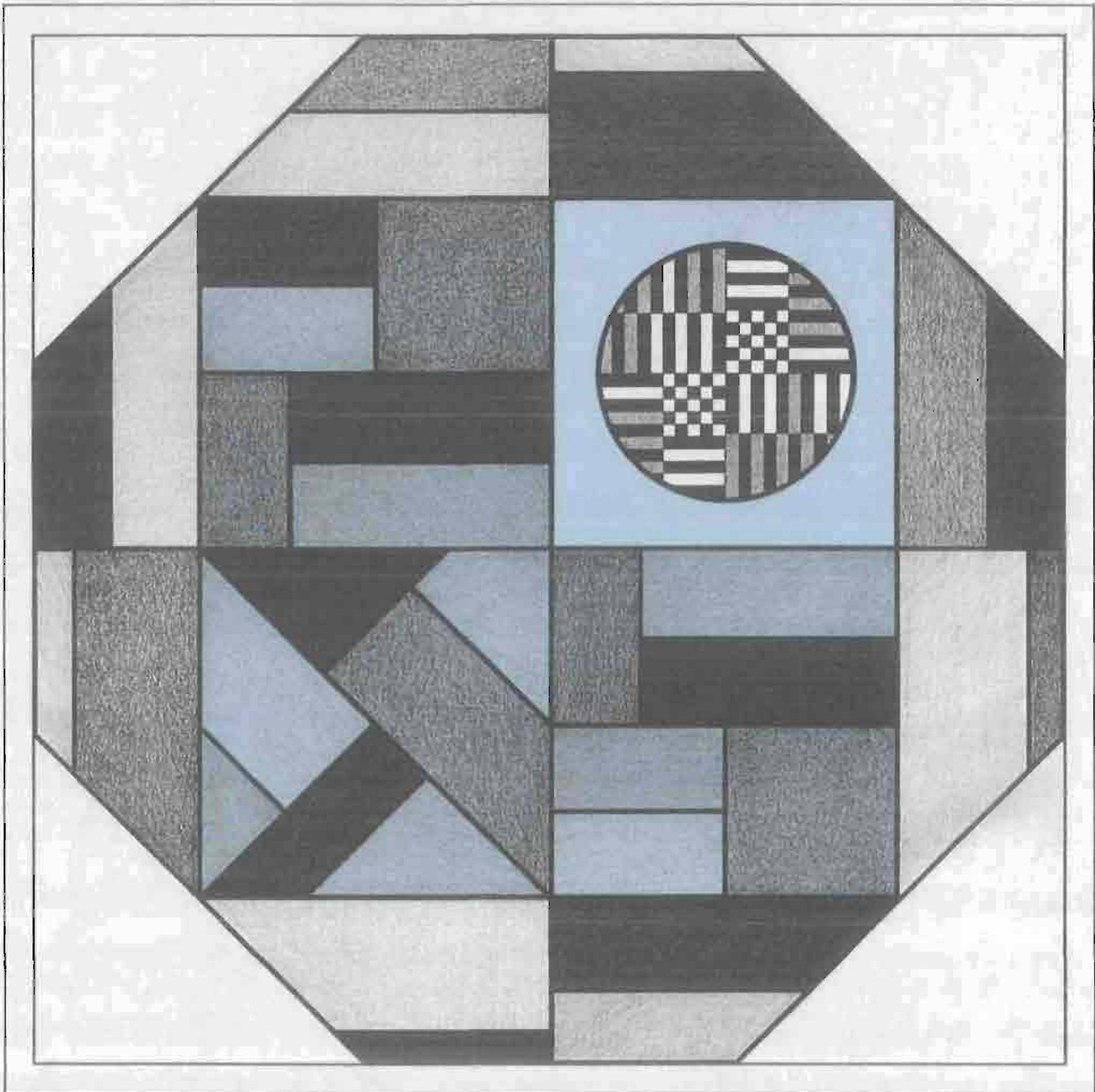
GROWTH DYNAMICS: THE DIFFERING PATTERNS



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Chapter I

DEFICITS AND DEFLATION IN INDUSTRIALIZED COUNTRIES

A. The legacy of the 1980s

During the 1980s the Governments of a number of the world's most industrialized countries introduced new approaches to economic policy. From the Reagan supply-side revolution in the United States, to the Thatcher revolution in the United Kingdom and the policy of a strong franc in France, they all involved greater reliance on market mechanisms and less on government, in the belief that this would yield both more stable prices and increased economic growth. Indeed, so strong was this belief that reducing the presence of government in the economy became itself a goal of policy, not only in industrialized countries, but also worldwide. For instance, it is now the centrepiece of the conditionality of the international financial institutions.

World economic prospects in the 1990s depend very much on the economic legacy of the 1980s: an increase in cyclical and structural unemployment, increased fiscal imbalances and government indebtedness, persistent trade imbalances, widespread financial fragility, and a weakening of international efforts to coordinate exchange rate and trade policy.

1. *Expansion and imbalances*

In the 1980s the international economy was characterized by the so-called "dual imbalances": the current account and government deficits of the United States, on the one hand, and the payments surpluses of Western Europe and Japan and fiscal surpluses or rapidly improving fiscal positions of the majority of the industrialized countries, on the other. These imbalances widened as the industrialized economies came out of their sharpest recession in the postwar period, to enter the longest period of sustained expansion since the immediate postwar years.

The dual imbalances were largely the result of a policy mix in the United States which combined tight monetary policy with supply side tax reductions. As a result, the United States became the international "locomotive" responsible for global expansion, at the cost of a sharp increase in government debt and a sharp deterioration in its trade balance. Western European countries were thus able to adopt measures to improve their fiscal positions without serious effects on internal demand and employment.

The continued appreciation of the dollar, caused by capital inflows attracted by high interest rates and high expected returns, reinforced by the rapid expansion while the trade balance continued to deteriorate, suggested that direct international action was required. The Plaza Agreement of 1985 proposed cooperative action to balance a reduction in the United States budget deficit by more expansionary policies in Western Europe and Japan. But, instead of improving the policy mix by relaxing monetary policy, the United States concentrated first on expenditure reduction, and then on increasing taxation, while

monetary policy remained tight. This brought about a slowdown in the expansion and an eventual improvement in the United States trade balance, resulting in slower growth, rising unemployment and falling government revenues in the European economies.

2. *Recession*

In Japan the relaxation of monetary policy and lowering of interest rates produced a sharp escalation of prices in the stock and property markets. The slowdown in the United States occurred at about the same time as the Bank of Japan moved to halt the boom in asset prices by tightening monetary policy; falling rates in the United States were thus accompanied by rising interest rates in Japan. During 1990, the United States, Canada, the United Kingdom and Australia went into recession, which was reinforced by the uncertainties in the Persian Gulf which were widely expected to reproduce conditions in world oil markets similar to those of the early 1970s.

Recession was delayed in the continental European countries by the increase in business investment in anticipation of the single European market in EEC that was to come into force in 1993, and, more especially, by the sharp increase in demand due to the unification of Germany. Unification produced a German policy mix similar to that of the United States in the early 1980s; a strong fiscal stimulus brought about a rapid deterioration of the current account and of budget deficits, in increasingly tight monetary conditions.

Although internal demand in the rest of Western Europe was weak, most EMS countries tightened monetary policy sharply to defend their parities, in the belief that any realignment of exchange rates would indicate inability to meet the conditions for the second phase of monetary union in 1994. Although the expansionary effect of German unification provided short-lived relief, the tight monetary policy was maintained, presenting most countries with a choice between preserving exchange stability and economic growth.

3. *Unemployment, trade and fiscal imbalances*

The result was to superimpose an increase in cyclical unemployment on a structural increase that had been part of the new policy experiments in the 1980s aimed at bringing about a shift in the distribution of income in favour of profits by disciplining the labour force through higher unemployment. This rising trend of unemployment was reinforced at the end of the 1980s as the private sector joined Governments in cutting spending, in order to reduce the debt servicing costs of the increased borrowing undertaken when financial markets were deregulated earlier in the decade. The increased ratio of interest costs to gross revenues had made firms highly vulnerable to the decline in cash flows produced by the recession. Since banks were cutting back on lending, the only alternative to bankruptcy was to reduce direct and overhead costs by eliminating the multiple layers of middle management, thereby adding white collar to blue collar unemployment.

Trade and budget imbalances continue to plague policy makers, but in a different way than before. Since the major trade imbalance is now the recession-driven Japanese trade surplus, due more to falling imports than to rising export volumes, there are no offsetting "locomotive effects" on global demand. The nature of the fiscal imbalances has also changed. The persistence of high interest rates, due first to United States internal policies, and then to Japan's efforts to quell the "bubble economy" and Germany's efforts to dampen the unification boom, has meant that in many countries it is the interest cost of servicing outstanding government debt, rather than inappropriate tax or expenditure policies, which has become the decisive factor in fuelling government budget imbalances (see table 33). Thus the budget imbalances have become increasingly widespread, and increasingly structural, rather than cyclical, in nature.

4. *Policy dilemmas*

This nature of the budget imbalances creates special difficulties, first because it makes it more difficult to employ expansionary fiscal policies to combat cyclical downturns, and second because budget surpluses will be necessary in order to reduce the stock of outstanding debt. This second aspect is reinforced by the convergence conditions contained in the Maastricht treaty as the precondition for monetary union. To meet these conditions, all the major economies would have to reduce net government expenditures drastically. Reducing the debt service burden by means of interest rate reductions thus becomes that much more important. However, any unilateral decision to

Table 33

GENERAL GOVERNMENT DEFICITS AND DEBT, 1992

(Percentage of GDP)

Country	*Budget balance*	*Debt*	*Interest payments*	*Primary balance* [a]
United States	-4.7	63.0	2.2	-2.5
Japan	1.3	64.9	0.4	1.7
Canada	-5.8	82.3	5.5	-0.3
EEC				
Germany	-3.2	44.0	2.6	-0.6
France	-2.8	50.1	2.6	-0.2
Italy	-11.1	108.4	10.9	-0.2
United Kingdom	-6.6	41.9	2.1	-4.5
Belgium	-6.1	134.4	9.8	3.7
Luxembourg	2.6	5.3	0.5	3.1
Netherlands	-3.8	78.3	5.1	1.3
Denmark	-2.6	62.2	3.7	1.1
Ireland	-2.5	98.1	6.3	3.8
Portugal	-5.4	66.7	9.1	3.7
Spain	-4.7	48.4	3.3	-1.4
Greece	-13.2	84.3	13.6	0.4

Source: *OECD Economic Outlook*, December 1992, and EEC, *European Economy*, May 1992.
a Budget balance net of interest payments.

reduce interest rates automatically risks producing exchange rate instability.

Thus, the imbalances of the 1990s present much more difficult policy choices than those of the 1980s. The use of high interest rates in Germany confronts other ERM countries with a choice between using monetary policy to preserve currency stability and expanding domestic output and employment. But choosing currency stability means increasing debt service. This will raise both fiscal deficits and government debt, and make it more difficult to meet the Maastricht convergence conditions. As discussed further below, any attempt to both retain currency stability and meet the Maastricht conditions would require massive fiscal retrenchment and extremely high domestic interest rates, staving off income growth.

In theory, a strong recovery in the United States economy could help resolve the European policy dilemma by providing a source of external demand, but the United States recovery is still stymied by debt deflation; in order to reduce their indebtedness firms and households have reduced their expenditures. This tendency has been reinforced as households, banks and firms have all tried to restore their net wealth positions after the losses incurred by the sharp fall in asset prices due to distress sales. The introduction of minimum capital adequacy ratios to strengthen the banking system has increased holdings of government debt at the expense of more highly risk-weighted, and thus more expensive, commercial and industrial lending to business. Thus, even though the Federal Reserve has been attempting to loosen monetary policy by consistently reducing short-term interest rates, bank lending and money supply growth have continued to decline.

Far from generating demand in other countries, the United States has so far been largely dependent for recovery on exports. The slowdown in Japan and Western Europe and the rise in the dollar relative to European currencies means that this source of demand will peter out. Further, the political perception that the United States federal debt is excessive has shifted fiscal policy towards measures to generate a primary surplus. A United States recovery cannot therefore be expected to solve the European dilemma.

With all countries looking for an external demand stimulus, the temptation to protect domestic producers has increased. As a substitute the United States appears to have returned

to its policy of the 1980s of favouring yen appreciation as a solution to the Japanese trade surplus. However, the rise of the yen relative to the dollar is likely to increase Japanese pressure on European markets and increase the potential for trade disputes between EEC, Japan and the United States.

Any policy to reduce the stock of outstanding debt will require either lower interest rates or higher fiscal surpluses. To the extent that a high level of indebtedness is responsible for high interest rates (because of the belief that there is a risk of inflation inherent in fiscal deficits required to finance the debt), fiscal surpluses will be required to bring indebtedness under control. Moreover, for those countries which are part of a fixed exchange rate system, the interest rate is reserved for meeting the exchange rate objective, and thus cannot be used with impunity to reduce debt financing costs and government deficits, unless there is a coordinated policy among members of the system to reduce interest rates. Therefore, many countries face a classical economic policy conflict in which the pursuit of policies to reach the objective of public debt reduction runs counter to the achievement of growth and employment objectives. Most economies also face an additional conflict between exchange rate stability and growth. Recession in the industrialized countries and the rise of cyclical and structural unemployment would require not only fiscal stimulus but also lower interest rates. However, in the absence of adequate international coordination of macroeconomic policies and cooperation in pursuing divergent policy objectives, any loosening of monetary policy quickly conflicts with exchange rate objectives.

The extent of this policy conflict can be seen in the dilemma faced by the United Kingdom after its decision to defend its ECU parity in the ERM despite the realignment of the lira in September 1992. The decision to raise central bank intervention rates in a single day from 12 per cent to 15 per cent, in order to preserve the parity of sterling relative to the deutsche mark, despite unemployment of over 10 per cent in the third year of a persistent slump, was clearly not a credible long-term policy, and the foreign exchange markets anticipated the eventual decision to give priority to internal equilibrium over maintenance of the exchange rate. Once the United Kingdom suspended its participation in the ERM, the Government moved quickly to reduce interest rates; the first signs of recovery became evident at the beginning of 1993.

The increasing importance of internal policy, and the widely different conditions being faced by the industrialized countries (as evidenced by the asymmetry in their cyclical positions), have led to a weakening of international cooperation. This has also brought the relevance of the Maastricht convergence conditions into doubt, produced a sharp increase in exchange rate uncertainty and volatility, and lessened individual countries' ability to pursue appropriate internal economic policies.

Coordination has become more difficult not only because internal and external policy objectives have come into sharp conflict with each other, but also because there are fewer available policy instruments. Resolution of the problems of the 1990s will require reconsideration both of the external objectives which have been set and of the range of policy tools available to achieve them.

B. Current policies and future prospects

1. United States: hesitant domestic recovery

The experience of two false starts in recovery suggests that the United States requires some form of demand stimulus. This brings into conflict the goals of economic expansion and deficit reduction. The 3.2 per cent expansion in 1992, capped by a 4.7 per cent increase in the fourth quarter, suggested that the recovery was well under way; besides, consumer spending led the expansion and was accompanied by strong export growth. However, employment failed to expand strongly, jeopardizing income growth, and continued weakness in the financial sector still plagued the economy. Consumer spending and exports both declined in the first quarter of 1993 as the trade deficit expanded sharply. Estimated GNP growth in the first quarter was revised downward to 0.9 per cent from the initial 1.8 per cent, while unemployment remained un-

changed. The adverse impact on employment of corporate restructuring and increasing international competition is reflected in a very strong growth in productivity. This, along with substantial buildups in manufacturing inventories in the first quarter, suggests that an annual GNP growth in the 2-3 per cent range will not reduce domestic unemployment; firms can satisfy modest increases in demand without hiring additional labour.

Further, given the weakness of most other OECD economies, it will require another exceptional recovery in the fourth quarter of this year for the United States to achieve even a 2 per cent annual rate of expansion. Exports will continue to be sluggish in the face of falling world demand, and both the budget and the trade deficits will increase. There is a clear danger that even a modest expansion will be accompanied by rising short-term interest rates: the Federal Reserve's Open Market Policy Committee is reported to have already approved such an instruction to counter potential inflation. Thus, the United States economy may well face a stagnant Europe in which short-term interest rates are being reduced to encourage recovery. This, along with the positive impact of rising productivity and stable wage rates on corporate profitability in the United States, could push growth, interest and profit rate differentials in favour of the United States, and attract foreign capital, as in the early 1980s. Use of fiscal policy to bolster employment in the context of tight monetary policy could reinforce this tendency. Any appreciation of the dollar would offset the impact of increased productivity on international competitiveness and reinforce the negative impact on exports of European and Japanese stagnation, producing a deterioration of the trade balance. This in turn could lead to renewed calls for trade protection.

The original economic programme of the Clinton Administration sought to solve the conflict between increasing employment and deficit reduction by allocating different time spans to the two policy objectives. Employment growth was to be supported by a stimulus package to create jobs that would be implemented immediately, while deficit reduction was to be achieved by a package of spending cuts and tax increases which would bind the Administration to a medium-term programme to cut the annual budget deficit to $140 billion by the end of 1997. The expenditure package included areas such as infrastructure spending, and investment tax credits. The deficit reduction measures included personal and corporate tax increases, as well as an energy tax; the bulk of the spending cuts were envisaged in the defence budget and increased user charges for subsidized government services. The ratio of higher tax revenue to reduced spending was around 3:1. Although the House has passed both the stimulus and the deficit reduction packages, the Senate had (at the time of writing) already voted down the former because of the perceived strength of the economy, and seemed likely to shift the balance from tax increases to spending cuts in the latter.

2. *Japan: reduction of the surplus and domestic expansion*

For the fiscal year 1992 (ending March 1993) the Japanese trade surplus amounted to $136 billion, and the surplus will probably reach $150 billion in FY 1993. For the first time since the war, domestic demand has fallen for three consecutive quarters, resulting in lower import volumes, while the volume of exports failed to grow because of stagnant world demand. In yen terms, exports rose 1.6 per cent in the calendar year 1992, while imports were down by 8.4 per cent. The recent fall in the dollar vis-à-vis the yen will increase the dollar measure of the trade surplus, which was already 20 per cent higher in March 1993 than a year earlier.

The economy is therefore in a difficult position, for despite the increasing size of the dollar surplus net exports contribute very little to demand. With stagnant domestic demand, capacity utilization in most firms is only just above the break-even level. The size and rapidity of the fall in both domestic and external demand has also left firms with large inventories. Thus, many firms are seeking to increase exports at a time when protectionist pressures abroad are particularly strong and the yen is reaching unprecedented levels.

The strength and rapidity of the slowdown in Japan in some respects mirrors the difficulties of the United States in launching a stable recovery. As the impact of the collapse in the stock market and the fall in property prices worked its way through the Japanese economy, it has constrained the expansion of private demand in much the same way as in the United States. Japanese consumer spending was declining throughout the last half of 1992. As firms restructure their balance sheets, and respond to the new international trade and exchange rate conditions, the stability of employment is threatened, with the increasingly frequent occurrence of large layoffs that shake the confidences of consumers. Private investment is also down sharply. In previous down-

Box 6

JAPANESE BUDGET

The Japanese central budget is financed by general taxation and other receipts, such as stamp duties. In FY 1993 general-account expenditures of 72.4 trillion yen were to be financed by 64 trillion yen of tax and stamp receipts and other non-tax revenues, the balance to come from the issue of government bonds. This budget was not much larger than in the previous year because of a fall in corporate tax revenues.

In addition, there is a "second budget", financed by the Fiscal Investment and Loan Programme, which provides financing for public investment programmes via Post Office savings and the issue of public bonds. Local governments also participate in the financing of investment programmes. Most of the financing for the new investment projects comes from these two sources, and these projects are accordingly expected to yield revenues for them - thus the emphasis on "asset-creating" projects. Consequently, although the programmes are large, they entail a very small increase in central budget spending.

Only spending which is financed by the issue of bonds to be sold to cover the central deficits is considered as "deficit" financing. With the current low level of interest rates on time deposits in banks, funds have been flowing back into postal savings accounts, which offer tax advantages. Around 19 trillion yen were mobilized in this way in 1991 and 16 trillion in 1992: in the first two months of 1993 postal savings increased by over 2 trillion yen. This is the source of finance for the new government packages without adding to the deficit and without generating additional debt service - a system of deficit financing very similar to that proposed in the 1930s by Simons (see box 10 below).

turns, excess labour in manufacturing was shifted to the service sectors, but, as in the United States, these are precisely the sectors which have been hardest hit by debt deflation. Besides, employment in the services sector has become more dependent on manufacturing and is unable to act as a buffer.

It is therefore unlikely that further yen appreciation will significantly reduce the trade surplus; indeed, the valuation effect may even raise it in dollar terms in the short term. The falling cost of imports due to the appreciation of the yen has failed to stimulate import demand because of the reduced propensity to consume. On the other hand, because of excess capacity and the accumulation of large inventories, Japanese producers are willing to cut profit margins and prices in order to maintain their market shares in freely traded goods, while increasing margins on goods subject to voluntary export restraints. However, the increase in demand required for recovery cannot come from exports alone, even if there is a sustained expansion in the United States.

Interest rates are at postwar lows, but as in the United States bank lending continues to contract, and the Bank of Japan has been unable to prevent the money supply from falling. Although the banks have generally met the BIS risk-adjusted capital requirements on schedule, loan loss reserves have increased. Despite improved margins from falling interest rates, most banks reported declines in net profits for FY 1992, and credit ratings have been lowered. This suggests that banks will be constrained in lending to finance any expansion in the economy. Although further declines in interest rates are unlikely to provide any direct stimulus to the economy, they may help to halt the rise of the yen. However, after the experience of the "bubble economy", the Bank of Japan is hesitant to reduce interest rates.

Japan thus still faces the problem of reconstructing its financial system as it emerges from the "bubble", in order to lay the foundation for expansion. The Government introduced a series of measures in 1992 and 1993 to support the financial sector and increase domestic expenditure. The aim is to increase expenditures by around 5 per cent of GDP. It is none the less expected that fiscal balance will be maintained (see box 6). In August 1992 the Government announced a spending plan equal to 2.2 per cent of GNP, including public investment, purchase of land and purchase of shares in the stock market. In September restrictions on stock purchases by social security and postal savings bank were lifted and institutions were urged to exercise utmost restraint in selling shares. Regulators also informed fund managers that they should be investing

Box 7

THE COOPERATIVE CREDIT PURCHASING COMPANY OF JAPAN

Since August 1992 there have been a number of developments aimed at resolving the problems of non-performing loans in the Japanese banking sector, and in particular those owned by debtors in the real estate sector. After discussions between the Japanese Bankers' Association and the Ministry of Finance, the Cooperative Credit Purchasing Company (CCPC) was established on 27 January 1993. It is staffed by employees seconded from the participating banks and was initially capitalized at Y8 billion ($64 million). The necessary financial resources for its future operations will come from private financial institutions. It was established for 10 years.

The original scheme, announced in August 1992, was for the institution to purchase the collateral of delinquent real estate loans, and help eliminate the loans themselves by liquidating the collateral to finance the loan obligations. The institution which was actually created, on the other hand, will purchase non-performing loans rather than the collateral. The operations of CCPC involve three steps. First, a bank proposes a loan, and CCPC determines the purchase terms. Second, the loan is purchased at a discount. The Company finances this acquisition by borrowing from the selling bank. Finally, CCPC repays the loan with funds received from the original borrowers. These may be the result of normal repayment of principal or of the sale of the property. If the proceeds result in a loss for CCPC, the bank that originated the loan bears the loss. It is expected that purchases of loans shall only take place during the first five years of the envisaged 10-year life span, while the "settlements" of the loans shall be carried out mainly during the second five years.

Since CCPC purchases non-performing loans rather than the loan collateral, its transactions are only with the banks which originated the loans, not the borrowers. As far as the banks are concerned, the sale of a loan to CCPC represents the exchange of a "bad loan" to the original borrower for a "good loan" to it.

In addition, much of this loss, up to 40 or 50 per cent, can be credited against corporate tax. Since the collateral is in fact sold by the original debtors, the banks are able to bypass Japan's slow foreclosure process and to realize immediate losses on bad loans, thereby generating quick tax write-offs for troubled banks.

Since there is no secondary market for non-performing financial assets the plan also envisaged the creation of a small organization to evaluate bad loans and determine the discount to be paid by CCPC for the non-performing loans. This "price-appraisal committee" consists of neutral third parties, such as certified public accountants and tax accountants assisted by real estate appraisers. In order to prevent "unfair" transactions in liquidating the collateralized assets, the new committee provides the public with a list of relevant land prices on a monthly basis.

with longer time horizons. As part of the policy to strengthen the banks' position the Government and the Japanese Bankers' Association also formed the Cooperative Credit Purchasing Company (CCPC) in January 1993 to help solve the problem of bad loans collateralized by real estate (see box 7).

Despite its size, the 1992 package had little impact in boosting growth or slowing exports and a new package was announced in April 1993. The new package amounts to 2.8 per cent of GNP and includes spending on public investment, in particular new social overhead spending on education, health, basic research and telecommunications and computing, in addition to the more traditional roads and bridges. Accordingly, the Government forecast a growth in the fiscal year starting in April 1993 of 3.3 per cent. However, the forecast was subsequently lowered to 2.3 per cent as a result of the recent appreciation of the yen. The most recent predictions for the calendar year 1993 are for growth of around 1 per cent.

Thus, while it is still unclear how much stimulus the government packages will provide, the April measures sent a clear message to the financial markets that the Government would prevent additional declines, and stock prices rose considerably. There is some dispute over the permanence of this recovery, since it has been engineered mainly by the government support measures. There is also some question of its basis in the performance of the real economy. Corporate profits are down sharply and there have been unprecedented layoffs. Yet corporate cash flows are extremely high;

as a result of high investment in the recent past amortization allowances are disproportionately high, reducing reported profits but laying the basis for a renewed investment boom to adjust to the new, higher value of the yen. The measures that have been announced by the Government will be much less powerful than anticipated because of the recent rise in the yen and continued weakness in consumer and foreign demand, although they should prevent the financial system from collapse and ensure that the Japanese growth rate remains positive.

3. Germany: interest rates and domestic growth

After a period of extremely rapid growth following unification, the German economy is also entering its worst decline of the postwar period. This is largely the result of the extremely restrictive monetary policy used to combat a sustained increase in the fiscal deficit, monetary growth and inflation. However, tight money has had little impact on either the rate of inflation or monetary growth, while the downturn in domestic demand concurrently with world recession has contributed to the increase in the deficit, already swollen by the transfers required for unification, which have proved to be much larger than expected. With internal demand plummeting, the Bundesbank is faced with a choice between using the interest rate to control monetary growth and supporting the level of activity. It has recently introduced a policy of reducing market rates in small steps. This process started in September 1992 as a result of the difficulties in the ERM due to high German interest rates, but it was only in January 1993 that the six-month growth rate of M3, which appears to be the preferred measure of monetary growth, fell back to within the new target range set at the end of 1992.

The annualized growth of M3 in May (7 per cent) was again outside the target. The current rate of inflation is also well beyond the Bundesbank's acceptable rate of 0-2 per cent, a rate that has been exceeded since 1989 and was only rarely achieved in earlier years. Indeed, the annualized rate of inflation in the western Länder for the first five months of 1993 of 4.3 per cent is equal to the annual average for the whole of the period 1960-1984. As much as half a percentage point is accounted for by changes in indirect taxation and special measures introduced to finance unification. A breakdown of this price index in western Germany shows that price increases for food are within the desired range, while rents and services are the major cause of the excess price increases (see table 34). The rent component is also influenced by the continued pressure on housing caused by migration from the eastern Länder. Neither rents nor services tend to be directly influenced by the level of short-term interest rates, which again suggests that if monetary policy is to be successful in keeping inflation within the desired range it can only be at the cost of deepening the recession.

The more positive long-term outlook for inflation is supported by the west German metal workers and public sector union wage agreements for a 3 per cent increase in wages in 1993. However, the increase for east German steel workers, and for electrical and metal workers, as part of the agreements to bring wages up to levels in the west by 1997, will do little to improve the financial conditions of east German firms and will further increase budget transfers.

These figures bring out another aspect of the dilemma faced by the Bundesbank. When short-term rates were raised, long-term rates fell substantially. Since a large proportion of bank lending to the private sector is long-term or linked to long-term rates, the tightness of policy has little direct effect on financing costs. Similarly, as short-term rates fall, the expansionary effect is relatively modest. But a decline in German interest rates may give leeway to Germany's European trading partners to lower their own interest rates, and to the extent that this allows them to import more from Germany it would create some indirect stimulus. However, if it is accompanied by monetary tightening and higher interest rates elsewhere, particularly in the United States, then the consequent capital outflows and the depreciation of the deutsche mark could exert upward pressure on import prices and make the control of inflation more difficult. There is thus a strong case for a coordinated reduction in interest rates.

The basic problem is the difficulty in using the government budget as a tool both for adjustment to unification and for economic stabilization. The Government announcement in May that the 1993 federal government deficit would rise considerably, because expenditures would increase by over 7 per cent instead of the 2-3 per cent originally announced, resulted in a firming of interest rates and aroused the expectation that the current period of falling rates might be interrupted until more positive results were achieved with respect to inflation and money supply.

Table 34

ANNUAL CHANGE IN CONSUMER AND OTHER PRICES IN GERMANY SINCE 1986 [a]

(Percentage change over the previous year)

	1987	*1988*	*1989*	*1990*	*1991*	*1992*	*March 1993* [b]
Consumer price index (CPI)	0.2	1.3	2.8	2.7	3.5	4.0	4.2
of which:							
Food	-0.5	-	2.2	3.6	3.2	2.4	0.5
Other goods	-1.1	0.3	3.1	2.2	3.2	2.9	3.1
Services	2.0	2.8	2.5	2.5	3.5	5.5	6.5
Rents	1.6	2.1	2.9	3.5	4.3	5.5	6.3
CPI excluding energy	1.1	1.7	2.3	2.5	3.2	4.2	4.4
Import prices	-5.3	1.3	4.5	-2.3	0.4	-3.3	-2.7
Export prices	-0.9	2.1	2.8	0.1	1.3	1.0	0.2
Producer prices	-2.5	1.3	3.1	1.7	2.4	1.4	0.3

Source: *Monthly Report of the Deutsche Bundesbank* (various issues).

Note: From July 1991 to June 1992 prices rose by approximately 0.5 per cent as a result of a special "solidarity" tax. In 1993 an increase in the value added tax to 15 per cent will add approximately 0.5 per cent to consumer prices.

a Relates throughout to the former Federal Republic.

b Increase over March 1992.

Despite the monetary relaxation in the first half of 1993, German industrial production has continued to fall and the IFO research institute predicts a 7 per cent decline in industrial production for the year as a whole after a fall of 2 per cent in 1992. Capacity utilization is expected to fall to a 10-year record low by the end of the year. Another unofficial estimate (from the Deutsche Bank) puts the fall in GDP this year at 1.7 per cent, after 1.5 per cent growth last year.

4. *Other major Western European countries*

Many other industrial economies in Europe face broadly similar conditions of high or rising government deficits, large or rising overall indebtedness, falling domestic activity, rising unemployment and weak financial sectors. All are thus faced with the choice of cutting expenditures or raising taxes to reduce deficits, while seeking to bolster domestic demand in declining world economic conditions. Countries that participate in the Exchange Rate Mechanism of EMS all also face a choice between retaining stable parities for their currencies and using monetary policy for domestic recovery.

As its first act on taking office, the new French Government announced measures to reduce government expenditures. Within weeks, however, unemployment passed the 3 million mark (rising to nearly 11 per cent), a figure that was expected to reach 3.5 million by the end of the year. The Government thus quickly reversed gears, with the aim of stemming the rise in unemployment by borrowing to finance the unemployment fund. The budget deficit for 1993 will be almost double the previous forecast, at around 5.5 per cent of GDP. Debt service now represents the third largest expenditure item after defence and education. GDP growth fell from over 4 per cent in 1988 to an average of less than 2 per cent in the following three years, and a decline of around 0.8 per cent is expected for 1993.

In the United Kingdom, as a result of the official policy of reducing government debt, the budget was in surplus until mid-1990, when growing unemployment and increased spending led to deficits. These are expected to reach 8 per cent of GDP in 1993 and 9 per cent in 1994.

The United Kingdom was the first Western European country to enter into recession: GDP contracted in the second half of 1990. At over three million, unemployment had risen to 10 per cent by 1992. The United Kingdom is the only country where Government spending has been allowed to rise in order to combat the recession; part of the increased public spending is for investment incentive programmes in the manufacturing sector, a sharp reversal of policy pursued by the Government of Mrs. Thatcher.

In Italy, the budget deficit remains solidly above 10 per cent of GDP, despite multiple supplementary budgets increasing tax rates, taxing bank deposits and reducing spending. Italy represents the extreme case of the changed nature of the debt burden, with the deficit net of debt service in near balance. The level of unemployment has been rising gradually and is now over 11 per cent.

In the smaller EEC countries, fiscal imbalances are also increasing, and despite active policies to reduce deficits in both the Netherlands and Belgium they have risen above forecasts as a result of lower than expected receipts. GDP is estimated to stagnate in 1993 in the Netherlands and fall in Belgium by 0.8 per cent after modest growth in 1992.

The typical response to the deterioration in budget balances has been action to reduce expenditures and increase taxation. The basic difference among Western European countries is in the behaviour of their exchange rates. All members of EEC appeared to consider it necessary to preserve exchange rate stability in the run-up to the second phase of monetary union, but some were more successful than others. Both Italy and the United Kingdom not only failed to defend their parities, but also suspended participation in ERM until further notice. Spain, Portugal and Ireland all devalued, the first two countries twice within six months. The Netherlands, France, Belgium and Denmark all managed to defend their parities, but at the cost of extremely high real rates of interest and of domestic output and employment forgone. The success of these countries' policies is completely dependent on a rapid recovery in world demand and a substantial relaxation of monetary policy in Germany, neither of which is expected in the near term, creating the possibility of further speculative pressure within the system. Since the Netherlands has announced that its only monetary target is stability of the exchange rate, it is the currencies of the other three countries which are more likely to come under pressure.

The French franc has already come under speculative attack, but this cannot be depicted as a case of the market imposing discipline. The current purchasing power parity of the deutsche mark relative to the French franc has been estimated to be DM 0.298 = FF1, which is within the ERM band.[61] For the period 1989-1992 the inflation differential between France and Germany was zero, while France currently enjoys an annual inflation differential of over 2 percentage points. France also compares favourably with Germany in terms of the other convergence indicators for monetary union. Furthermore, the German trade surplus with France fell by almost one half from 1990 to 1992. Admittedly, the franc has appreciated against a number of European currencies, including the lira, sterling and the peseta, which may eventually lead to the weakening of the French trade balance. None the less, economic fundamentals do not suggest a clear misalignment of the two currencies. The speculative attack on the franc reflected, rather, the belief that, in the absence of recovery the Government would be forced to favour the pursuit of internal over external policy objectives.

On the other hand, two of the countries that opted to suspend participation in the ERM have experienced sharp increases in exports, without as yet any inflationary effects. The United Kingdom was able to reduce interest rates, and unemployment has fallen steadily since the beginning of the year; there are also clear signs of a recovery in consumption. The economy of the United Kingdom is the only one in Western Europe which is expected to grow in 1993, although by a modest 1.3 per cent. The fall in interest rates has reduced the mortgage burden for house-owners, and inflation has fallen to around 2 per cent, from over 10 per cent in 1990, but there are concerns that the impact of rising government deficits, monetary expansion and sterling devaluation will raise the inflation rate to 4 per cent. In Italy inflation has fallen to around 4 per cent since the devaluation, which is the lowest rate since the sharp rise in world oil prices. However, there has been a much smaller reduction in interest rates, and the lira has strengthened somewhat.

The events which forced exchange rate adjustment on the United Kingdom, Ireland, Italy, Spain, and Portugal, and the speculative pressure experienced by France, have brought into question not only the success of convergence in stabilizing exchange rates, but also the future of the ERM and of the European Mon-

61 Département économie politique, Union de Banques Suisses, Zurich, "La conjoncture internationale 1993/94", 1er trimestre 1993, p. 4.

etary Union (EMU). Although devaluation appears to have been of benefit to the countries involved, it has done little to contribute to the basic problem of reducing debt and interest rates. At best, it has postponed resolution of the problem, and at worst it increases the risk of a return to the inflationary spirals of the past. Although wages and import prices are no longer linked directly, thanks to less wage indexation in Italy and strike legislation in the United Kingdom, attempts to use the newly found freedom to lower interest rates so as to reduce debt service and increase employment will run the risk of prompting further devaluations and eventually producing inflationary pressures.

Thus these countries will still need some instrument to keep exchange rates reasonably stable and in line with competitive conditions. Recent experience in the ERM suggests that this cannot be done by using the reserves of a single central bank, and can only be achieved with great difficulty within the ERM, even given central bank cooperation. Some kind of control over capital flows will be required until conditions are ripe to re-enter the ERM.

C. The Maastricht Treaty and fiscal retrenchment

Despite falling or weak output and employment, all the major industrialized economies, with the exception of Japan, are seeking deficit and debt reduction. European Governments are especially keen because of the requirements set out in the Maastricht Treaty of December 1991 for proceeding to monetary union. These include convergence rules not only on inflation, interest rates and the exchange rate, but also on fiscal performance. Fiscal convergence is defined in terms of two ratios: (a) a general government deficit to GDP ratio of 3 per cent or less and (b) a public gross debt (including the monetary base) to GDP ratio of 60 per cent or less. The rules for inflation, the interest rate and the exchange rate are rather strict, but those on fiscal convergence are more nuanced. A deficit of over 3 per cent of GDP may be acceptable if it is exceptional and temporary and remains close to the reference value, if it does not exceed public investment expenditure, or if it is declining continuously to the reference value. Similarly, a debt to GDP ratio of over 60 per cent may be acceptable if it is approaching the reference value at a satisfactory rate.

The rationale for setting fiscal constraints stems largely from the fear that excessive deficits in a member of the monetary union can create negative spillovers for others. For instance, they could create financial instability, or even an unsustainable pace of debt accumulation resulting in a solvency crisis, possibly leading to the violation of the "no bailout" clause; this would shift the burden onto other Governments and/or necessitate considerable monetary expansion, thus creating "moral hazard". Similarly, an increase in government borrowing could crowd out private investment elsewhere in the Community, or the emergence of large budget deficits within the union could lead to exchange rate and payments problems vis-à-vis the rest of the world. More generally, a common monetary policy could conflict with independent national budgetary policies unless the latter were coordinated and their consistency with monetary policy ensured. The treaty seems to assume that Governments have an inherent tendency towards excessive deficits, and that explicit constraints on fiscal policy are needed to check this tendency and to attain the requisite degree of coordination and consistency. Most of these problems concern divergence of a single country from the norm. They are less important if all countries fall short of the norm to an equal degree.

1. The scope for fiscal convergence

At the end of 1992 only two of the 12 EEC countries (France and Luxembourg) met both fiscal requirements (see table 33), but France will not do so in 1993. Five countries (Italy, Belgium, Netherlands, Portugal and Greece) met neither condition while three (Germany, United Kingdom and Spain) have deficit ratios and two (Denmark and Ireland) have debt ratios above the specified limits. Thus, if EMU is to be introduced on schedule all the major economies will need to make considerable fiscal retrenchments.

Table 35

NOMINAL GDP GROWTH RATES NEEDED TO MEET THE MAASTRICHT DEBT TARGET BY 1997 AND 1999

(Per cent per annum)

Country	With a balanced budget		With a deficit/GDP ratio of 3 per cent		Memo Item: Growth of nominal GDP in 1992
	1997	1999	1997	1999	
Italy	15.9	10.4	20.9	15.0	5.7
Belgium	22.3	14.4	27.2	18.8	4.0
Netherlands	6.9	4.5	12.0	9.5	4.5
Denmark	1.0	0.6	5.4	5.1	3.6
Ireland	13.1	8.5	17.2	12.4	5.9
Portugal	1.9	1.3	7.1	6.4	13.5
Greece	8.9	5.8	13.9	10.7	17.2

Source: UNCTAD secretariat estimates, based on OECD and EEC statistics.

Table 35 gives some indication, for the seven countries concerned, of the extent of and scope for the fiscal adjustment needed to meet the debt target. The first two columns show the margins by which the annual growth rate of nominal income (i.e. the rate of inflation plus the rate of growth of real income) must exceed that of government debt in order for the debt ratio to fall to the required 60 per cent level by 1997 and 1999, respectively. These figures are calculated assuming that deficits are eliminated immediately and budgets are balanced thereafter; if deficits were to be reduced gradually and/or by a smaller amount, nominal income growth would have to be faster. The third and fourth columns of the table show the growth rates of nominal income required to bring the deficit down to 3 per cent by the end of the transition period. For the two countries (Ireland and Denmark) where the deficit ratio is already below this level, the calculations assume that the current ratio will be maintained. The figures indicate that for most countries, including two of the so-called core-currency countries (Belgium and the Netherlands), even an instantaneous reduction in deficits to the Maastricht levels would not permit the debt target to be reached by 1999.

The deficit ratios and the swings in fiscal balances needed to lower the debt ratio to 60 per cent by 1997 and 1999 are given in table 36. The calculation assumes a nominal income growth of 5 per cent annually. Except for Denmark and Portugal, all countries would need budget surpluses, starting in 1993. The swing in the budget balance required to reach the debt target by 1997, and even by 1999, is virtually impossible for Italy, Belgium, Greece and even Ireland. The fiscal adjustment needed by Italy, Belgium and Greece exceeds the adjustment achieved by Mexico during 1987-1991, when the public sector borrowing requirement was reduced by 14.5 per cent of GDP. However, in Mexico this adjustment was largely due to lower inflation and interest rates: the increase in the primary surplus was relatively small. In the three European countries, by contrast, the burden of adjustment would have to fall almost entirely on the primary budget, unless real interest rates are substantially cut.

2. *Impediments to fiscal convergence*

European interest rates are too high for fiscal adjustment. When the nominal rate of interest on government debt exceeds the rate of growth of nominal income, or when the real rate of interest exceeds the real growth of GDP, the ratio of debt to GDP will rise unless there is a corresponding primary surplus. Currently, long-term interest rates on government bonds

Table 36

BUDGET BALANCES AND FISCAL ADJUSTMENT NEEDED TO MEET THE MAASTRICHT DEBT TARGET BY 1997 AND 1999

(Percentage of GDP) [a]

	Actual budget balance	*Annual budget balance required to meet the target by:*		*Adjustment required to meet the target by:* [b]	
Country	*1992*	*1997*	*1999*	*1997*	*1999*
Italy	-11.1	7.8	3.9	18.9	15.0
Belgium	-6.1	13.6	9.4	19.7	15.5
Netherlands	-3.8	1.2	-0.3	5.0	3.5
Denmark	-2.6	-2.3	-2.5	0.3	0.1
Ireland	-2.5	5.6	2.5	8.1	5.0
Portugal	-5.4	-1.8	-2.2	3.6	3.2
Greece	-13.2	2.5	0.6	15.7	13.8

Source: UNCTAD secretariat estimates, based on OECD and EEC statistics.

a A minus sign indicates a deficit.

b The difference (in percentage points) between the actual budget balance in 1992 in column 1 and the required balances in columns 2 and 3, respectively.

exceed both the recent and the projected growth rates of nominal income for all members of the Community with moderate or low inflation (i.e. all countries except Greece and Portugal), implying that unless there is a sizeable decline in the real rate of interest, these countries will continue to need large primary surpluses simply to prevent their debt-to-GDP ratio from deteriorating further. They thus face a double challenge.

Table 37 shows (for those countries for which adequate data were available) the primary surpluses and fiscal adjustment needed to keep the debt-to-GDP ratio unchanged from the 1992 level. With the exception of Ireland, all countries would need primary surpluses higher than in 1992. In other words, unless interest rates decline considerably, countries such as Germany, France, the United Kingdom and Spain, which do not currently have "excessive debt" would have constantly rising debt ratios even without any increase in the primary deficits. With current (end-1992) interest rates and growth prospects, it would take only 3 to 4 years for the United Kingdom, France and Spain to become "excessive debt" countries. This means that they too would have to raise their primary surpluses; for the United Kingdom the fiscal adjustment needed would amount to as much as 6.5 per cent of GDP. A similar increase would be needed in Italy simply to keep the debt ratio at its present level.

The catch is that budget cuts on this scale would reduce income, thus widening the gap between the real rate of interest and the real growth rate, thereby necessitating a further round of cuts. A big fall in real interest rates is crucial to avoid this trap, even though that would by itself not eliminate "excessive" levels of indebtedness.

3. Consequences of fiscal retrenchment for economic activity

The debt and the deficit rules of the Maastricht Treaty are inherently deflationary because they require countries with "excessive deficits" to cut back without obliging other countries to expand, and without making it mandatory to adopt a more expansive monetary policy. The Bundesbank may well choose to relax monetary policy in response to a reduction in the German deficit, but it is under no obligation to do so in response to a fiscal adjustment elsewhere.

Table 37

PRIMARY SURPLUSES AND FISCAL ADJUSTMENT NEEDED TO MAINTAIN THE DEBT/GDP RATIO AT THE 1992 LEVEL

Country	*Long-term interest rate [a] in 1992*	*Inflation in 1992 (GDP deflator)*	*Required primary surplus [b]*	*Required fiscal adjustment [c]*
	Per cent		*Per cent of GDP*	
Germany	7.9	5.5	0.4	1.0
France	9.1	3.2	2.0	2.2
Italy	11.5	4.5	6.3	6.5
United Kingdom	9.1	5.4	2.0	6.5
Belgium	8.7	2.7	6.3	2.6
Netherlands	8.1	3.0	2.8	1.5
Denmark	8.9	2.4	3.3	2.2
Ireland	9.1	3.2	3.1	-
Spain	12.2	6.9	1.8	3.2

Source: OECD, *Economic Outlook*, December 1992, and *Main Economic Indicators*, March 1993; and UNCTAD secretariat calculations.

a Secondary market yield on government bonds.

b Calculated on the basis of the difference between the long-term nominal interest rate (column 1) and the rate of growth of nominal GDP (table 35, column 5), and the debt/GDP ratio in 1992 (table 33, column 2).

c The difference between the primary surplus required and the actual primary balance in 1992 (table 33, column 4).

Deficit cuts would affect output in two ways: (a) in the long term, by changing the supply side through investment and productivity growth and (b) in the short term, through reduced effective demand. While both would depend on exactly how the deficits were reduced, the short-term effects would clearly be deflationary, even if lower deficits led immediately to lower long-term interest rates and higher levels of private spending. The sum total of fiscal adjustments needed to hit the Maastricht deficit target within five years amounts to about 2.5 per cent of the combined GDP of the Community. According to the multipliers of the OECD's INTERLINK macroeconometric model, the cumulative output loss over five years stemming from action to lower government deficits by 1 per cent of GNP averages about 1.7 per cent for the large ERM countries other than Germany (i.e. France, United Kingdom, Italy and Spain) and 1.1 per cent for the Netherlands, Belgium, Denmark and Spain.[62] This suggests that the demand effects would be serious, particularly for Italy, the United Kingdom and Belgium.

Based on the INTERLINK model, OECD has undertaken simulations of the effects of fiscal retrenchment in the ERM countries. While the findings of the study with respect to falls in output have not been reported, there is some information on the results of the simulations as regards unemployment. Despite the expansionary monetary policy assumed in the simulation, fiscal contraction leads to a rise in unemployment by 2 percentage points in Italy and 1.5 points in Spain above the baseline. Unemployment in Belgium shoots up initially before it returns to the baseline level in 1998, whereas the impact on other countries, with smaller adjustment, is found to be small. The debt ratios of all high-debt countries stay well above the Maastricht target.

In retrospect, the projections which these simulations took as baseline have proved to be too optimistic. After they were made economic activity slowed down, raising government deficits. Also adding to deficits and debt was the sharp rise in interest rates, especially in countries such as Italy, with large initial stocks of debt. Consequently, the fiscal deficits currently

62 A.S. Englander and T. Egedo, "Adjustment under fixed exchange rates: application to the European Monetary Union", *OECD Economics Department Working Paper*, No. 117 (Paris, 1992), p. 48, table 7.

estimated by OECD for 1993 are higher than the baseline projections of the above simulation: by 2.2 percentage points for Italy, 3.9 points for the United Kingdom, and about 1 percentage point for Spain and the Netherlands. These deficits may not necessarily diminish much in the course of a cyclical upturn, since they have added considerably to the stock of government debt. In the United Kingdom the debt ratio rose from 35 per cent in 1990 to an estimated 42 per cent in 1993, reversing the continued decline since the early 1980s. In Italy the increase during the same period amounted to 12 percentage points.

A simulation undertaken by IMF is reported to have yielded similar results.[63] Apparently, the simulation estimated the output loss for the Community at between 0.4 per cent and 0.8 per cent, depending on the credibility of government policy in financial markets. These estimates were made when growth in the Community was expected to be strong. The growth forecast of IMF for the Community for 1993 was revised from 2.8 per cent to 0.1 per cent between May 1992 and May 1993. Thus, the convergence of deficits to the Maastricht target would most probably entail deeper cuts and deflation and greater unemployment than estimated earlier.

D. Policy options

The changed nature of the fiscal and trade imbalances in the 1990s has created a policy impasse and threatens to create a debt trap in the industrialized countries. When primary surpluses run alongside overall deficits because of the high interest bill, deficits are not expansionary. On the other hand, attempts to curb them will tend to be contractionary. At the same time, when economic activity is too low everywhere, exchange rate adjustments will simply serve to shift trade imbalances from one country to another. But fixing exchange rates will constrain the use of monetary policy and, by keeping interest rates high, make fiscal adjustment even more difficult. The European Monetary Union is designed to make policy coordination easier, but the transition to it aggravates the problems of policy makers. The additional factor of German unification has meant that monetary policy is also restrictive.

The policy impasse can be resolved only by acting directly on the stock of outstanding debt. However, if the major industrialized countries all simultaneously pursue policies to reduce debt by deficit reduction, the world economy will remain in recession and unemployment will mount. An individual country has the option of raising its level of activity and reducing its deficit by increasing exports, but if all countries try to do so they will trigger competitive exchange rate adjustments and severe trade conflicts. Adjustment through growth requires coordinated fiscal expansion, not contraction.

A coordinated reduction in interest rates would immediately reduce deficits by lowering financing costs, especially for the most heavily indebted Governments, where outstanding debt has a very short maturity structure. In countries without large stocks of outstanding debt, it would remove the need to generate deflationary primary surpluses in order to maintain a stable debt/GDP ratio. In countries with primary surpluses lower interest rates would contribute greatly to lowering debt and deficits while helping recovery. They would be compatible with exchange rate stability since that depends on interest rate differentials, not on the absolute levels of rates. However, as long as the overriding concern of German monetary policy is inflation, there can be no coordinated reduction in interest rates.

63 Ministère de L'Economie et des Finances, Paris, Communiqué, 29 July 1992; see also W.H. Buiter, G. Corsetti and N. Roubini, "'Excessive deficits': sense and nonsense in the Treaty of Maastricht", *CEPR Discussion Paper*, No. 750 (London: Centre for Economic Policy Research, December 1992), pp. 34-35. The study was reported to have been originally prepared for inclusion in IMF's *World Economic Outlook*, October 1992. (See *International Herald Tribune*, 29 July 1992.) The final IMF document did not make any reference to the study, but argued that "successful economic convergence would substantially strengthen output growth in the EC over the medium term because it would result in lower interest rates and less financial uncertainty. Although those countries with large fiscal adjustment requirements need to put in place a stronger fiscal policy that could entail a transitional decline in aggregate demand, the short-term effects of fiscal consolidation could be significantly attenuated" (p. 30).

There seem to be only two ways of reducing government debt without raising unemployment, namely privatization and a capital levy.

1. Privatization

Privatization would not significantly deflate the economy since the funds received by the Government would be recycled to the private sector through debt retirement. The basic impact on income would depend on the difference between fixed interest payments previously received on government debt and the dividends received from the shares which replaced them in private portfolios. However, share prices might be adversely affected by their supply, especially if a large number of Governments chose to sell assets simultaneously.

The decline in government deficits will depend on the difference between the income forgone from public assets and the interest payments on the debt retired. If they are equal, privatization will reduce public debt without reducing deficits. In a relatively efficient capital market, privatization will reduce deficits only if the enterprises concerned are expected to increase their earnings by improving management or discontinuing non-commercial objectives. Privatization could be particularly helpful in countries where the public sector is large and where also reducing government ownership and control would significantly increase efficiency, for instance by reducing bureaucratic irregularities and malpractices.

However, practical difficulties can make it very difficult to privatize on a large scale very quickly. For instance, very little progress has been made in Italy (see box 8). Moreover, in countries with a large stock of public debt, even large-scale privatization might prove insufficient.

2. Capital levy

As Keynes pointed out, a once-and-for-all capital levy designed to lower an unsustainable stock of government debt is more equitable than attempts to meet the claims of bondholders year after year by increasing and inventing new kinds of taxation on income and economic transactions (see box 9: because of its continued relevance this box is reproduced from *TDR 1989*, which discussed the domestic debt problems of developing countries). But, since a capital levy usually reduces current income, the real challenge is to design the levy with a minimum of impact on private income and expenditure.

There are two different ways to evaluate the reduction in demand due to a capital levy:

- The loss of interest from government bonds would reduce the real disposable incomes of households. However, the resulting decline in expenditure could be offset by an increase in government spending. This would increase the deficit net of debt servicing, but since the reduction in expenditure would certainly be less than the decline in interest income, the increased public spending and the associated increase in the primary deficits would also be less than the reduction in government interest costs. Consequently, there would be a net reduction in the overall deficit;
- The levy would reduce the real wealth of individuals and their anticipated income.

Although the two effects may be considered formally equivalent, they differ in their consequences for consumer liquidity. Proper assessment of the negative "wealth effect" on spending is crucial for determining the amount of offsetting fiscal stimulus required. Two recent experiences provide some indication of the strength of this effect: the recent debt deflation and the 1987 stock market crash.

In the recent debt deflation, spending decisions appear to have been affected in a number of ways. First, the decline in the value of assets reduced the growth of consumer spending as households attempted to increase savings. Second, the decline in the value of corporate assets necessitated cuts in borrowing and spending to increase internally generated funds. Third, the increase in the ratio of debt service to income reduced discretionary spending and investment in both the household and the corporate sectors. The increased debt service burden on consumers and corporations and the balance sheet adjustment in the corporate sector appear to have been more important than the negative wealth effect on consumer spending.

The $600 billion loss of household wealth in the October 1987 stock market crash was the equivalent of a fall of about 20 per cent in personal disposable income, yet there was little effect on the level of economic activity. Since

Box 8

PRIVATIZATION IN ITALY

Italian privatization was initiated with the creation of the Cassese Commission in 1985, which established a register of State property available for privatization. The commission valued the possible proceeds from privatization at L380 trillion, but other estimates, which took into account numerous types of infrastructure, were much higher (up to L900 trillion), equivalent to around 60 per cent of 1992 GDP.

As a first step, privatization of public sector enterprises was launched in July 1992. The Government announced the conversion into joint stock companies of Italy's four main industrial and financial State concerns: IRI - the biggest public sector holding company; EMI - the State-owned energy and chemical group; ENEL - the national electricity company; and INA - the State insurance agency. Their total net assets are estimated at L60 trillion ($48 billion or around 4 per cent of 1992 GDP), and the Government intends to sell off an initial 45 per cent to the public.

The privatization programme was to raise L27 trillion for the Treasury over three years, leaving the State with only minority holdings in many sectors. Separately, in order to reduce the debt of Italy's largest public sector company, IRI, L10 trillion are to be raised by selling various companies under its control. Negotiations over the sale of IRI have broken down as a result of divergent views concerning the valuation of assets.

Progress in privatization has been slow also for several other reasons. First, it has turned out that corruption was widespread in many State-owned enterprises, which reduces the companies' value in the view of potential private buyers; second, against the background of recession in Italy and elsewhere in Europe there appears to be a lack of private capital, while Italy is competing with many other countries, which have also launched large-scale privatization programmes, for foreign investors; third, many companies that are to be privatized sold some of their output at - often *substantially - subsidized prices, which renders their business performance unattractive for the* private sector and requires a solution to the complex problem of subsidization; fourth, decision making on methods of privatization and administrative procedures have turned out to be extremely time-consuming as three different ministries are involved in the process and several legal difficulties have been encountered.

Thus, while the 1993 budget contained revenues of L7 trillion from privatization, no sales have taken place so far. In order to stimulate the purchase of shares of publicly owned companies the Government has announced fiscal incentives for stockholders as well as swap arrangements whereby government bonds can be exchanged with shares in privatized companies.

In any case, even if the financial targets for the annual proceeds from privatization were attained - L7 trillion ($5.6 billion) in 1993, L15 trillion ($12 billion) in 1994 and L12 trillion ($8.5 billion) in 1995 - these would be modest in comparison with the outstanding public debt: less than 1 per cent of GDP per year.

most of the financial assets of households are held through institutions such as pension funds and insurance companies, the impact was primarily on future retirement incomes rather than on current income and spending. This experience suggests that if the capital levy is applied to financial wealth alone, and is supported by monetary relaxation, the negative wealth effect on spending, and hence the offsetting fiscal stimulus needed, could be negligible. On the other hand, taxing real property could further glut property markets and depress asset prices, increasing the possibility that the tax would be paid out of current income. The levy should therefore be primarily on financial wealth held with institutional investors. In order to avoid a liquidity crisis and sharp declines in asset prices, debt retirement should begin before the capital levy is collected so that the liquidity needed is first injected into the economy; alter-

Box 9

KEYNES ON DEBT AND INFLATION

In writing on what he called "progressive and catastrophic inflations" in Central and Eastern Europe during the early 1920s, Keynes characterized the debt problem and possible solutions to it in the following terms: [1]

> The active and working elements in no community, ancient or modern, will consent to hand over to the ***rentier*** or bond-holding class more than a certain proportion of the fruits of their work. When the piled-up debt demands more than a tolerable proportion, relief has usually been sought in one or other of two out of the three possible methods. The first is repudiation. But except as the accompaniment of revolution, this method is too crude, too deliberate, and too obvious in its incidence. The victims are immediately aware and cry out too loud; so that, in the absence of revolution, this solution may be ruled out at present, as regards ***internal*** debt, in Western Europe.
>
> The second method is currency depreciation ... The owners of small savings suffer quietly, as experience shows, these enormous depredations, when they would have thrown down a Government which had taken from them a fraction of the amount by more deliberate but juster instruments ... It follows the line of least resistance, and responsibility cannot be brought home to individuals. It is, so to speak, nature's remedy, which comes into silent operation when the body politic has shrunk from curing itself.
>
> The remaining, the scientific, expedient, the capital levy, has never yet been tried on a large scale; and perhaps it never will be. It is the rational, the deliberate method. But it is difficult to explain, and it provokes violent prejudice by coming into conflict with the deep instincts by which the love of money protects itself ... Once currency depreciation has done its work, I should not advocate the unwise, and probably impracticable, policy of retracing the path with the aid of a capital levy. But if it has become clear that the claims of the bond-holder are more than the taxpayer can support, and if there is still time to choose between the policies of a levy and of further depreciation, the levy must surely be preferred on grounds both of expediency and of justice.
>
> There is a respectable and influential body of opinion which, repudiating with vehemence the adoption of either expedient, fulminates alike against devaluations and levies, on the ground that they infringe the untouchable sacredness of contract; or rather of vested interest ... Yet such persons, by overlooking one of the greatest of all social principles, namely the fundamental distinction between the right of the individual to repudiate contract and the right of the State to control vested interest, are the worst enemies of what they seek to preserve. For nothing can preserve the integrity of contract between individuals, except a discretionary authority in the State to revise what has become intolerable. The powers of uninterrupted usury are too great. If the accretions of vested interest were to grow without mitigation for many generations, half the population would be no better than slaves to the other half.
>
> These conclusions might be deemed obvious if experience did not show that many conservative bankers regard it as more consonant with their cloth, and also as economising thought, to shift public discussion of financial topics off the logical on to an alleged 'moral' plane, which means a realm of thought where vested interest can be triumphant over the common good without further debate. But it makes them untrustworthy guides in a perilous age of transition. When ... we enter the realm of State action, ***everything*** is to be considered and weighed on its merits. Changes in death duties, income tax, land tenure, licensing, game laws, church establishment, feudal rights, slavery, and so on through all ages, have received the same denunciations from the absolutists of contract, who are the real parents of revolution.

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1 "Public finance and changes in the value of money", chap. 2 of *A Tract on Monetary Reform* in *The Collective Writings of John Maynard Keynes*, vol. IV, Cambridge University Press, 1971, pp. 53-55.

Box 10

THE "CHICAGO" PLAN FOR DEBT REDUCTION

In many industrialized countries the increase in government indebtedness has been accompanied by both weakness in the commercial banking system and the persistence of conditions of debt deflation. A plan first proposed in the Great Depression by members of the early Chicago School considered the three problems to be related. [1] The plan is based on the premise that monetary stability is a prerequisite for the efficient operation of markets. Financial markets and institutions should be publicly controlled and designed in order to avoid debt deflation, since only in conditions of monetary stability can markets function efficiently in the rest of the economy. The chief cause of instability was the use of short-term debt created by fractional reserve banks to finance ongoing business operations. In a fractional reserve system an exogenous change, such as a rise in the public's desire to hold currency, causes banks to compete for reserves by reducing lending and recalling loans. This interrupts business plans and produces distress sales to provide liquidity, which may lead to a collapse of asset prices and the risk of bankruptcy of both banks and their business clients.

These economists concluded that the simplest way to eliminate this problem was to require banks to hold 100 per cent reserves against deposits, since this would mean that banks could no longer lend to business. Instead, long-term business lending would be done by investment banks issuing long-term liabilities rather than deposits, or by direct sale of shares to the public.

Transforming an existing fractional reserve banking system into a 100 per cent reserve system could be achieved by the Central Bank's advancing reserves against the commercial banks' outstanding loans. This would allow them to meet the 100 per cent reserve requirement. As these outstanding loans were repaid or liquidated, the banks would repay the advances to the Central Bank. In order to keep the quantity of money from declining, these funds would be returned to the system by the purchase of outstanding government debt. This would lead to a change in the proportion of money to debt in household portfolios and alter interest rates. Thus the plan would create stronger banks, avoid debt deflation and also lead to a reduction in outstanding government debt.

It was concurred that the transfer to such a system would take some time, but that once it had occurred the Government should limit itself to financing expenditure by taxation or by direct monetary creation. In addition, the money creation required to meet the rising demand for money in a growing economy would have to come from the continued repurchase of government debt. At the end of the process all debt would be held by the Central Bank, with the interest paid on the debt returned to the Treasury each year as part of Central Bank profits, thereby reducing the debt service.

Irrespective of its academic credentials and its logical plausibility, the complete elimination of government debt by means of a reform of the banking system of this type is not a ready solution to a problem which requires action in the short term. However, it is very similar to the proposal for narrow banks put forward to solve the crisis of commercial banks in the United States.

Modern day followers of the Fisher-Simons-Mints position such as John Hotson and William Hixson also argue against the issue of debt to finance government expenditures. [2] They would calculate the potential benefit of the introduction of a 100 per cent reserve system as follows (data from January 1993). About $730 billion of the $1033 billion United States M1 money stock are transactions deposits of commercial banks. To keep the money supply constant, an equivalent amount of the $3,048 billion privately held goverment debt would have to be retired. This would mean that net debt would be about a quarter lower and interest expenditures would be about $50 billion lower.

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1 See Paul Douglas, *Controlling Depressions* (London: Unwin, 1935); Lloyd W. Mints, *Monetary Policy for a Competitive Society* (New York: McGraw-Hill, 1950); Henry C. Simons, "A positive program for laissez faire" (1934) in *Economic Policy for a Free Society* (Chicago: Chicago University Press, 1948); Irving Fisher, *100% Money* (New York: Adelphi, 1935); and Milton Friedman, "A monetary and fiscal framework for economic stability", *American Economic Review*, 39 (1948).

2 See John H. Hotson, "The Keynesian revolution and the aborted Fisher-Simons revolution", *Economies et Sociétés*, Série Monnaie et Production, No. 4 (1987); William F. Hixson, *A Matter of Interest* (New York: Praeger, 1991); and Robert E. Litan, *What Should Banks Do?* (Washington, D.C.: The Brookings Institution, 1987).

natively, provisions should be made to meet the levy by tendering government debt.[64]

The decision to tax or borrow affects primarily the composition of household portfolios between money and government securities, and the rate of interest. Increased borrowing means increased sales of government bonds and higher rates of interest. Current conditions might be described as an excessive issue of debt leading to an increase in interest rates which is depressing activity and, because of the size of the outstanding stock of debt, increasing the government deficit. If increased taxation is undesirable because of its effects on demand, the problem could also be alleviated (though not solved) by greater use of monetary financing in order to reduce government interest-bearing debt and interest payments. That is what was advocated in response to the crises of the 1930s by Irving Fisher of Yale and Henry Simons, Paul Douglas, Jacob Viner and Lloyd Mints of the University of Chicago, and has been adopted in a modified form in the early postwar period by Milton Friedman (see box 10).■

64 There is strong academic support for the proposition that a capital levy should have a minimal impact on spending in the "Ricardian equivalence" theorem. See R. Barro, "Are government bonds net wealth?", *Journal of Political Economy*, vol. 82 (1974); B.D. Bernheim, "A neoclassical perspective on budget deficits", *Journal of Economic Perspectives*, vol. 3, 1989. According to this theorem rational individuals should not view government bonds as net wealth since they must ultimately be redeemed with the revenues from increased taxation. If the present value of increased taxation is equal to the government bonds then "a tax-for-debt swap would have no real effects". Since at any point in time private wealth includes savings undertaken in the past in anticipation of the additional taxes required to redeem debt, a reduction in government debt should not have a major effect on private spending. Of course, the theory rests on a number of unrealistic assumptions such as complete rationality, intergenerational altruism, no uncertainty over the timing and amount of future taxes, unlimited consumer borrowing at market interest rates, and so on, so that it is reasonable to conclude that capital levy would not be neutral in impact, but would probably cause some reduction in spending and thus require some offsetting increase in the primary deficit to eliminate the deflationary impact.

Chapter II

ADJUSTMENT AND STAGNATION IN SUB-SAHARAN AFRICA

The economic performance of sub-Saharan Africa (SSA) over the past two decades has been very poor compared to that of other regions. While many developing countries in other regions have managed to restore growth of per capita income after sharp declines in the 1980s, most SSA countries have been unable even to halt the decline, notwithstanding the intense policy efforts and market-oriented reforms which many of them have undertaken in the past years.

This chapter reviews the experience of SSA countries and assesses the factors influencing their recent economic performance. It considers the adequacy of the external funding for adjustment and the design and implementation of adjustment programmes in the light of the needs and potentials of these countries and their external environment, particularly commodity prices. It goes on to suggest how financing and adjustment may be improved.

A. Recent performance and prospects

1. Performance

After a sharp decline during the early 1980s, growth in SSA improved in the second half of the decade, before collapsing once again in the early 1990s. With output growing on average far less than population, per capita income fell by more than 15 per cent from 1980 to 1992. The average growth rate of the region was one half to one third of the average for developing countries as a whole. This gap has widened in the 1990s: since the beginning of the decade growth in all developing countries has been close to 4.5 per cent per annum, giving a per capita income growth of more than 2 per cent, compared to an average growth rate of 1.3 per cent in SSA, i.e. a decline of 1.7 per cent per annum per capita. This decline was partly due to the severe drought in southern Africa in 1992, but the recession in the industrial world in the 1990s has had an even bigger impact in view of the heavy dependence of African economies on primary commodity exports to the industrialized countries. The prices of commodities exported from SSA declined by almost 15 per cent during 1990-1992.

Behind this overall picture was a certain amount of diversity in economic performance. For 39 SSA countries for which data are available, the average growth rate in 1986-1990 ranged from -2.4 per cent to a positive 10.3 per cent; the standard deviation (2.5 per cent) was almost as large as the mean growth rate (2.9 per cent). However, both the dispersion and the average growth are greatly reduced if a few constantly successful outlying countries (e.g. Botswana and Mauritius) are excluded. Of these 39 countries, more than one half experienced declines in per capita income during 1986-1990, and there were only five countries, including the outlying ones, where per capita growth rates matched the average of other developing regions.

2. Prospects

Past projections of growth have generally proved over-optimistic. Growth in SSA depends critically on the behaviour of commodity

prices and external resource transfers, neither of which is easy to predict. The World Bank projects an increase of annual average GDP growth from 2 per cent during 1982-1992 to 3.7 per cent during 1992-2002, i.e. a per capita growth of 0.4 per cent annually.[65] Such a rate - the lowest growth projection among developing countries - would not restore the per capita income of the early 1970s. Indeed, the number of people living in poverty would grow considerably. The baseline projection assumes somewhat optimistically that the secular decline in the terms of trade will be reversed because: (a) growth in the industrialized countries will be the same as in 1982-1992, and (b) structural adjustment programmes (SAPs) will succeed in reducing the growth of output of perennial commodities through greater diversification and a lessened dependence on tropical beverages. However, it is recognized that the outlook is "especially fragile, with the biggest risk being a continuation of the deterioration of the terms of trade and continuation of political unrest".[66] Thus, the low-case scenario, based on lower growth rates in the industrial world and further declines in commodity prices "carries very gloomy implications for this region ... The prospects would be one of negative growth of per capita GDP and consumption".[67]

The risk of such an outcome is indeed considerable, since growth prospects for the industrialized countries for the coming years are bleak (see chapter I of this Part). Moreover, as discussed in greater detail below, there has so far been little progress in diversification, and the current level of investment is too low to produce a quick shift to processing and manufacturing.

The short-term commodity price forecast of the World Bank is more optimistic than that of other institutions; it foresees an increase in 1993 of 3.3 per cent, whereas other estimates range from a rise of 1.3 per cent (IMF) to a decline of 5 per cent (Association d'instituts européens de conjoncture économique). Project LINK expects cocoa and coffee prices to fall by 20 per cent and 17 per cent, respectively, in 1993, rising thereafter in the second half of the 1990s. In the first quarter of 1993 prices of tropical beverages and minerals did indeed fall in dollar terms.

In the absence of a relatively strong recovery in commodity prices, growth will depend on a significant increase in the transfer of external resources. However, the World Bank projections assume no such increase since "the high level of ODA flows to Africa may not be forthcoming as easily as in the 1980s because of an increase in demand from other countries ... and increasing donor scrutiny of domestic policies".[68] The past record shows that domestic savings and investment rates and exports are not likely to rise enough to fill the foreign exchange and savings gaps.

B. Adjustment programmes and performance

Nowhere else have structural adjustment programmes (SAPs) been applied more intensely and frequently than in SSA since the early 1980s. Figures from the World Bank's latest report on adjustment lending show that since 1980 a total of 35 SSA countries have been under IMF and/or World Bank-sponsored adjustment programmes, giving an aggregate of 162 high conditionality policy-based programmes (IMF stand-by, SAF or ESAF and World Bank SALs, excluding sectoral adjustment loans), against 126 for the rest of the world.[69] A number of countries have had several SAPs since the early 1980s. For example, Senegal and Togo underwent four SALs while Malawi, Côte d'Ivoire and Central African Re-

65 *Global Economic Prospects and the Developing Countries 1993* (Washington, D.C.: The World Bank, 1993), tables 1-4.

66 *Ibid.*, p. 65.

67 *Ibid.*, p. 66.

68 *Ibid.*, p. 65.

69 *Adjustment Lending and Mobilization of Private and Public Resources For Growth* (Washington, D.C.: The World Bank, 1992), Policy and Research Series No. 22.

public had three each. One factor behind the frequent and widespread application of SAPs has been financial distress; reschedulings at the Paris Club almost invariably require a prior agreement with IMF.[70]

The rate of discontinuation, however, has been very low. Of the countries which engaged in SAPs during the 1980s, only Mauritius ended its adjustment programme as a result of success in improving its economic conditions. All other countries which severed links with the Fund and the Bank did so either because they could not meet performance criteria or repayments (e.g. Congo in 1988, when its last stand-by with IMF expired, and in 1989, when its last SAL ended; and Côte d'Ivoire, which discontinued SAL II in 1987 and suspended repayments to IMF during 1987 and 1988, but subsequently resumed relationships with the Fund) or because of domestic political problems or pressures (such as Zambia in 1986, which subsequently resumed relationships with the Bretton Woods institutions in 1991, or Kenya in March 1993). Some countries tried to discontinue adjustment (e.g. Senegal in 1984 and Mali in 1986 and 1987), but as financial assistance and growth came to a halt immediately, adjustment programmes had to be quickly reinstated. Currently there are more than 30 SSA countries with adjustment programmes.

The high frequency and persistence of SAPs in SSA thus indicate that these countries are locked into adjustment policies, unable to restore self-sustained growth. While it is true that adjustment takes time, this situation does not tally with the original expectation of structural adjustment. Adjustment lending was introduced to help countries respond to severe external shocks, and was subsequently extended to enable them to correct macroeconomic imbalances and policy distortions. Structural adjustment was meant to be a finite process whereby appropriate policies, with the help of external aid flows, would permit countries to restore growth and to tackle long-term development problems. The fact that such a graduation from adjustment is not general after so many years of effort puts in question the effectiveness of SAPs.

Assessing the impact of SAPs on economic performance is extremely tricky since it requires making a counterfactual exercise ("what would have happened without the SAP?"). Difficult methodological questions arise, especially regarding the precise definition of causality, effects of initial conditions and various exogenous factors ranging from the terms of trade to weather and civil disorder and war. Besides, SAPs combine three elements (financing, policy design and implementation) and involve three parties (donors, international financial organizations and the Government). Although each party concentrates primarily on one aspect of an adjustment programme, their interactions make it difficult to assign responsibilities for success or failure.

The World Bank has recently introduced a four-way classification of the countries in SSA according to their adjustment policy stance and some other factors affecting their performance: (I) countries with social unrest; (II) countries members of the CFA (Communauté financière africaine); (III) small economies with populations of less than one million each; and (IV) the remaining 15 countries, coined as a core group of adjusters.[71] Each group contains countries with SAPs. The rationale for separating countries with social unrest from the others needs no explanation. The CFA countries differ from other countries because their exchange rate is not adjustable, being pegged to the French franc; SAPs usually require devaluation. It has been found that during the period 1986-1990 GDP growth increased in the core group of adjusters while it stagnated or fell in the others (see table 38). The average rate of growth for the core group during that period was equal to the average for developing countries as a whole, whereas for the first and the second groups it was considerably lower. Furthermore, the core group achieved significantly greater increases in growth in agriculture and, more particularly, in exports than the others.

However, there are significant variations within each group. Indeed, the ordering of countries according to their growth rates does not show very close correlation with their ordering according to whether or not they are "adjusting". For instance, some CFA countries, such as Mali, Senegal and Togo, had better growth rates than many core group countries,

[70] C. Lancaster, *African Economic Reform: The External Dimension*, Policy Analyses in International Economics, No. 33 (Washington, D.C.: Institute for International Economics, 1991).

[71] Group I comprises Angola, Chad, Ethiopia, Liberia, Mozambique, Rwanda, Sierra Leone, Somalia, Sudan and Zaire; Group II comprises Benin, Burkina Faso, Cameroon, Central African Republic, Congo, Côte d'Ivoire, Gabon, Mali, Niger, Senegal and Togo; Group III comprises Cape Verde, Comoros, Djibouti, Equatorial Guinea, Guinea-Bissau, Sao Tome and Principe, Seychelles and Swaziland; and Group IV comprises Burundi, Gambia, Ghana, Guinea, Kenya, Lesotho, Madagascar, Malawi, Mauritania, Namibia, Nigeria, Uganda, United Republic of Tanzania, Zambia and Zimbabwe. Two countries (Botswana and Mauritius) are excluded as outliers. See Edward V.K. Jaycox, *Africa: From Stagnation to Recovery* (Washington, D.C.: The World Bank, February 1993).

Table 38

ECONOMIC PERFORMANCE OF DIFFERENT COUNTRY GROUPS IN SUB-SAHARAN AFRICA SINCE 1975

(Annual average percentage change)

Indicator/country group	*1975-1980*	*1981-1985*	*1986-1990*	*1991*
GDP				
Countries with social unrest	2.9	1.4	1.5	-7.0
CFA countries	4.4	3.1	1.5	1.2
Small economies	5.0	4.6	3.3	0.6
Core group of adjusters	1.9	1.5	3.9	2.9
Agricultural output				
Countries with social unrest	4.2	0.8	2.0	..
CFA countries	2.7	2.5	3.0	..
Small economies	-	0.9	2.5	..
Core group of adjusters	0.1	1.1	3.2	..
Export volume				
Countries with social unrest	0.5	-0.2	0.1	..
CFA countries	7.2	1.5	2.3	..
Small economies	-	4.7	5.2	..
Core group of adjusters	2.0	-1.6	3.4	..

Source: Edward V.K. Jaycox, *Africa: From Stagnation to Recovery* (Washington, D.C.: The World Bank, February 1993), table 1.
Note: For the country composition of the four groups see text.

and were among those that "have emerged as particularly successful agricultural performers" and/or among those where "adjustment measures have also encouraged greater production of export crops".[72]

More important, as noted by another study at the World Bank, "the comparison of economic indicators before and after adjustment programmes does not give an accurate picture of the true contribution of these programmes".[73] The study used an econometric methodology and found that "in SSA there is strong indication that World Bank adjustment programmes have contributed to improving exports in a significant way ... However, World Bank adjustment lending has not significantly affected economic growth and has contributed to a statistically significant drop in investment ratio ... Also, adjustment lending programmes did not significantly affect inflation or saving to GDP ratio".[74] The Bank's third report on adjustment lending, using a similar methodology, found only a moderate improvement in the growth rate. Other evidence also suggests the same conclusion for countries under SAPs continuously for at least three years.[75] Generally, however, the impact of SAPs on growth in the region has been found to be weaker than in other developing countries.[76] Even among the core adjusters, the rate of growth of per capita income is presently around 1 per cent; at this pace of growth it would take some 70 years to double per capita income in SSA.

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72 Edward V.K. Jaycox, *Africa: From Stagnation to Recovery* (Washington, D.C.: The World Bank, February 1993), p. 7.

73 I.A. Elbadawi, D. Ghura and G. Uwujaren, *World Bank Adjustment Lending and Economic Performance in Sub-Saharan Africa in the 1980s*, Policy Research Working Paper, WPS 1000 (Washington, D.C.: The World Bank, October 1992), p. 4.

74 *Ibid.*, p. 5.

75 Cf. B. Leenhardt and M.F. L'Hériteau, "Une décennie d'ajustement en Afrique: performances comparées de 28 pays africains", *Notes et Etudes No. 43*, Caisse centrale de coopération économique, Paris, 1991.

76 P. Mosley, in Mosley, Harrigan and Toye (eds.), *Aid and Power* (London: Routledge, 1991); *Policies for Sustainable Growth*, Policy and Research Series No. 14 (Washington, D.C.: The World Bank, 1990). See also L. Summers, "The challenges of development: some lessons of history for sub-Saharan Africa", *Finance and Development*, March 1992.

In assessing SAPs it is important to separate short-term increases in output from sustainable growth - i.e. from improvements in growth potential that truly reflect structural change. An increase in output growth not associated with a faster pace of investment is not sustainable, just as an increase in exports resulting from a sharp devaluation cannot be repeated unless export capacity is enlarged. Spurts of output growth often occur even when the resource inflows associated with SAPs are not sufficient to finance both the imports needed to raise the rate of capacity utilization and the imports needed to raise the rate of investment. Since capacity utilization often has priority over investment, output tends to rise while investment stagnates. Then, the faster growth is simply due to adjustment lending, and the gain in output is ephemeral.

The behaviour of investment and the composition of trade, particularly non-traditional exports, are much more important indicators of successful adjustment than the rate of increase in output and exports. For these reasons it is particularly a cause for concern that SAPs do not improve the investment ratio. Adjustment programmes typically comprise cuts in public investment, but the expected increase in private investment fails to materialize (see table 39). This also appears to be one of the main reasons why, as will be seen below, there has been very little diversification of production and exports in SSA.

Even though reforms can improve the quality of investment, growth will not be possible unless the level of investment is sufficiently high both to sustain demand over the short term and to enlarge supply in the long run. The decline in investment spending appears to have been an important reason for the stagnation of output despite the relatively strong response of exports to policy reforms. On the other hand, the inability to restore growth over the medium term shows that efficiency gains are rarely enough to make up for investment cuts.

C. The external context of adjustment

1. External shocks and resource flows

It is widely acknowledged that structural adjustment in SSA calls for considerably more external finance than in more advanced developing countries. For one thing, the external trading environment is generally more unfavourable because of the greater dependence on exports of commodities and imports of manufactures. For instance, from 1981 to 1991 the terms of trade of SSA dropped by some 40 per cent, against a decline of 25 per cent for all developing regions. Second, these countries also require additional resources in order to build capacity in non-traditional exports and import substitutes, i.e. to industrialize. In short, extremely low levels of income make it impossible to absorb terms of trade shocks and at the same time to generate resources for development.

Since it is not easy to specify exactly the overall external resource requirements of these countries, controversy over the adequacy of resource inflows is inevitable. However, evidence suggests that inflows have been barely sufficient to make up for the terms of trade losses, let alone provide for new investment. Table 40 gives estimates for such losses during 1980-1990 for a number of SSA countries belonging to three of the four World Bank groups referred to in the previous section. Twenty-one of the 25 countries listed in the table experienced terms of trade losses, the average decline being close to 30 per cent, giving a loss of output of about 8 per cent of GDP. The average loss in terms of GDP was close to this figure in CFA countries and the core group of adjusters, but considerably lower in countries with social unrest.

Only six of the 21 countries concerned received increments of ODA to cover their terms of trade losses; of these, four were in the core group and one each in the other two groups. Of the remaining 15 countries, five suffered from both terms of trade losses and declines in ODA flows, while for the rest ODA flows offset terms of trade losses only partially. Adding the losses and gains to GDP across the table and comparing them with total ODA shows that less than 15 per cent of the losses

Table 39

PRIVATE AND PUBLIC INVESTMENT IN SELECTED SUB-SAHARAN AFRICAN COUNTRIES, [a] **1970-1989**

(Percentage of GDP)

	1970-1981	*1982-1984*	*1985-1989*
Private	10.1	7.4	7.2
Public	11.2	7.9	7.1
Total	21.3	15.3	14.3

Source: Louis Serven and Andres Solimano, "Debt crisis, adjustment policies and capital formation in developing countries: Where do we stand?", *World Development*, vol. 21, No. 1 (1993).

a Côte d'Ivoire, Ethiopia, Ghana, Kenya, Malawi, Mauritius, Nigeria, United Republic of Tanzania, Zaire and Zimbabwe.

was compensated by ODA: i.e. there was an additional ODA flow of $2.4 billion against a GDP loss of $16.4 billion. If the major oil exporters (Congo, Gabon and Nigeria) are excluded, only one half of the combined terms of trade losses was covered by additional ODA.

The picture does not change if all capital flows, and not only ODA, are compared with both interest rate and terms of trade shocks. As the figures in table 41 show, net external transfers (i.e. "resource balance deficits") to SSA countries with adjustment programmes increased considerably in the first two years of the 1980s compared to the 1970s. However, they subsequently fell back, particularly during 1986-1990, to levels below those of the 1970s although losses due to higher interest rates and lower terms of trade amounted to 4-5 per cent of GDP per annum. Indeed, despite some declines in the second half of the 1980s, interest rates on external debt remained considerably higher than in the 1970s, whereas the terms of trade of SSA fell every year from 1985 except for a modest improvement in 1988. Consequently, while full compensation of these external shocks would have required net capital flows to be higher by 4-5 per cent of GDP per annum during 1986-1990 compared to the 1970s, in reality they were lower, particularly for the newcomers (other adjustment lending countries).

Over the medium term the terms of trade of a country depend in part on its ability to restructure its production and trade through domestic policies. Thus, the movement of the terms of trade itself can be an indicator of success of adjustment. However, failure to restructure production may be due as much to underfunding of SAPs as to misguided policies.

2. *Export performance and the import constraint*

The inadequacy of external flows is aggravated by poor export performance. As indicated in the last column of table 40, export volumes fell or stagnated in most of the countries facing terms of trade losses. Only a few countries succeeded in raising export growth sufficiently to make up for such losses (e.g. Burkina Faso, Congo, Niger, Malawi, Mauritania and, to a lesser extent, Ghana) or to sustain export growth after an improvement in the terms of trade (notably Mali and, to a lesser extent, Senegal).

Poor export performance, together with the decline in real prices of exports, resulted in a sharp decline in the purchasing power of exports in SSA, by about 37 per cent from 1980 to 1991, compared to an increase of 22 per cent in other developing countries. Similarly, the share of SSA in world exports fell from about 2.4 per cent in 1980 to 1.1 per cent in 1990, while its share in the exports of all developing countries fell from about 10 per cent to 5 per cent in the same period.

Africa has been progressively marginalized in world trade because it has been unable to keep up with either industrial or developing countries. It has lost market shares to Malaysia and Indonesia in palm oil and

Table 40

CHANGE IN TERMS OF TRADE, DEVELOPMENT ASSISTANCE AND EXPORT VOLUME IN SUB-SAHARAN AFRICA, BY COUNTRY, 1980-1990

	Terms of trade, 1990	*Terms of trade loss (gain), 1990* [a]		*Increase (decrease) in annual ODA, 1980-1990*	*Annual export volume growth 1980-1990*
Country	*1980=100*	*$ million*	*Per cent of 1990 GDP*	*Millions of 1989 dollars*	*Per cent*
Countries with social unrest					
Ethiopia	58	215	3.5	401	-0.3
Liberia	108	(37)	..	(53)	-2.7
Rwanda	51	108	5.0	33	0.1
Sierra Leone	71	56	6.2	(73)	-1.4
Somalia	110	(12)	(1.3)	(232)	-3.3
Sudan	76	126	1.5	(240)	-0.9
Zaire	86	140	1.8	128	-10.0
CFA countries					
Burkina Faso	98	3	-	(31)	10.1
Cameroon	63	704	6.3	52	-1.3
Central African Republic	94	8	0.6	54	-1.3
Congo	70	484	16.9	59	5.0
Côte d'Ivoire	62	1594	16.1	305	2.7
Gabon	63	1451	30.1	43	1.4
Mali	109	(29)	(1.2)	34	9.9
Niger	69	195	7.7	86	4.3
Senegal	102	(15)	(0.3)	296	5.6
Togo	72	117	7.2	72	2.4
Core group of adjusters					
Ghana	48	800	12.8	207	3.8
Kenya	75	344	3.9	449	1.0
Madagascar	85	59	1.9	(17)	-1.5
Malawi	98	8	0.3	224	4.3
Mauritania	93	35	9.5	(58)	3.8
Nigeria	57	10313	29.1	142	-1.6
Uganda	55	124	4.1	415	-1.9
United Republic of Tanzania	77	90	3.8	104	-7.4

Source: G.K. Helleiner, "Trade, aid and relative price changes in sub-Saharan Africa in the 1980s", paper presented at the conference "From stabilization to growth in Africa", Marstrand, Sweden, 6-7 September 1992, and UNCTAD secretariat calculations.

a Loss or gain in 1990 due to change in the terms of trade since 1980, calculated on the basis of 1990 exports.

cocoa, in coffee to Indonesia, in groundnut oil to Argentina and, except for the Western African countries covered by the Compagnie Française des Textiles (CFDT), in cotton to Pakistan. Improvements in market share in tea against India and Sri Lanka, and tobacco against India, Philippines and Thailand, have been small in comparison.

The evidence also suggests that there is very little "vertical" diversification in SSA (i.e. a shift towards processed commodities and manufactures), while "horizontal" diversification (i.e. diversification within the primary commodity sector) has not generally been sufficient to reduce importantly dependence on a few commodities. The only significant export diversification which occurred has been in oil. Otherwise, the structure of SSA exports has been remarkably stable. The share of primary commodities (including oil) in total SSA exports decreased by only 3 per cent from 1965 to 1990 (from 92 per cent to 89 per cent) and

Table 41

SUB-SAHARAN AFRICA: EXTERNAL SHOCKS AND RESOURCE BALANCE DEFICITS IN THE 1970s AND 1980s

(Percentage of GDP)

	Total external shock		*Resource balance deficit*			
	1981-1985 vis-à-vis 1971-1980	*1986-1990 vis-à-vis 1971-1980*	*1971-1980*	*1981-1982*	*1983-1985*	*1986-1990*
Intensive adjustment lending (IAL) [a]	-4.8	-5.0	7.4	11.6	6.7	7.3
Other adjustment lending (OAL) [b]	5.1	-4.0	9.8	13.4	7.7	7.6

Source: *Adjustment Lending and Mobilization of Private and Public Resources for Growth* (Washington, D.C.: The World Bank, 1992), Policy and Research Series No. 22, tables A.2 and A.3.

a Countries which received at least two SALs or three adjustment loans of any type as of end-FY 1990.

b Other countries that received adjustment loans effective by the end of FY 1990.

the share of manufactured goods increased from 7 per cent to 11 per cent; during the same period, the share of manufactured goods in total exports of all developing countries doubled, from 33 per cent to 66 per cent. Similarly, 30 out of 42 countries in SSA are still dependent on exports of unprocessed commodities, and only a small number of countries has managed to increase the share of semi-processed or processed commodities in total exports (e.g. Equatorial Guinea, which reduced the share of its raw commodity exports, mainly cocoa, from 96 per cent to 70 per cent from 1979-1981 and 1988-1990 while raising that of its semi-processed exports, mainly timber, from virtually zero to 8 per cent; Benin, which diversified from cocoa beans into cotton lint; and Madagascar, from coffee beans to shell fish and sugar).

During the 1980s, 25 out of 38 countries for which data are available increased their dependence on commodities, and several countries (including Mozambique, Sudan, Togo and Zaire) lost their earlier gains in reduced commodity dependence.[77] There has been virtually no diversification of agricultural exports: the share of the six main commodities (cocoa, coffee, cotton, sugar, tea and tobacco) in total agricultural exports was around 55 per cent in the 1960s; it rose to 66 per cent in the 1970s and to 70 per cent in the late 1980s. The recent increase in exports from SSA has primarily been in traditional crops rather than new products. Consequently, four out of five African countries still depend on only two commodities for over half of their export earnings.

As will be discussed in the subsequent section, an important reason for poor export performance has been domestic policies, including those formulated in the context of SAPs. There are, however, a number of well known external and structural factors at work against commodity exporters. First, many African countries are trapped in a vicious circle. The existing production structure can generate little diversification and export growth in the absence of new investment, which requires substantial amounts of imports and foreign exchange. Export growth is thus constrained by the availability of imports, which cannot be increased because of inadequate export earnings and external resource flows. This dilemma is accentuated when the loss of purchasing power of exports is not compensated and imports have to be compressed.

Considerable import compression has indeed taken place in SSA since 1980, seriously constricting supply. As total import volume stagnated, per capita imports fell, in many countries drastically, while they grew in all other developing regions. Chart 3 shows the evolution of real imports and real gross domestic investment per capita from 1980 to 1991

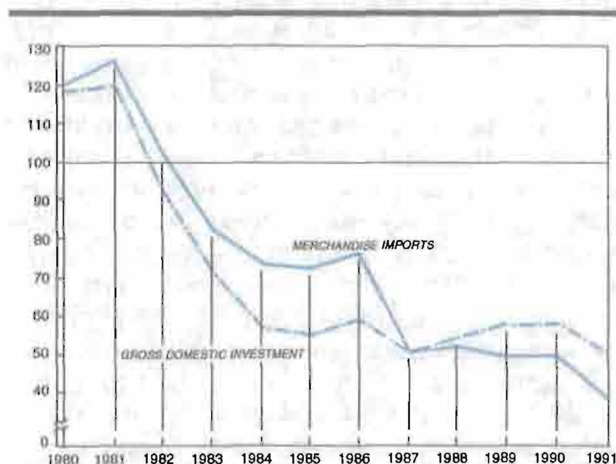
77 UNCTAD, *Final Review and Appraisal of the United Nations Programme of Action for African Economic Recovery and Development 1986-1990* (TD/B/1280/Add.1/Rev.1), United Nations publication, Sales No. E.91.II.D.10.

for 12 selected sub-Saharan countries, mostly in the core group of adjusters. In 1986-1990 average per capita imports were around 46 per cent lower for this group of countries than in 1980-1984. They increased in Ghana and Zaire, stagnated in Burundi and the United Republic of Tanzania, but fell in other countries by between 6 per cent (Kenya) and 68 per cent (Nigeria). As can also be seen from chart 3, real investment per capita followed the evolution of imports for this group. While it rose in Ghana and remained unchanged in Burundi, it fell in all other countries, by between 3 per cent (Madagascar) and 64 per cent (Nigeria). Import compression, together with declines in investment, is certainly the most important factor explaining the poor growth performance of the economies of SSA.[78]

Chart 3

IMPORTS AND INVESTMENT IN SELECTED SUB-SAHARAN AFRICAN COUNTRIES, [a] 1980-1991

(1980-1984 = 100)



Source: World Bank, *World Tables*, 1990 and 1992 editions.

a Burundi, Gambia, Ghana, Kenya, Madagascar, Malawi, Mauritania, Nigeria, United Republic of Tanzania, Zambia, Zaire and Zimbabwe.

Second, success in raising the volume of traditional exports can be self-defeating in so far as it serves to depress prices because of low price elasticities of demand. Aggressive exchange rate policies and outward-oriented trade strategies in the developing world in the 1980s have had an adverse impact on world prices of traditional, and even non-traditional, raw materials.[79] Thus, the inverse relation observed between export volumes and terms of trade in table 40 for some countries (e.g. Ghana and Côte d'Ivoire) is not just a coincidence; these countries are large suppliers in world markets.

The elasticity problem takes two forms. For some commodities when aggregate supply volume increases, the total export revenue falls. This seems to be the case for cocoa. For most commodities, however, export revenues rise proportionately less than export volumes, in which case it may not be possible to recover the cost of the additional output. In both cases, an individual country may be able to avoid the elasticity problem when its share in the market is small, but all countries taken together cannot do that - hence the fallacy of composition.

In SSA as a region the fallacy of composition argument is valid in both senses. Furthermore, the elasticity problem arises at the individual country level for some countries and products. A study at the World Bank shows that "the expansion of cocoa exports from Ghana and Nigeria under their structural adjustment programmes has contributed to depressed world prices but the relative contribution of this expansion to lower prices is small ... The simulations show that world cocoa prices would have been on average 8 per cent higher ... had there not been structural adjustment programmes in Ghana and Nigeria over the period 1982/83-1989/90".[80] This figure may be relatively small compared to the sharp decline in the price of cocoa over that period, but the consequent loss of export value is not negligible for a country dependent on it. Moreover, the study goes on to argue that "the major part of the world cocoa price decline in the 1980s can be attributed to the rapid production increase in other countries - Côte d'Ivoire, Indonesia and Malaysia".[81] But this only shows that, as would be expected, the fallacy of composition is operating more forcefully at the global than at the regional level.

Another factor is lack of regional dynamics. African countries do not serve as outlets for each other's manufactured goods in general and intermediate goods in particular. Regional trade arrangements represent a small part of total external trade. The intra-trade of UDEAC (the Customs and Economic Union of Central Africa) or ECOWAS (Economic

78 B. Ndulu, "Growth and adjustment in sub-Saharan Africa", in A. Chibber and S. Fischer (eds.), *Economic Reform in Sub-Saharan Africa, A World Bank Symposium* (Washington, D.C.: The World Bank, 1991).

79 See *TDR 1992*, Part Three, chap. I, sect. C, and Part One, chap. II above.

80 Ishrat Husain, "Trade, aid and investment in sub-Saharan Africa", paper presented at the Royal African Society Conference on Africa 1993: "Governance, Business and Aid", Oxford, 21-23 March 1993 (mimeo), p. 6.

81 *Ibid.*, p. 7.

Community of West African States) represented respectively 4.3 per cent and 6.1 per cent of total trade of the member countries in 1990, as opposed to 18.5 per cent for ASEAN (Association of South-East Asian Nations) or 10.4 per cent for ALADI (Latin American Integration Association).

3. *The adequacy of aid*

The above considerations suggest that a significantly greater amount of external resources will be needed to lift growth. The World Bank's long-term perspective study[82] estimates that sub-Saharan Africa would need about 9 per cent of its GDP to be added from external sources during the 1990s in order to attain a growth rate of 1-2 per cent per capita, but this was judged in another study to be "a very conservative estimate of the requirements for such targets in light of the fact that, according to the DAC, ODA already accounted for 11 per cent of sub-Saharan African GDP in the late 1980s during which growth rates fell short of the targeted rates. It was based on highly optimistic projections of export growth, rates of return on investment and savings rates, none of which have so far been realized".[83]

These additional resources need to come from ODA since, at least in the foreseeable future, most countries can expect little by way of foreign direct investment (FDI), lending by international capital markets and export credits. Indeed, private flows in current dollars stood in 1990-1991 at roughly one quarter of their average 1986-1987 level, while non-concessional flows stagnated. There has been very little FDI, and in many countries there is barely any sign of a return of flight capital, despite the emphasis placed on them in SAPs.

While official resource transfers are the main source of external funding of SAPs in SSA, official debt is the main drag on adjustment, since most of Africa's external debt is owed to official creditors. As discussed in Part Three, chapter II, this inter-relation indeed calls for an integrated approach whereby debt relief initiatives and new aid can be coordinated so as to provide the net transfer of external resources needed to support adjustment efforts - something that requires a coherent position on the side of donor/creditor Governments. Considerable progress has been made in recent years in the Paris Club in reducing the burden of Africa's external debt, but much more needs to be done in order to free SAPs from the debt overhang. Currently, SSA makes net negative transfers on account of total long-term debt, including that of the World Bank, as well as FDI and transactions with IMF (see table 42). Although this is offset by official concessional lending, total net transfers to the severely indebted low-income African countries have shown a tendency to decline in the 1990s, after rising in the second half of the 1980s. There is thus a compelling case for debt reduction well above what has been granted so far by Paris Club members. Action is also needed to reduce the obligations and arrears of such countries to multilateral institutions and their debt to private creditors.

The inadequacy of the net transfer of external resources is not the only problem. It is also necessary to make such flows more predictable and continuous. There is consensus that African adjustment is a slow process and one that needs to take the long view in dealing with the structural problems of these countries. But this consensus is not reflected in resource flows. As already noted, there are occasional surges in transfer of resources, as in the early and late 1980s, but these rarely last long enough to allow the build-up of an indigenous capacity to generate resources. Similarly, while it is agreed that policy reforms take a long time to design, implement and yield results, the financing facilities associated with them (such as SAF or ESAF) have relatively short horizons: usually they are provided for one to three years and performance is assessed every six months.[84] Since the predictability of finance is essential for taking the long view both for Governments and for firms, a short-leash approach tends to undermine the credibility and effectiveness of SAPs.

Finally, there is the problem of the quality of aid. While an important part of net resource flows to SSA is concessional, the benefits of concessionality tend to be offset by additional costs due to the conditions and procedures attached by donors to the aid, including

82 *Sub-Saharan Africa. From Crisis to Sustainable Growth. A Long-Term Perspective Study* (Washington, D.C.: The World Bank, 1989).

83 G.K. Helleiner, "External resource flows, debt relief and economic development in sub-Saharan Africa", paper prepared for the seminar on "Adjustment and Development in Sub-Saharan Africa", UNICEF International Child Development Centre, Florence, 19-20 November 1992, p. 2.

84 G.K. Helleiner, "The IMF, the World Bank and Africa's adjustment and external debt problems: an unofficial view", *World Development*, vol. 20, No. 6 (1992), p. 786.

Table 42

NET RESOURCE TRANSFERS TO SUB-SAHARAN AFRICA, 1986-1992

(Millions of dollars)

Net transfer	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992* [a]
Long-term debt	2480	3877	2274	2904	958	-933	-268
Official	3477	3842	2367	3392	2277	790	1722
Of which: World Bank	30	-75	-725	-391	-556	-1213	..
Private	-997	34	-93	-488	-1319	-1723	-1990
Foreign direct investment	-620	-744	-500	1396	-644	598	-923
IMF	-954	-863	-461	-734	-455	-261	-170
Grants (excluding technical cooperation)	4880	5195	6619	6864	11669	12627	12649
Total net transfer [b]							
$ million	5786	7465	7932	10431	11526	12031	11289
Per cent of GNP	3.7	5.1	5.3	7.0	7.1	7.4	6.7
Memo item:							
Total net transfer of severely indebted low-income SSA countries [c]	4164	5319	4914	7090	5971	5262	..

Source: World Bank, *World Debt Tables, 1992-93*, vol. 1, Washington, D.C., 1992.
a Projected.
b Including IMF, but not short-term credit.
c Countries with 1991 GNP per capita below $635 and with a present value of debt service to GNP above 80 per cent or present value of debt service to exports above 220 per cent in 1989-1991. These countries are: Burundi, Equatorial Guinea, Ethiopia, Ghana, Guinea-Bissau, Kenya, Liberia, Madagascar, Mali, Mauritania, Mozambique, Niger, Nigeria, Sao Tome and Principe, Sierra Leone, Somalia, Sudan, Uganda, United Republic of Tanzania, Zaire and Zambia.

tying them to a positive list of goods for import licensing. In many countries importing firms tend to use untied funds, such as those generated through their own exports or acquired from the parallel markets, in order to avoid costs due to cumbersome administrative procedures. In the case of tied loans it can take up to 15 months from the initiation of an import process to the arrival and clearance of the merchandise, whereas the delay is one to two months for untied funds. Taking into account the interest cost as well as transaction costs due to procurement restrictions and other conditions, $1 of donor money is often worth no more than 80 cents of free money. For this reason many Governments apply highly preferential rates to the donor money in order to create demand for it - a factor which also prevents creation of an integrated foreign exchange market and constrains use of market forces in the allocation of foreign exchange. This also implies that resources released through debt relief add more to import capacity than seemingly equivalent increases in tied aid. Moreover, project aid is sometimes tied to local currency contributions by the borrowing country. In some SSA countries, difficulties in meeting this requirement, due to the tight budget constraints, have resulted in lower aid disbursements.

While it is generally agreed that SSA needs a considerable external transfer of resources, there are also concerns that a greater volume of aid may not help development. One source of concern is that greater aid would allow Governments to pursue inappropriate policies, thereby lowering the chances of success of adjustment programmes ("aid dependency"). This argument implicitly assumes that aid always promotes appropriate policies. But, as will be discussed subsequently, the conditions on aid have not always been the best. More important, there is no evidence that policy effort is reduced by the receipt of greater aid. Indeed, the Third Report on Adjustment Lending of the World Bank points out that "the lower growth rates and other aggregate indica-

tors of outcomes in low-income and sub-Saharan African countries do not appear to be due to a lack of macroeconomic policy change ... they had undertaken more, not less, adjustment".[85] The report also states that "total official external flows have a positive, independent influence on growth in the low-income countries" and that "in sub-Saharan Africa such flows are positively associated with investment".[86]

Aid dependency tends to emerge rather because of the short-leash approach to external financing. A critical mass of aid and policy efforts, appropriately combined, is needed for "take off into sustained growth" in SSA. This critical mass cannot be obtained by substituting more policy efforts for less aid, and if it is not attained, both aid and effort may be wasted, and aid would be needed permanently simply to sustain a low level of activity.

Finally, there are concerns that aid may be wasted because of limited absorptive capacity. In any country there is a limit at any point in time on the extent to which external resources can be used productively, and this limit tends to be low in SSA. However, the present rate of aid flows appears to be far below that limit:

> Concern over "the absorptive capacity" of recipient African Governments for increased external assistance may in some circumstances, particularly where there is war, civil strife or gross mismanagement in government, be appropriate. In the main, however, in the light of the sharp reduction in African imports (and, even more, imports per capita) below prior levels, the virtually universal phenomenon of import-related underutilization of both social and directly productive capital, and continuing increases in population which will expand import needs, such concerns are inappropriate. Particularly is this so where there are adjustment programmes in place.[87]

D. Problems in policy design and implementation

1. The policy content of SAPs

SAPs typically contain three sets of policies: (a) expenditure-reducing (monetary and fiscal) policies to lower inflation and balance of payments deficits; (b) expenditure and production-switching (exchange rate and wage) policies to promote exports and import substitution; and (c) supply-side, "growth-oriented" policies (e.g. trade and sectoral policies, and public enterprise reforms) to remove the structural causes of macroeconomic imbalances and to raise the volume of investment while improving its efficiency.[88] The ultimate aim of these policies is to raise growth permanently by restoring macroeconomic balances and removing "price distortions". The expectation has been that the process of restoring macroeconomic balances will dampen output only in the short run, and that growth will pick up as structural reforms are implemented. It is taken for granted that the private sector will react favourably to changed incentives and a more competitive economic environment by investing in and producing internationally tradeable goods and services, thereby raising savings and earning more foreign exchange.

While almost everywhere SAPs emphasize macroeconomic stabilization and liberalization, the specific policy content varies from region to region and from country to country. In SSA, emphasis has been placed on: fiscal retrenchment, currency devaluation, agricultural price liberalization and trade liberalization. Implementation has been generally satisfactory, with an average rate of compliance for all conditions and actions of 75 per cent: the rate of achievement of targets is particularly high with respect to fiscal policy, exchange rate policy and wage policy.[89] With the exception of trade and price liberalization, the implemen-

85 *Op. cit.*, p. 14.
86 *Ibid.*, pp. 18-19.
87 G.K. Helleiner, "External resource flows ...", pp. 3-4.
88 See *Adjustment Lending. Policies for Sustainable Growth* (Washington, D.C.: The World Bank, 1990), Policy and Research Series No. 14, p. 40.
89 *Ibid.*, table 4.3.

tation rate is lower for supply-side policies than for absorption reduction or switching policies. Sectoral policies for energy and agriculture have been only partially implemented and there has not been much reform of the financial sector or public enterprises (PEs).

It is often forgotten that while a particular policy is usually assigned to a particular objective, policies typically have effects in more than one area. These effects often conflict: a policy has positive effects usually in one area but exerts negative influences in at least another.[90] More important, the positive effects of a particular policy instrument tend to diminish rapidly as that instrument is used more intensively, while the disruptive side effects rise. Thus, heavy reliance on a few policy instruments can generate undesirable spillovers which can overwhelm the positive effects and reduce growth. In Africa this has occurred because of (a) the paucity of external resources and (b) the difficulties of making reforms in certain areas. Massive devaluation is a typical example of the former, and excessive fiscal retrenchment, because of failure to reform PEs, of the latter.

2. *Policy reforms in the public sector*

SAPs have been relatively successful in reducing public sector deficits. For African IAL countries these fell from 7.3 per cent of GDP in 1983-1985 to 5.6 per cent in 1986-1990,[91] primarily through cuts in spending rather than increased revenues. Cuts were needed in some areas to rationalize the public sector and release resources for more productive uses. This is certainly true for military expenditures; these have been reduced in some countries, but there is still considerable scope for further cuts almost everywhere in SSA. However, the burden of fiscal retrenchment has fallen mainly on investment.

Even if the public sector pulls out entirely from production of goods and services in industry and agriculture and cuts down its investment in these sectors, it still needs considerable resources for health, education and infrastructure. This calls for tax reform, which has been given much less emphasis than spending cuts in many countries. The paucity of external financial flows has also tightened the fiscal constraint because of the close links in Africa between external finance and the budget.

One area of reform warranting emphasis is the administrative capacity of the State bureaucracy. Designing, implementing and evaluating SAPs is a difficult challenge for scarce human resources in public administration, and improvements in this area call for increased government spending. SAPs have indeed included reforms of the civil service, but emphasis has been placed simply on reducing public sector employment and the wage bill, and hence the reforms have not always made an important contribution to deficit reduction, while they have weakened the efforts to build capacity in the civil service.

Similarly, little progress has been made in reforming PEs. According to the available data in eight "intensive adjusters", PE reforms consisted of: 75 privatizations, 89 liquidations and only 8 rehabilitations.[92] Included among the enterprises liquidated are both manufacturing firms and agricultural marketing boards (see below). The emphasis on privatization is partly the result of the failure of earlier attempts to rehabilitate PEs,[93] but it also reflects what is now a point of principle, that the public sector should not be producing goods and services. However, privatization has run into the usual obstacles. Often, an additional impediment has been the fear that it would benefit foreigners and ethnic minorities, since indigeneous entrepreneurs are unable to compete with such groups. This has also been in some countries an important reason for reluctance to liberalize foreign direct investment regulations and for continued bureaucratic impediments to FDI. The focus on privatizing ownership has diverted attention from other ways to deal with PEs, such as privatizing management through management contracts, leases and concessions. Consequently, the problem of inefficiency in PEs has remained largely unsolved.

3. *Devaluation*

Currency devaluation is the most frequently and intensively used tool in adjustment programmes in SSA. For the IAL countries the real effective exchange rate (REER) fell by

90 See *TDR 1989*, Part One, chap. II.

91 See the World Bank, *Adjustment Lending and Mobilization of Public and Private Resources for Growth* ..., table A.5.

92 *African Development Indicators* (Washington, D.C.: The World Bank, 1992).

93 See *TDR 1992*, Part Three, chap. II.

around 30 per cent during 1986-1990.[94] Since some of these countries are members of CFA, with exchange rates pegged to the French franc, the rate of devaluation in the countries belonging to the core group of adjusters was much greater, reaching, on average, 50 per cent. Some countries in this group (e.g. Ghana, Kenya and Nigeria) had declines of REER of about 70 per cent from 1987 to 1990.

Many of these countries had allowed their real exchange rates to appreciate considerably by keeping the nominal rate unchanged during prolonged periods of high inflation. There has, however, been a tendency to rely excessively on exchange rates partly because of the underfunding of SAPs, and partly because of over-optimism regarding market responses.

The purpose of exchange rate policies in SSA countries should not be to reduce current account deficits. They need a greater, not a smaller, net transfer of resources. Nor should exchange rates be used to respond to terms of trade losses, which should be covered by contingency (supplementary) financing to allow SAPs to stay on track. Similarly, any deterioration in external balances associated with trade liberalization should be met by increased external financing.

In a commodity-dependent economy sharp devaluations can be particularly disruptive over the short term. The scope for rapidly switching goods from domestic absorption to exports is more limited than in semi- or newly-industrialized countries. Usually export goods are specific to foreign markets and consumed hardly at all at home. The main role of exchange rates is therefore to redirect resources so as to increase the supply of exportables. Since such a response usually takes time, a gradual approach is needed to allow resources to be redeployed and new capacity built up.

By contrast, the fact that the CFA countries are precluded from adjusting their nominal exchange rates has put an excessive burden on monetary and fiscal policy. To obtain a real depreciation, these countries have had to rely on demand restriction in order to keep domestic inflation below international levels. There exist fiscal equivalents of currency adjustment, such as export subsidies and import taxes, but SAPs emphasize reduced use of such tools. Consequently, while these countries have a better stabilization record, their external adjustment has usually required greater deflation, particularly since the early 1980s, when inflation in industrial countries began to decline. Moreover, they are also highly sensitive to sharp swings in exchange rates among the major industrial countries. REERs for this group of countries depreciated during the first half of the 1980s as the dollar appreciated considerably vis-à-vis the French franc. During this period their economic performance was relatively satisfactory. However, the subsequent weakness of the dollar required considerable retrenchment in order to avoid real appreciation. Indeed, most of the countries in this group managed to stabilize REER, and some even succeeded in depreciating slightly, though at very high cost. They did so primarily through monetary restriction and sharp increases in interest rates, which in turn reduced private investment and added to public deficits.

4. Reform of agricultural pricing and marketing

In commodity-dependent countries the supply response to currency devaluations has to come mainly from agriculture. An important component of SAPs in Africa has thus been reform of agricultural pricing and marketing policies in order to ensure that exchange rate changes are reflected in higher prices for producers. These reforms have taken many forms. In some countries and/or for some crops, marketing boards have continued to operate as monopolies but started linking producer pricers to world prices. In others they have been eliminated or the private sector has been allowed to compete with them.[95] Liberalization in markets for the major staple food crops has progressed even faster. In a large majority of countries there is now virtually no government intervention in these markets.

Price liberalization and devaluation have been the main factors in the swing in the domestic terms of trade in favour of agriculture in many countries. Within the agricultural sector it appears that relative prices of food and export crops have shifted in favour of the latter. Since producers often respond positively to

94 For the definition of IAL countries, see table 41, footnote *a*.

95 The countries deregulating domestic purchasing from producers and/or export sales in major crops include Burundi (coffee), Cameroon (coffee, cocoa), Central African Republic (coffee), Gambia (groundnuts), Guinea-Bissau (cashews), Madagascar (all export crops), Niger (cowpeas), Nigeria (cocoa and palm oil), Togo (cotton) and Zambia (cotton, groundnuts).

shifts in relative prices, this creates a trade-off between food and export crop production unless *aggregate* supply increases sufficiently. Aggregate supply has in fact increased in response to price incentives but only moderately. More important, the response has been to increase traditional export crops subject to the fallacy of composition rather than promote horizontal diversification towards non-traditional crops. This, too, suggests that massive devaluations accompanied by abolition or reduction of export taxes can be harmful.

A number of factors serve to obstruct diversification:

- Commodity processing or diversification into products such as fisheries, timber, vegetable oils or cotton products is relatively easy because these can be produced in small-scale processing plants, and there is growing demand for specific products of this kind. Nevertheless, they still require considerable investment funds, which the producers often lack and which they cannot obtain either from the Government, when its priority is to cut spending, or from the banking system, because of the limited access of small producers to credits, especially when credit expansion is being limited. Similarly, shifting to new products such as fruits and vegetables is constrained by a paucity of packaging, transport and storage facilities, particularly in low-income countries. Here again, cuts in government investment can impede structural change;

- Needed producer services are also often in short supply. With the demise of many marketing boards, one established framework for producer services such as R & D, input supply, extension services and credits has disappeared without another system being put in its place. It is true there were considerable inefficiencies in the provision of these services, and marketing boards were not always very active in diversification. Nevertheless, firing extension officers, abolishing quality controls, and liquidating input supply and credit systems do not help diversification;

- Nor is enough external finance available for diversification. For instance, in the late 1980s, only about $1 billion a year was made available by the various international development banks for commodity-related, export-oriented diversification in developing countries, and much of that went to projects involving production of traditional commodities, such as cocoa, coffee, rubber and palm oil;[96]

- There are also barriers to entry into world markets for many commodities in processed forms. In industrial countries both tariff and non-tariff barriers escalate with the degree of processing, and this includes commodities of interest to SSA such as meat, cocoa and tobacco.[97] More important, such markets are characterized by widespread restrictive business practices such as cartel agreements, differential pricing and limitations on technology exports. The tendency towards concentration has been on the rise, with brand names steadily becoming more important, particularly in food. While some companies in SSA are cooperating with retailers in industrial countries or starting promotion campaigns, these factors make it very difficult for small and low-income countries to enter markets for processed goods;

- Marketing reforms are needed to increase flexibility and efficiency, but the fragmentation of the marketing system causes several problems. For example, "the threat that the old-fashioned cocoa boards and their equivalents could disappear, or lose their regulatory powers, is worrying some international buyers. The concern is not only that quality standards may suffer, but that private firms will not be trusted to meet distant delivery dates. For some chocolate manufacturers a state-run marketing agency still inspires more confidence than a private enterprise".[98] In order to provide some of the desirable activities of the old structures, exporters are establishing cooperative frameworks in some countries (e.g. Kenya and Nigeria). International cooperation in this respect is, however, inadequate;

- In many countries the bargaining position of exporters has been weakened by the abolition of central marketing boards. For many commodities, access to the international trade system has become more difficult for new, relatively unknown market entrants. Small exporters have problems attaining the levels of sophistication re-

96 UNCTAD, "Financial resources for diversification projects and programmes" (TD/B/C.1/AC/12), August 1990.

97 A. Maizels, *Commodities in Crisis* (Oxford: Clarendon Press, 1992), chap. 14.

98 *World Commodity Report* (London), 15 August 1991, pp. 4-5.

quired nowadays for commodity trading operations, and do not have the financial strength to engage in more sophisticated marketing methods.

In view of the continued volatility of commodity prices and the adverse effects of export instability on growth, abolishing marketing boards may not necessarily be the best course of action in SSA. The original rationale of the "caisse de stabilisation" system - namely, to regulate markets by fixing producer prices and acting as shock absorbers while trading alongside private firms - is still valid today.[99] Even countries at much higher levels of development, including some industrial countries, continue to find it necessary to intervene in agricultural prices and/or marketing. While many of the marketing boards in Africa are working inefficiently and placing a big burden on public finances, some of them have run into financial difficulties precisely because they have continued to pay high prices to producers of food and export crops despite the declines in world markets.[100] There are also efficient enterprises, making significant contributions to the budget (e.g. Kenyan Tea Development Authorities, the Cotton Development Authority of Madagascar, Zimbabwe Tobacco Marketing Board, and Agricultural Development and Marketing Corporation of Malawi). As discussed in greater detail in *TDR 1992*, there is scope for reforming them by revising their objectives, changing their incentives and making them more accountable.

There has been a deterioration in the domestic terms of trade of agriculture in many SSA countries, explaining to a large extent the the poor performance of the sector. There is a continuing need to reverse such tendencies, for almost all modern examples of industrialization have been associated with rapid agricultural development, which is not possible without providing adequate incentives. However, while this tendency has been due mainly to deliberate efforts by Governments to extract resources from agriculture, it is also a reflection of global trends in commodity prices. Consequently, Africa will need considerable external aid if its agriculture is to be appropriately developed.

5. Trade policy and industrialization

SAPs seek to promote manufacturing investment and exports through both trade liberalization and currency devaluation. The rationale is that while devaluation raises prices of traded goods relative to non-traded goods, trade liberalization reduces the cost of imports to exporters towards world levels, thereby allowing them to compete internationally. Import liberalization is thus seen as a prerequisite for growth of non-traditional exports. It is also expected to bring the discipline of competition to domestic industry, thereby helping to raise productivity - that is why liberalization embraces also consumer goods. SAPs in Africa usually involve reducing or eliminating import rationing that is brought about through foreign exchange controls, reducing non-tariff barriers by introducing open general licence schemes, increasing the number of goods importable with such licences, and lowering the average level and dispersion of tariffs.

There can be little doubt that many countries in SSA, as elsewhere, had raised their protection of local industry to excessive levels and that in practice protection failed in its objective of fostering the maturation of infant industries. Instead, it encouraged inefficiency and created windfall profits for those with privileged access to import licences. However, the experience of many developing countries with successful export performance shows that a high degree of import liberalization is neither necessary nor sufficient for export expansion.[101] Moreover, a swift removal of protection to local industry tends to be disruptive even in countries at a high level of industrial development. It is therefore no surprise that import liberalization has failed to improve export performance and investment, and has instead caused serious problems for industry.

The immediate effect of import liberalization has been to widen balance of payments deficits, often accompanied by a change in the composition of imports in favour of consumer goods, especially luxuries. This has increased the need to devalue and/or restrict demand, with the attendant consequences for stability and the level of activity. If imports are not restrained by expenditure reductions, liberali-

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99 See A. Maizels, *op. cit.*, chap. 4.

100 See J. Sharpley, "Kenya: macroeconomic policies and agricultural performance", OECD, Development Centre, Paris (1984); C. Colclough, "Competing paradigms in the debate about agricultural pricing policy", *IDS Bulletin*, vol. 16, No. 3 (1985); A. Thompson, "Zimbabwe", in *Agricultural Pricing Policy: Four Country Studies* (London: MacMillan, 1988); and R.T. Prasada, W.F. Shepherd and K. Sharma, "A comparative study of national price levels, agricultural prices and exchange rates", *World Development*, vol. 16, No. 12 (1988).

101 See *TDR 1989*, Part One, chap. IV.

zation may have to be reversed. That was the case in Kenya during 1989-1990 as well as in many CFA countries.[102]

Indeed, SAPs in African countries can cause deindustrialization.[103] A sudden rollback of trade protection, together with devaluations, demand restraint and removal of subsidies, and hikes in interest rates, tends to lower capacity utilization in industry and gradually erode the industrial base. A positive response to sharp swings in relative prices requires a considerable amount of investment, since existing machinery, equipment, structures, etc. cannot be easily relocated and reshaped to match the new relative price configuration. On the other hand, an important indicator of such restructuring is manufacturing exports. It is revealing that the share of SSA in world manufacturing exports has been falling constantly, indicating that SAPs have not made much progress in these countries in raising efficiency and competitiveness in manufacturing, and hence the chances of survival in the new environment.

However, the main problem with import liberalization in SSA has been that it has rarely been accompanied by greater import capacity because of the inadequate response of exports and of external funding. When imports are curbed, liberalization cannot improve efficiency. That provides compelling reason to put export promotion before import liberalization in these countries. SAPs have put very little emphasis on designing and implementing an effective strategy for export promotion.

An important component of such a strategy is to ensure easy access of exporters to all material inputs, including imported components, raw materials and capital goods. This calls for simplification of import procedures to minimize delays and giving exporters access to inputs at world prices through export retention and duty drawback schemes. Across-the-board liberalization of imports is not a necessity. Moreover, special facilities need to be designed for export credits, particularly since banks are not always willing to extend credit to new entrants. Because entry into new markets involves sizeable costs, other incentives are also needed in countries which have followed an "inward-oriented" strategy, such as subsidized credits and special tax rebates or tax breaks (e.g. exemption of export profits from taxation for a temporary period).

Designing and implementing such export promotion/import substitution strategies requires the State to play a more active role than envisaged in SAPs, though for it to do so an extensive reform of the bureaucracy and of the system of governance is also needed, to overcome such problems as corruption and political clientism. Moreover, for trade strategies to succeed in boosting investment and industrialization, they need to be placed in the context of industrial policy. However, as frequently noted,[104] SAPs do not provide for industrial policy. Admittedly, there has been much misguided intervention in the past; but that is no reason to throw the baby out with the bath water.

6. *Adjustment policies and private investment*

The ultimate aim of SAPs is to prepare the ground for sustained growth driven by private investment. However, as already noted, SSA has a very weak record in this respect. The poor performance in investment is related to a failure by SAPs in Africa to lead to vigorous export growth, in contrast with other countries engaged in SAPs, which have had successful investment records: "In the high (investment) response countries, exports as a share of GDP rose continuously during the 1980s, and by 1989 private investment shares of GDP recovered their preadjustment levels. In the most rapidly recovering economies, investment followed the resumption of export growth by about one year. The boom in these economies, in other words, did not result from investment demand stimulating aggregate demand. Investment responded to export-led growth".[105]

The reason for the failure in SSA was structural. The region's industrial basis is weak and the scope for switching to exports limited. Consequently, initially it is investment that needs to take the lead. It is therefore important to identify and address the impediments to private investment.

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102 I. Husain, *op. cit.*, p. 11.

103 See, e.g. H. Stein, "Deindustrialization, adjustment, the World Bank and the IMF in Africa", *World Development*, vol. 20, No. 6 (1992).

104 See R. Riddle (ed.), *Manufacturing Africa: Performance and Prospects of Seven Countries in Sub-Saharan Africa* (London: James Currey and Heinemann, 1990); and UNCTAD, *Final Review and Appraisal ...* .

105 World Bank, *Adjustment Lending and Mobilization of Public and Private Resources for Growth ...*, p. 34.

In its last assessment of adjustment lending the World Bank provided the following explanations for the fall in investment:[106]

> In an adjustment program, stabilization measures have a temporarily negative effect on investment ... Removing distortions also has disruptive effects on investment in the transition to a new relative price regime. Devaluation, for instance, raises the cost of imported capital goods. Empirical country studies on the impact of real devaluations on private investment usually show a short-term contractionary effect, followed by an expansion. Import liberalization causes investors to immediately postpone or eliminate investment in import-competing sectors, while investment in exporting sectors usually responds with a lag ... The shift in economic incentives during adjustment can temporarily reduce the willingness and ability of the banking sector to finance private investment ... Surveys of investors identify limited access and high interest rates as major impediments to investment.
>
> Private investment response among the low-income (and sub-Saharan African) groups of intensive adjustment lending countries is surely also constrained by longer-term factors - a weaker human capital base, inadequate and often deteriorating infrastructure, less diversified economies, and poorly functioning institutions and factor markets.

The World Bank sees the decline in investment as an "investment pause". However, the continued depression of private investment in SSA suggests that the adverse effects of SAPs themselves have been long-lasting, thereby continuously hindering graduation from stabilization to structural adjustment and growth. First, SAPs tend to be restrictive even after the stabilization phase, keeping the breaks on domestic demand largely in order to keep the external balances under control - a factor related to underfunding of the programmes. This tends to discourage even investment in traded goods sectors, since such investment is rarely undertaken solely to supply foreign markets alone. Continued fiscal austerity also hurts because of the complementarity of public and private activities, in both agriculture and industry. The persistence of the longer-term, structural impediments such as "a weaker human capital base and inadequate and often deteriorating infrastructure" is at least partly a reflection of the ineffectiveness of SAPs in removing them.

Second, given that there is limited entrepreneurship and very little private capital accumulation, improved incentives cannot be expected to result automatically in industrial restructuring and new industries. Investment depends largely on financing, but the reform of the financial system is one of the weakest parts of African SAPs. This is partly because it calls for a restructuring of corporations, both financially and technologically. To break this vicious circle, the State needs to play an active role, with a well defined industrial policy - something to which SAPs are averse.

There can also be little doubt that removing impediments to private investment and business requires government action. Government attitudes in SSA are not always conducive to greater private initiative and capital accumulation. Owing to suspicions about private property that have their roots in colonialism, when capital and power were concentrated in alien hands, some Governments are still reluctant to deregulate the markets and reduce or abolish investment licensing. These attitudes need to change if private investment is to become the driving force.

E. Conclusions

The recent performance of SSA countries has been very poor. Even under an optimistic scenario regarding commodity prices, their prospects for the remainder of the current decade are rather bleak. Thus, both domestic and international policies need to be revised considerably if the rise in poverty is to be reversed and the marginalization of Africa halted.

On the international front there is a need to support the SAPs with a greater transfer of external resources on a continued and predictable basis. This is necessary both to meet the continued terms of trade losses and to increase the import and investment capacity. Perhaps the most important role in this respect can be played by debt reduction (see Part Three). It is also important for donors and international

[106] *Ibid.*, pp. 34-35.

financial institutions to design aid to meet fully the needs of the recipients and to abandon the short-leash approach.

There are a number of positive elements in African SAPs, including the importance attached to agricultural development and macroeconomic stability. However, there are also many shortcomings, including both omissions and commissions. The important areas neglected to varying degrees in the design and implementation of SAPs include public investment, tax reform, reform of PEs, export promotion and capacity building in the public administration. Similarly, there is very little effort to design agricultural commodity production and export strategies to avoid the fallacy of composition problem, and/or to coordinate SAPs across countries for this purpose. By contrast, there is a tendency for excessive reliance on devaluations, trade liberalization, privatization and demand restraint. These cannot make up for missing reforms, and they are counterproductive once the adverse effects start to outweigh the positive contribution to adjustment.

There can be no doubt that the process of adjustment and development in Africa is inevitably slow and that no miracles can be expected. A pragmatic rather than a doctrinaire approach is required. The debate concerning the best ways of adapting adjustment programmes to the needs and realities of these countries needs to be open. However, the participation of Governments in the initiation and design of SAPs has so far been limited, and their commitment to and ownership of the programmes weak. This lack of ownership is reflected even in the design of technical cooperation projects:

> External development agencies failed ... to insist on full local participation in identification and design of projects. Having failed to ensure local involvement, it is not surprising that local commitment and sense of ownership was weak. ... But problems in making technical assistance effective were not all the fault of donors. The approach on the part of African officials ... has often been ambivalent ... In sum, the donors have done a disservice to Africa, and many African Governments have participated blindly.[107]

It is important that these conclusions be reflected in improvements in the design and implementation of SAPs as well.■

[107] "Capacity building: the missing link in African development", address by Edward V.K. Jaycox, Vice President, African Region, The World Bank, to a conference sponsored by the African American Institute, Reston, Virginia, 20 May 1993, p. 2.

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Chapter III

RECOVERY AND UNCERTAINTY IN LATIN AMERICA

A. Introduction

Only five years ago the economies of Latin America were still in serious crisis, with widespread macroeconomic imbalances involving large budget deficits and very high inflation and even, in a number of countries, hyperinflation. Imports were tightly compressed in order for the economies to generate the massive trade surpluses needed to service debt, and there was very little by way of external lending or inflows of private capital. Growth was almost zero and net investment barely positive.

The picture today is still much the same for Brazil, Peru and some smaller economies, but has changed radically for the others, and there is a widespread feeling in most countries that the crisis is over. Growth is up, and inflation and budget deficits are down. Net transfers are again positive, with a massive inflow of private capital to almost every country in the region. Indeed, the large trade surpluses of the past have been replaced with even larger trade deficits, flooding the economies with imports and satisfying the pent-up demand of years of hardship. Trade has been liberalized to a far greater degree than elsewhere, and Latin America appears to be integrating rapidly into the international trading and financial systems.

There are, however, serious weaknesses and risks. With very few exceptions, growth is still low compared to the postwar average of the continent, and compared to countries in East Asia at a similar stage of development. Besides, it is generally driven by consumption rather than investment, and the region is losing competitiveness because of currency appreciations brought about by the influx of capital. Equally important, there is the risk of a sharp drop in private capital inflows. If that were to occur, it would once again undermine both stability and growth.

B. The general tendencies

Since the beginning of the decade growth has accelerated in Latin America, averaging 2.3 per cent annually for 1990-1992. If Brazil, Peru and some smaller economies still suffering from recession are excluded, the average growth rate rises to 5 per cent. Similarly, the average rate of inflation fell drastically after peaking in the late 1980s. For the region as a whole, excluding Brazil, where hyperinflation remains a problem, inflation dropped to 49 per cent in 1991 and to 22 per cent in 1992.

This recovery in Latin America has taken place at a time when the major industrialized countries, particularly the United States, its main trading partner, entered into a deep and prolonged recession, and world trade slowed down significantly. There is no doubt that considerable policy efforts made over the last decade have played a major role in this turnaround. However, the most remarkable change governing the evolution of the Latin American economies concerns the external financial sector. First, there has been a significant fall in the interest bill, due to the decline in interest rates in the United States. Second, there has been a sudden and marked reversal of capital movements.

Thanks to the fall in interest rates, annual average interest payments on external debt from the region fell from $28.5 billion in 1988-1989 to around $23 billion in 1991-1992. These gains have more than offset the deterioration of the terms of trade. Consequently, for the first time in many years the overall external environment has moved in favour of Latin America.

A much more important development, however, has been the reversal of capital flows. Admittedly, this is connected with the decline in interest rates in the United States, which, as already discussed in Part One, chapter III, section D, has helped create large margins in favour of financial assets issued within the region. Likewise, lower United States interest rates have raised the net return on investment in productive assets in Latin America. This second factor, together with prospects of capital gain, has played an important role in bringing FDI into the region and in the success of privatization - for instance, in Argentina, where transnational firms have actively participated in the process. However, it has to be borne in mind that, while short-term rates declined in the United States, long-term rates remained quite high, and that short-term rates rose considerably in Europe. Besides, in some countries the arbitrage margins with the dollar-denominated assets are so large that a change of a few percentage points in the United States cannot make much difference. In any event, such margins are not sufficient on their own to attract capital flows. Indeed, even higher margins had emerged in some countries in Latin America during the 1980s when capital was flowing out. Nor can capital flows be attributed simply to improved economic policies and performance. Capital has been flowing into almost every country, including those with serious macroeconomic imbalances, and the recipient countries differ in their fiscal posture and exchange rate and trade policies.

There can be little doubt that the surge in these flows has been triggered by a favourable shift in market sentiment about Latin American economies, and sustained by a bandwagon effect, or a speculative bubble, with people lending or investing just because everybody else is doing it.[108] In a sense, this is reminiscent of the "contagion" of the early 1980s, when bank lending virtually to every country in the region was cut after the Mexican crisis.

Capital flows to Latin America grew more than six-fold in a very short time, rising from an annual average of about $8 billion in the late 1980s to one of about $50 billion in 1991-1992. This, together with the decline in interest payments abroad, meant that for the first time since the debt crisis the region began to receive net financial transfers from abroad. A swing in annual transfers to the region of about $50 billion from 1988-1989 to 1991-1992[109] allowed many countries to finance a higher current account deficit; the negative balance for the region rose from $6 billion in 1990 to $19 billion in 1991 and $33 billion in 1992. Since the interest bill has been falling, this represents an even sharper swing in the trade surplus. Indeed, in 1992, for the first time since 1983, Latin America as a whole ran a trade deficit of more than $8 billion; all countries of the region had deficits, with the exception of Brazil, Colombia, Chile, Ecuador and Venezuela (see table 43). The swing in the trade balance is more impressive if the massive trade surplus ($15.6 billion) of Brazil is excluded: the deficit then reaches $24 billion, giving a swing of $38 billion from 1989.

The relaxation of the external constraint has been accompanied by drastic trade liberalization in many countries. The number, average level and dispersion of tariffs have been reduced, and although most non-tariff barriers have been replaced by tariffs, Latin America now has lower tariff protection than other developing regions. Compared to East and South-East Asia, the average and maximum tariff rates in six of the largest countries of Latin America are smaller by almost one half and two thirds, respectively, and their dispersion is considerably smaller; the discrepancy is even smaller if Brazil is excluded (see table 44). Non-tariff barriers for all products

108 For a discussion of these issues see Y. Akyüz, "On financial openness in developing countries" in UNCTAD, *International Monetary and Financial Issues for the 1990s*, vol. II (a United Nations publication), New York, 1993; and (by the same author) "Financial liberalization: the key issues", *UNCTAD Discussion Paper*, No. 56, March 1993.

109 In the first two-year period there was a net outflow of about $57 billion and in the second a net inflow of $36 billion.

Table 43

INDICATORS OF MACROECONOMIC PERFORMANCE OF LATIN AMERICAN COUNTRIES IN 1992 [a]

	GDP growth	Consumer price index	Trade balance	Current account balance	Fiscal surplus [b]
Country [c]	Per cent	Percentage change	$ million	$ million	Per cent of GDP
Chile	10.4	12.7	700	-800	3.0 [d]
Argentina	9.0	17.7	-2 900	-8 000	0.0 [d]
Panama	8.0	1.2	-220	-550	-3.0
Dominican Republic	7.5	5.9	-1400	-490	3.0
Venezuela	7.5	33.4	1750	-1500	-6.1 [d]
Uruguay	7.0	58.6	-350	20	1.0
El Salvador	4.6	16.8	-850	-350	-4.7
Honduras	4.5	5.4	-80	-340	-5.8
Guatemala	4.5	11.6	-660	-540	-0.5
OECS members [e]	4.2	..	..	..	..
Costa Rica	4.0	18.1	-300	-450	-2.0
Bolivia	3.8	11.4	-260	-610	-3.0 [d]
Ecuador	3.7	66.0	700	-440	-3.2 [d]
Colombia	3.3	25.7	1560	1070	-0.4 [d]
Guyana	3.0	..	..	..	..
Mexico	2.6	12.0	-18800	-20750	3.4 [f]
Paraguay	2.5	17.0	-470	-510	-0.5
Jamaica	1.5	13.7	-500	..	..
Bahamas	1.0	..	..	..	..
Nicaragua	1.0	2.2	-500	-1000	-7.3
Trinidad and Tobago	-	7.7	..	..	..
Suriname	-	..	..	..	..
Brazil	-1.5	1131.5	15560	6600	-2.5 [g]
Peru	-2.5	56.6	-650	-2030	-1.0
Barbados	-2.5	5.8	..	..	..
Haiti	-5.0	17.5	-160	-90	..

Source: UNCTAD secretariat calculations, based on ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1992*; *Latin American Economy and Business, Quarterly Update*, May 1993; and national sources.

a Preliminary. No data were available for Belize and Cuba.
b Central Government, unless otherwise indicated.
c Ranked in decending order of growth rate.
d Non-financial public sector.
e Organization of Eastern Caribbean States (Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines).
f Consolidated public sector.
g Operational deficit of non-financial public sector.

other than fuel are quite moderate and on the whole lower than those in industrialized countries (see Part One, chapter II, table 20) as well as the developing countries of East and South-East Asia (see table 45).

The increased capital inflows, accompanied by trade liberalization, have caused imports and domestic absorption to increase substantially. From 1990 to 1992, imports of the region grew at an average annual rate of 17.4 per cent in value and 14.9 per cent in volume. Nevertheless, the reversal in capital inflows has been so abrupt and significant that in many countries foreign exchange reserves accumulated rapidly as Central Banks intervened to relieve pressure on their currencies to appreciate. However, none of them succeeded in avoiding an appreciation in real terms, something that reinforced the rise in imports. The combination of trade liberalization and currency appreciation has put considerable

Table 44

COMPARATIVE MFN TARIFFS IN 1991: LATIN AMERICA AND EAST AND SOUTH-EAST ASIA

(Percentage)

	Average [a] tariff	Maximum tariff	Standard deviation
Latin America (six countries)	15.1	65.0	3.8
Argentina	11.8	35.0	7.4
Brazil	20.8	65.0	14.2
Chile	12.0	11.0	0.7
Colombia	11.8	40.0	6.3
Mexico	13.0	20.0	4.4
Venezuela	15.7	50.0	11.3
Asia (five countries) [b]	25.8	220.0	13.7

Source: UNCTAD secretariat estimates.
Note: For all countries shown minimum tariffs were zero.
a Weighted by imports in 1991.
b Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.

squeeze on domestic industry in some countries, particularly Argentina[110] and Venezuela.

The expansion in activity and the lag in the movement of the exchange rates behind inflation have served to foster macroeconomic stability. Fiscal balances have shown an extraordinary improvement throughout Latin America in the last two years. Because of the tax structure, revenues are typically very sensitive to the level of activity and external trade. Currency appreciation and the decline in dollar interest rates have also helped improve the fiscal balance by reducing the real value of the domestic currency required for servicing external debt. Many countries in the region have now reached a controlled fiscal situation and are running either a surplus or a small deficit. But in a few (notably Brazil), the central bank absorbed much of the capital inflow by issuing public debt at very high interest rates; accordingly, the budget deficit escalated.

Thus, the trade-off between external and fiscal balance that came to the fore in the 1980s has continued to operate in the 1990s, but in different ways, and with variations from country to country. In the 1980s currency depreciations and trade surpluses generally worsened the fiscal balance by increasing the need for budgetary surpluses in order to make external transfers (i.e. the "domestic transfer problem"), except where, as in Chile, the Government itself was an important earner of foreign exchange.[111] In the 1990s, currency appreciations have improved fiscal balances, but the inflow of capital has widened fiscal deficits where sterilization has raised the level of government domestic debt and debt-servicing costs.

Capital inflows are typically expected to push up inflation by raising the money supply and spending. This did not happen partly because of the sterilization of the effect of capital inflows on the stock of money and partly because of currency appreciations which kept import costs down. The latter has been one of the most important factors explaining the steep fall in inflation despite the expansion of aggregate demand. In addition, some countries (notably Argentina) have used the exchange rate as a nominal anchor to dampen inflationary expectations at the cost of a further real appreciation of the currency.

The improvement in economic activity and price stability thus has weaknesses. In the first place, many countries in the region have achieved price stability at the cost of competitiveness. But there is the risk that the

[110] See *TDR 1992*, Part Two, annex II.
[111] See *TDR 1989*, Part One, chap. IV.

Table 45

MAJOR TRADING COUNTRIES IN LATIN AMERICA AND ASIA: IMPORT COVERAGE RATIOS [a] OF SELECTED NON-TARIFF MEASURES IN 1992

(Percentage)

	Broad definition [b] of NTMs	*Narrow definition [b] of NTMs*				
Region	*All selected measures*	*Variable levies*	*Non-auto. licences*	*Quotas*	*State monopolies*	*All selected measures*
Latin America [c]	4.2	0.2	2.3	0.4	1.5	3.4
Asia [d]	10.2	-	9.2	0.3	0.8	10.0

Source: UNCTAD Data Base on Trade Control Measures.

a All imports except fuels (SITC 3).

b For the "broad" and "narrow" definition of NTMs see table 18.

c Argentina, Brazil, Chile, Colombia, Mexico and Venezuela.

d Indonesia, Malaysia, Philippines, Republic of Korea and Thailand.

capital flows which made it possible to maintain imports will not be sustained. If they peter out rapidly, a substantial devaluation will be needed. This would undermine macroeconomic stability through its effects on inflation and fiscal balances. Furthermore, the required swing in the trade balance may also necessitate cuts in domestic income and absorption in order to reduce imports.

In the second place, even though there has been a sizable softening of the external constraint, growth is still quite slow, giving only a small increase in per capita income. Although investment and domestic savings have recovered somewhat, they are still considerably below pre-crisis levels. The belief that the role of the public sector should be minimized has meant that fiscal adjustment has taken the form of reducing public investment to extremely low levels. Given the complementarity between public and private investments, this has been a drag on the slow recovery of the latter.

C. Recent economic performance

1. *Economic activity and growth*

The trend towards recovery and disinflation that began at the turn of the decade strengthened in 1992. The average growth rate of the region, excluding Brazil, reached 4.3 per cent, while inflation generally continued to fall. As may be seen from table 43, in Argentina, Chile and Venezuela, and in three smaller economies, the increase in GDP was 7 per cent or more; among the latter, growth in Uruguay benefited greatly from expansion in Argentina. However, in most countries, including Colombia and Mexico, GDP growth was barely above population growth. Similarly, many Central American and Eastern Caribbean countries continued with the very modest growth rates they attained in the 1980s. Brazil and Peru have still shown no signs of recovering from the recession that began in 1988-1989; their stagnation is becoming chronic.

The forces driving growth differ considerably from one country to another. Among the three largest fast-growing countries mentioned above, Chile has been steadily expanding for nine consecutive years, at an average rate of 6.2 per cent, with growth increasingly driven by investment and exports: in 1992 the volume of investment grew by 20 per cent, in large part due to the private sector, and that of exports by 15 per cent. But neither Argentina nor Venezuela can be said to have achieved a sustainable, high-growth path. Argentina's recent expansion reflects a short-term upswing after the crisis of the late 1980s, when investment and output collapsed and inflation rose rapidly. The Convertibility Plan reversed the downturn and attained very high growth rates in 1991-1992, but unlike Chile, growth has been driven by consumption sustained by private capital inflows. Exports continued to stagnate and while aggregate investment has shown a significant improvement, it is still below its 1980-1981 level. Much the same is also true of Venezuela, where growth was due to activity in the private, non-oil sector after the expansion in the oil industry for two consecutive years.

Among the countries with more moderate growth rates, exports, and especially non-traditional exports, played an important role in some Central American countries, in particular Honduras and Costa Rica, while in others, such as Guatemala and El Salvador, the driving force has been investment (public investment in infrastructure and energy in the latter and private investment in the former).

In Colombia also, investment continued to be by far the most dynamic component of aggregate demand in 1992, even though exports continued to expand. However, growth since the 1980s has not been associated with structural change in industry and the composition of domestic production: no sector has systematically played the leading role in growth. By contrast, there has been a substantial amount of structural change in Mexico, but the pace of change is slowing down because of the weak overall economic growth. Although the Mexican economy has been growing steadily for the last five years, growth has been weak, below 3 per cent, barely keeping up with the growth of the labour force. This, together with the industrial restructuring necessitated by greater openness and increased competition, has been causing a contraction in industrial employment.

The strains are even greater in those economies without either growth or structural change, particularly Brazil and Peru. The export sector in Brazil is showing dynamism, but it is largely due to the recession; indeed, as recession deepened, exports rose (by 15 per cent in volume). Such was not the case in Peru, however, where the cumulative decline in output during the last five years amounts to about one quarter, reflecting the high costs of the policies implemented to stop hyperinflation.

To sum up, in most of Latin America, private investment and exports have not yet become the driving forces of growth. Thus, although many countries have made a significant turnaround from the deep crisis of the 1980s, no country, with the possible exception of Chile, can yet be said to have genuinely completed structural adjustment.

2. *Inflation and exchange rates*

Countries in Latin America can be classified into roughly three groups according to their price performance: those with low inflation, those with moderate-to-high inflation, and those with hyperinflation. Most fall in the first category, with rates below 20 per cent in 1992. Five countries have inflation rates between 20 per cent and 70 per cent (Colombia, Ecuador, Venezuela, Peru and Uruguay). Finally, there is Brazil, with an average monthly inflation rate of more than 20 per cent. It is noteworthy that this classification shows no correlation with growth performance (see table 43).

Many countries that have adopted stabilization programmes in recent years have faced the conflict between price stability and international competitiveness. The low inflation countries Chile, Argentina and Mexico have used the exchange rate as an instrument of disinflation. In Chile, inflation continued to fall in 1992, particularly during the earlier part of the year, despite the expansion of effective demand and the reduction in unemployment, in large part because the nominal exchange rate adjustment lagged behind prices; inflation showed a tendency to rise in the second half as the currency depreciated more rapidly due to a more active exchange rate policy.

The problem of currency appreciation has been much more serious in Argentina and Mexico. The Convertibility Plan in Argentina used the exchange rate as a nominal anchor in order to permit domestic inflation to converge towards international levels. Although inflation came down rapidly during 1991-1992 (thanks also to trade liberalization, fiscal adjustment, de-indexation of nominal contracts, price agreements in some strategic industries,

and other incomes policy measures), full convergence has not been achieved, and the currency has appreciated sharply in real terms. Mexico has also utilized the exchange rate as a nominal anchor, and since the launching of the stabilization plan (the "Pacto" of December 1987), there has been a systematic tendency for the currency to appreciate. In this respect 1992 was no exception, despite the acceleration of daily adjustments in the nominal exchange rate later in the year. Similarly, in Uruguay and Peru the fall in inflation was partly due to the lag in exchange rate adjustments. In Ecuador, by contrast, inflation accelerated, largely due to devaluation.

After Nicaragua's success at arresting hyperinflation in 1992 by fixing the nominal exchange rate (something made possible by external aid), Brazil is now the only country in Latin America with more than two-digit annual inflation. Monthly inflation rates rose steadily from under 10 per cent in mid-1991 to over 20 per cent in the first quarter of 1992, partly due to devaluations. Subsequently, however, as a crawling peg was adopted and monetary policy tightened, the inflation rate was stabilized within the 20-26 per cent range. This outcome is viewed as the best that monetary policy could do, given the large fiscal deficit.

The problem confronting many countries with low or moderate inflation is how to realign exchange rates without refuelling inflation, a result which would conflict with their reducing inflation further, to single-digit levels, in order to converge to the levels prevailing in the major industrialized countries. Such convergence is deemed necessary in view of greater integration of these countries into the international trading and financial systems. They are thus confronted by a major dilemma, since lower inflation may necessitate further currency appreciations.

3. *The external sector*

The considerable deterioration of trade balances in Latin America has been due primarily to the rapid expansion of imports that resulted from trade liberalization, accelerated economic growth and real currency appreciation. The first two factors have operated in almost all the larger economies except Brazil, while appreciation of the currency in real terms has weakened export performance (again, except in Brazil, as well as in Chile and some of the smaller countries such as Costa Rica and Honduras). Exports from the region nevertheless grew faster than GDP. The increase in volume in 1992 was 6.4 per cent, but in value terms was smaller because of a decline in export unit values of more than 2 per cent which affected not only the oil-exporters (Venezuela, Mexico, Colombia and Ecuador), but also other commodity exporters, particularly in Central America. For the latter, together with the Caribbean countries, the decline in export prices averaged 4.2 per cent, but for some countries it was more pronounced: 14.5 per cent in Nicaragua, 9 per cent in Honduras and 7 per cent in El Salvador. In some countries a substantial increase in export volumes more than made up for lower unit values (e.g. Costa Rica and Honduras), while in others export earnings fell. In Paraguay, for example, they fell by 13 per cent largely because of lower cotton prices. It should be noted that the greater preferential access to the United States market enjoyed by the Central American countries as a result of the enhancement of the 1985 Caribbean Basin Initiative in 1991 has played an important role in promoting non-traditional exports from the region, helping them to offset the declines in the prices of traditional exports.

There have also been three different types of experience as regards external deficits and their financing. In some countries, most notably Argentina and Mexico, although there was a large swing from a trade surplus to a deficit, owing to trade liberalization and currency appreciation, the capital account made an even larger swing in the opposite direction. In Mexico imports surged despite sluggish growth, whereas in Argentina strong growth was an additional factor. In both countries exports stagnated, with the result that the 1992 trade deficit exceeded $18 billion in Mexico (down from a surplus of $8 billion in 1987), while in Argentina total imports doubled from 1990 to 1991 and again from 1991 to 1992, rising to $15 billion, and the trade balance swung from a surplus of $8 billion in 1990 to a deficit of $3 billion. Despite a sizeable decline in interest payments, the current account balance in Argentina fell from a surplus of $1.8 billion in 1990 to a deficit of $8 billion in 1992, largely due to a surge in tourism abroad. Notwithstanding these developments, foreign exchange reserves rose in both countries. Positive net private transfers were far greater than the negative net transfers that the public sector continued to make abroad on debt servicing.

In other countries the current account deteriorated rapidly, and private capital inflows were not sufficient to avoid public borrowing and/or a drawing down of reserves. In Venezuela, for instance, the current account swung from a surplus of $8.3 billion in 1990 to a $1.5 billion deficit in 1992 as a result of the

decline in oil prices and a surge in imports. However, as the ambitious reform programme initiated in 1989 (comprising trade liberalization, privatization, deregulation, and the reform of the public sector) ran into difficulties and privatization virtually stopped, private capital inflows fell sharply: in 1992 the capital account surplus was maintained at around the 1991 level through increased borrowing by the public sector, but it was not large enough to finance the current account deficit. The gap had to be met by drawing down foreign exchange reserves accumulated in the previous two years, with the consequence that reserves fell (by $1.5 billion) for the first time since 1988.

The third type of experience was that of countries such as Chile and Colombia, which succeeded in maintaining rough balance on external account. In 1991 Chile had run a current account surplus for the first time in 15 years, which turned into a small deficit in 1992 (about 2.3 per cent of GDP). The deficit is expected to reach 4 per cent of GDP in 1993. While imports grew rapidly (mainly as a result of liberalization and rapid economic growth), strong export growth, particularly of non-traditional (i.e. non-copper) exports, kept the current account in balance. Export competitiveness was helped by a more rapid appreciation of the currencies of neighbouring countries. Colombia's imports rose as a result of accelerated trade liberalization, inducing a fall in the current surplus, as export volume growth was not enough to compensate for both the increase in imports and the decline in the terms of trade. The capital account was in surplus in both countries, particularly in Chile, giving rise to a rapid accumulation of international reserves.

By contrast, the trade balance improved in Brazil. Imports of both goods and services have been sluggish due to continued recession, despite a programme of trade liberalization implemented at the beginning of the Collor Administration. Exports, however, have grown rapidly. As a consequence, Brazil showed a "mega-surplus" in the trade account in 1992. The main reasons for the export boom have been the more favourable real exchange rate since the end of 1991, as well as currency appreciation and tariff reductions in Argentina resulting from the integration process in MERCOSUR. Despite the unstable macroeconomic environment, Brazil received a large inflow of private capital, which together with the current account surplus led to a more than doubling of its international reserves, to a level of $19 billion, or about one year of imports.

4. Monetary and fiscal performance

There has been a remarkable fiscal adjustment in Latin America during recent years. Only a few economies are still running fiscal deficits at levels typical of the 1980s; some of these deficits (e.g. in Nicaragua, Bolivia and Honduras) have been financed almost completely by aid flows, i.e. without generating macroeconomic disturbances in the economy. On the monetary front, by contrast, several countries have been struggling to cope with the destabilizing effects of capital movements.

Chile and Colombia have been able to preserve the sound fiscal positions they had reached earlier, with the Chilean public sector running a surplus and that of Colombia a balanced budget. Mexico has maintained the fiscal control it attained in the 1980s. Although the primary surplus has declined slightly, the total deficit fell as a result of reduced interest rates on external debt as well as a smaller stock of debt. During 1992, the public sector received funds from privatization equivalent to 3 per cent of GDP, using them primarily to redeem public debt. Lower interest rates on domestic debt, resulting from lower inflation, also played a role. Cuts in public investment continued, whereas there was a sharp increase in social spending, which now accounts for almost half of total budget expenditures.

Argentina also achieved a sound fiscal position in the 1990s, not so much through spending cuts as through a spectacular increase in tax receipts due to economic recovery, better collection and control, and increased public willingness to pay: total tax revenue reached an unprecedented 24 per cent of GDP in 1992. Overall fiscal balance was also favoured by lower international interest rates and by receipts of $11 billion from privatization over the last few years. These funds, together with the primary surplus, have so far enabled the Government to roughly comply with the IMF fiscal targets, as well as to service its debt without resorting to inflationary financing of public expenditures.

In the other major countries of the region fiscal balances have deteriorated during the last two years. Venezuela had achieved a major fiscal adjustment in the late 1980s, turning a deficit of 8.6 per cent of GDP in 1988 to a surplus of 0.7 per cent in 1991. However, there was continued heavy dependence of fiscal revenues on oil. Thus, as oil prices declined, and the currency appreciated, government revenues fell sharply, generating a deficit of 6 per cent of GDP in 1992.

In 1990-1991 the Brazilian budget reached an operational surplus averaging about 1 per cent of GDP after a deficit of 7 per cent in 1989.[112] However, this was not sustainable because of the "one-off" character of several of the more important fiscal measures that formed part of the Collor I and Collor II stabilization plans. Together with attempts to sterilize the monetary effects of increased international reserves, this was the main reason for an operational deficit of 2.5 per cent of GDP in 1992.

In Brazil the central role increasingly assigned to monetary policy since mid-1990 to combat inflation has been the main factor in the sharp rise in interest rates and the emergence of large arbitrage margins already discussed in Part One, chapter III. The margin widened in 1992 and capital inflows picked up, particularly in the first half of the year, before the deepening of the political crisis. As a result of sterilization, domestic public debt rose from 4.2 per cent of GDP in 1991 to about 10 per cent in 1992. As in the 1980s, the increase was intended for the purchase of foreign currency from the private sector. However, the purchases were made not, as in the past, to make net transfers abroad but to prevent an appreciation of the currency and maintain competitiveness. Thus, capital flows are adding to budget deficits, rather than to trade deficits, because the interest that can be earned on reserves is much lower than that on government paper issued to sterilize the inflow. In an attempt to prevent further adverse effects of capital inflows, the Government in June 1993 extended the withholding tax to all Brazilian Eurodollar bond issues with a maturity of less than eight years.

The consequences of capital inflows for government debt and deficits have been less serious for other countries in the region. First, the currency was allowed to appreciate, taking partly the burden off monetary policy and government debt. Second, inflation and interest rates have been considerably lower, alleviating the effect of sterilization on deficits. Third, initial fiscal positions were more comfortable, making it possible to generate and/or use budget surpluses to absorb capital flows. But even in these countries managing capital flows has proved to be difficult and a number of measures have had to be taken to control them.[113]

The Central Bank in Chile had tried to sterilize the increase in the monetary base, thus putting upward pressure on interest rates, which strengthened the incentive to import short-term capital and put further pressure on the currency to appreciate. The authorities therefore adopted several other measures to limit inflows. They imposed non-interest-bearing reserve requirements on almost all financial inflows (in the form of investment as well as borrowing), thus sterilizing them at no cost. The measures also included regulations covering external bond issues and equity offerings specifying the minimum credit rating of entities eligible to make them, the minimum size of such issues and offerings, and (in the case of bonds) their minimum maturity as well as the extent of the underwriting commitment of overseas securities firms undertaking them. A stamp tax on foreign credits was also imposed. Subsequently, these measures were reinforced by innovations in exchange rate setting designed to create greater uncertainty concerning the levels for major currencies, including putting to an end the practice of advance announcement of devaluation of the peso, widening the currency band, and linking the peso to a basket of currencies instead of the dollar. Furthermore, restrictions on remittances and investments abroad by private pension funds have been relaxed.

In Colombia, the Government reacted to the "capital bonanza" in the same way as the "coffee bonanza" in the 1970s, i.e. taking it as a temporary positive shock. It attempted to generate a fiscal surplus to offset at least partly the expansionary effects, and strengthened the fiscal position in 1992 with a reform that increased the rate and scope of the value added tax. Simultaneously it tried to sterilize the monetary growth by issuing bonds, and allowed some appreciation of the peso (by 14 per cent from 1990 to 1992). Monetary policy was modified at the end of 1991, and in order to prevent interest rates from rising, monetary targets were abandoned and a ceiling (of 35 per cent a year) was imposed on lending rates. Several other measures were also taken to discourage capital inflows, including those hidden in current account transactions. For example, tourists were not allowed to bring in more than $25,000 and higher commissions were charged on cash purchases of foreign exchange.

Mexico has imposed reserve requirements on banks' liabilities denominated in foreign currencies and limited their borrowings in dollars. The differential points for the peso-dollar exchange rate have also been widened so as to create uncertainty about the arbitrage margin.

112 Operational fiscal balance allows for the depreciation in the real value of government debt due to inflation and hence only includes *real* interest payments.

113 For a review of the policy responses up to early 1992, see *TDR 1992*, Part Two, annex II.

In early 1993, however, following the decline in Mexican equity prices, the Government appeared to be willing to raise short-term interest rates to prevent an outflow of funds.

As noted above, the reaction of Argentina to private capital flows has been largely passive. As a result, capital inflows added to the stock of money, which rose from 8.2 per cent of GDP at the end of 1990 to 17.1 per cent two years later. None the less, the worsening of the trade balance started raising some fears in the private sector by mid-1992, resulting in some slowing of the capital inflow during the latter part of the year. An attempt to improve the real exchange rate in late October through foreign trade taxes triggered a run against the peso. Even though the central bank reacted firmly to maintain convertibility and dollar purchases quickly stopped, a substantial rise in domestic interest rates could not be avoided.

D. Growth prospects and policy dilemmas

1. *Sustainability of capital flows*

It is doubtful whether private capital inflows will continue at their recent pace. The flows were largely constituted by repatriated flight capital, which is a finite process as the assets held abroad are drawn down. Capital attracted by privatization is, too, of a one-off nature. Similarly, capital flows to equity markets represent partly a portfolio diversification by international investors exploring opportunities in the so-called "newly emerging capital markets" and attracted also by low asset values. For the recent pace of equity investment to continue, the corporate sector in Latin America would need to grow very rapidly, requiring a rate of investment far above that observed in recent years. Much the same is true for FDI, which is also partly a one-off response to the recent liberalization and opening up of the Latin American economies.

Moreover, it is widely believed that lower interest rates in the United States have played a major role in the inflow of private capital by both improving the solvency of Latin American debtors and generating large arbitrage margins.[114] The expected rise in interest rates in the United States (see chapter I of this Part) would therefore discourage these flows, particularly to countries with close financial relations with the United States.

Furthermore, the particular configuration of exchange rates, interest rates and stock prices underlying the recent surge in capital flows cannot be expected to last. An important part of the arbitrage margins has been due to currency appreciations, particularly in Argentina and Mexico, which, if continued, would eventually lead to an external payments crisis as exports fall and trade deficits mount. If, on the other hand, the currency appreciation is suddenly reversed, the arbitrage margin will disappear, possibly triggering a sharp drop in short-term capital flows. Thus, the best strategy would be to let nominal exchange rates slide gradually while controlling short-term capital inflows. Greater stability of the real exchange rate is also important for trade performance. Realignment of real exchange rates and subsequently maintaining their stability would certainly reduce arbitrage margins and hence affect short-term capital flows.

If continuous appreciations are avoided, the only way for large arbitrage margins to emerge is through very high real interest rates, as in Brazil today. But this creates a serious dilemma between maintaining capital flows and growth. Sooner or later interest rates will have to be lowered. This is also true for portfolio equity investment. It is the expectation that equity prices will rise faster than the nominal depreciation of the domestic currency that is attracting money into equity markets. Such an expectation tends to be self-fulfilling since inflows serve both to raise stock prices and maintain the value of the currency. Indeed, most stock market booms in Latin America occurred after the rise in capital flows. There has been a much stronger presence of nonresidents in some stock markets: in Mexico, for instance, their equity holdings are estimated to

[114] See, e.g. G.A. Calvo, L. Liederman, and C.M. Reinhart, "Capital inflows and real exchange rate appreciation in Latin America", *IMF Staff Papers*, vol. 40, No. 1, March 1993.

have amounted to about a quarter of the market's capitalization in the second quarter of 1992, compared to about 5 per cent in the major capital markets such as New York and Tokyo. However, the bubble cannot keep growing indefinitely: indeed, as seen in Part One, chapter III, section D, the initial buoyancy has not endured and there was a considerable decline in net inflows in 1992. More recently, stock prices have shown some weakenening in Mexico. If trade balances in Latin America deteriorate further, expectations of devaluation can become widespread, thereby triggering profit-taking and capital outflows.

2. Vulnerability to reversal of capital flows

It is often suggested that so long as the budget is balanced, current account deficits and capital flows merely reflect a discrepancy between private savings and investment, and should not be a cause for concern. However, this argument assumes that private capital flows always finance higher investment rather than higher consumption. The proposition that the private sector cannot have an unsound financial position is clearly refuted by the recent history of the United States, as well as that of the Southern Cone countries in the 1970s and 1980s.

When capital flows finance investment in traded goods sectors, they generate new export capacity, but this is often not the case when the capital is attracted by large arbitrage margins or the prospect of quick capital gains. Higher productive investment is not possible when domestic interest rates are prohibitive and long-term investment with funds borrowed abroad at lower rates carry a high exchange rate risk. In such a case, the scope for responding to a drop in capital flows by export expansion is limited, and external adjustment usually requires cutting imports by reducing growth and domestic absorption, i.e. reversing the earlier benefits of the capital inflow.

Low investment continues to be a serious problem in Latin America. Although the increased financial inflows have been accompanied by higher gross domestic investment in some countries, the increase in the rate of investment has been much less than the swing in the net transfer of resources, particularly where growth has been driven primarily by consumption. From 1989 to 1991 the swing in net transfers to the region amounted to about 4 percentage points of GDP while the investment/GDP ratio fell by 2.5 percentage points, and within this total the ratio for private investment rose by only 1.5 percentage points.

In Mexico greater capital inflows have been associated with a sharp drop in private savings. Public sector savings increased, but not enough to compensate. Aggregate domestic savings fell by 3 percentage points of GDP from 1988 to 1992, and the investment/GDP ratio increased by only 1.5 percentage points, despite a sharp increase in external savings, by about 4.5 percentage points. In Venezuela aggregate investment fell from 18 per cent of GDP to less than 14 per cent in the same period, mostly on account of private investment. In Brazil both capital inflows and domestic savings (at more than 20 per cent of GDP) are adding to reserves rather than investment; the latter fell, according to preliminary data, to an unprecedented level of under 15 per cent of GDP in 1992. In Argentina domestic savings remain very low. Only in Chile, and to a lesser extent Colombia, have increased net transfers been translated into a higher rate of investment, but even in Chile the investment ratio is lower than in the past (19.5 per cent in 1990-1991 against 21.9 per cent in 1980-1981).[115]

Domestic savings have declined despite significantly higher real interest rates for two main reasons: the rapid increase in the supply of consumer goods as a result of trade liberalization; and the effect of financial liberalization in raising household spending by allowing easier access to credit. Indeed, there has been a substantial rise in consumer credit (such as for cars and other durables and through the issue of credit cards).

Capital inflows have played a much smaller role in stability and growth in some countries than in others. In Chile and Colombia growth and stability had been achieved by the mid-1980s, i.e. before the resurgence of capital inflows, and these two countries are much less dependent on external finance to sustain growth; this is particularly true for Chile, where growth is much faster. A decline in capital flows to Brazil, on the other hand, may even be expected to facilitate fiscal adjustment and disinflation, since foreign exchange has never been a major constraint since the mid-1980s. Thus, the countries which are

115 See G.P. Pfeffermann and A. Madarassy, "Trends in private investment in developing countries 1993. Statistics for 1970-91", *IFC Discussion Paper* No. 16 (Washington, D.C.: The World Bank, 1992).

Box 11

CHILE: FROM ADJUSTMENT TO DEVELOPMENT

Like the vast majority of Latin American countries, Chile was strongly affected by the debt crisis of 1982. Indeed, it was one of the most profoundly affected. A decade later, however, Chile seems to be the country of the region that has emerged best from the difficulties of the 1980s. Growth has been restored and a significant softening of the external debt burden has been achieved.

Although the market-oriented reforms have been highlighted by most analysts and policymakers, the policy packages of stabilization and structural reform implemented during the 1980s have in fact been very pragmatic. They combined market orientation with a leading role for the State. Besides, one important characteristic that differentiates the Chilean experience from that of other Latin American countries that adopted structural reforms in the last decade is the strong external support received during the most difficult part of the adjustment period.

In a nutshell, the key features of the successful Chilean adjustment have been: a net external transfer abroad during the 1980s that was lower than the Latin American average because of the financial support of IMF and the World Bank; a countercyclical fiscal policy that managed to maintain public investment during the crisis; a strong fiscal position, supported primarily by the funds stemming from the State-owned copper enterprises; a strategy oriented to increasing exports based on a very low real exchange rate; and the maintenance of market-oriented policies such as the opening of the economy to trade and foreign investment, the privatization of public enterprises (other than copper) and debt-equity swap schemes that not only induced a reduction in the outstanding external debt but also fostered foreign direct investment.

The performance of Chile over the last few years has also been helped by a very positive external environment: Chile is an oil importing country, and oil prices have been low in recent years; it is a debtor country and LIBOR has declined sharply; the price of its main export item (copper) basically held up; and Chile benefited from a more rapid currency appreciation in other Latin American countries. Capital inflows have been important not only in reducing the stock of debt through debt-equity swaps but also in financing current account deficits.

At the beginning of the present decade, a democratically elected Government took office for the first time since 1973. The team in charge of the economy since then has generally maintained the model that was set up in the 1980s, while trying to correct its negative consequences for income distribution and poverty.

In the short run the most important challenge for Chile is to manage its exchange rate without undermining competitiveness or price stability. Over the medium term, it is to industrialize through export-led growth.

least vulnerable to a reversal in financial flows fall into two extremes: Chile, where a successful adjustment has been followed by steady and high growth under price stability, and Brazil, which has not been able to emerge from the crisis that began in the early 1980s, despite a well performing, highly resilient, external sector (see boxes 11 and 12).

3. Prospects

The recent recovery in Latin America has been uneven and unbalanced. It is too early to conclude that the region has succeeded in adjusting and moving on to sustained development. Performance is divergent, with half of the Latin American economy (i.e. Brazil) still plagued by recession and instability, and suffering from much the same constraints and imbalances that underlay the crisis of the 1980s. The growing part of Latin America, on the other hand, has weaknesses and imbalances, particularly with respect to investment and external equilibrium. Domestic policies are thus the main determinant of growth prospects in Latin America today, perhaps more than at any other time during the last 10-15 years.

Colombia and Chile have been relatively more successful in sustaining growth without generating serious imbalances; for the latter country the most important challenge is to enter a new stage in its export-led-growth strat-

Box 12

BRAZIL: FROM EXTERNAL ADJUSTMENT TO INTERNAL CRISIS

External savings in Brazil averaged about 5.6 per cent of GDP in 1980-1982 (i.e. after the second oil price rise and the sharp increases in international interest rates). Following the Mexican debt crisis in 1982, Brazil suffered a drastic cut-back in the availability of external resources. By 1984, such resources had effectively dried up and since then they have played hardly any role in financing Brazilian imports and investment. However, despite a sustainable current account balance, Brazil could not restore stable and normal relations with its external creditors and the multilateral financial institutions, as witnessed by two "moratoria" on payments to commercial banks in 1987 and 1989. In mid-1991 the new Administration initiated negotiations for that purpose. An agreement was reached with IMF at the end of 1991, and a preliminary agreement was also obtained with private foreign creditors in mid-1992. But as a consequence of the political crisis, the normalization process could not be completed.

While Brazil solved the external transfer problem and reduced the foreign exchange gap, it was not able to eliminate the corresponding fiscal deficits and solve the problem of domestic budgetary transfers. After a temporary reduction at the end of the military Administration in 1984 (when the operational deficit fell to 2.7 per cent of GDP, the lowest level in the 1980s), fiscal deficits grew steadily, returning in 1989 to levels of the early 1980s, at around 7 per cent of GDP. The main cause was a rapid increase in public consumption during the so-called "New Republic" period, which shot up from 8.3 per cent of GDP in 1984 to 14.3 per cent in 1989.

Thus, the main macroeconomic imbalance in the late 1980s was due to the inconsistency between external and fiscal adjustment. The public sector was no longer able to finance its deficits from external sources as in the early 1980s. By contrast it needed to purchase foreign exchange originating from massive trade surpluses in order to service debt. As it lacked genuine resources, these had to be financed by domestic debt, which exerted enormous pressure on financial markets, setting the stage for hyperinflation. Both the political uncertainty associated with the Presidential election of 1990, as well as the perceived risk of a "moratorium" on payments on mounting domestic debt, increased instability. Large capital inflows that came on top of massive trade surpluses and fiscal deficits in the early 1990s made the situation worse. Thus, since the beginning of the decade the economy has remained stagnant, with GDP falling on average by almost 0.5 per cent per annum, with a record postwar fall in 1990 by 4.3 per cent. Inflation could only be contained for short periods (after the so-called Collor I plan of March 1990 and the Collor II plan of January 1991), rising rapidly thereafter.

The Brazilian experience shows that first, external imbalances can be eliminated without any fiscal adjustment; second, elimination of external imbalances may even aggravate the fiscal imbalance; third, it may be easier to generate additional foreign exchange earnings than tax revenues; and fourth, external adjustment is not sufficient to attain stability and growth.

egy. This implies increasing the level of "industrialization" of exports. Much of its recent export success has been based on production with a high resource content and low manufacturing value added. The share of manufacturing in exports is still very low, both absolutely and relative to other semi-industrialized countries in the region. It is thus important to avoid currency overvaluation. Although both countries have been relatively successful in restraining short-term capital flows, they may need to impose further direct controls as long as interest rates (and, in Colombia, inflation) remain high.

In Argentina and Mexico growth is more fragile, and there is a much more serious trade-off between price stability and competitiveness. Currency appreciations, together with trade liberalization and high interest rates, are undermining investment and export performance, resulting in large trade and current account deficits which may not be sustained over the medium term. Even though autonomous capital flows have so far been more than enough to finance external deficits, these countries need to undertake an external adjustment through higher investment and exports. If the opportunities for an expansionary adjustment are not exploited, deflationary adjustment may eventually become unavoidable.

A number of countries have yet to overcome the forces that in the 1980s restricted

growth and stability. These include Brazil, Venezuela, Peru and a number of smaller countries. For Brazil the main constraint continues to be internal, namely the fiscal deficit, whereas the others, notably Venezuela and Peru, have to contend with both fiscal and foreign exchange problems. In addition, political uncertainty is common to all these countries, and a main impediment to fiscal reform. In Brazil the dominant view today is that inflation should be reduced gradually, without any intervention in price formation, by fiscal and monetary action, and that a comprehensive tax reform is essential for stabilization. There is barely any historical example of successful *gradual* stabilization under hyperinflationary conditions. The absence of fiscal reform has certainly overburdened monetary policy, resulting in recession and rapid accumulation of public domestic debt. Without fiscal reform, it will be difficult even to keep inflation at its present level, let alone revive growth. However, the resilience of the Brazilian economy to past shocks and disturbances, and its strong recent trade performance, suggest that it could recover rapidly and settle on a high growth path if a political consensus could be reached to deal with the fiscal problem and tackle inflation.

Venezuela has not succeeded in its aim of reducing the dependence of the budget and growth on oil. The failure to close the fiscal and external gaps and to implement structural reforms raises doubts not only about the sustainability of the recent expansion, but also on the prospects for keeping inflation under control. Even if fiscal fragility were remedied swiftly, it would take many years to restructure the economy and reduce its dependence on oil and public sector activity. The need to reduce the fiscal gap is equally pressing in Peru, where adjustment has so far relied on spending cuts; a tax reform is needed. The balance of payments is also highly fragile and vulnerable to shifts in capital flows.

The prospects for smaller countries are even more dependent on the evolution of the external accounts and the terms of trade than are those for the larger economies. Furthermore, their performance, particularly those in South America, is greatly influenced by developments in the larger economies on whom they neighbour. Growth prospects in the Caribbean depend very much on the recovery of economic activity in the developed countries, which are their major sources of export income (including income from tourism).■

Chapter IV

GROWTH AND INTEGRATION IN THE INDUSTRIALIZING EAST

Together with China, the developing countries of East Asia now constitute an important and fast-expanding market.[116] During the first half of the 1980s their combined real GDP grew at an annual rate of 7.6 per cent, compared to a world total of 3.0 per cent. With a broadly sustained growth rate (7.8 per cent) in the second half, output growth in these countries was 4.7 percentage points above the world average. Moreover, during the global recession of the early 1990s, when world output more or less stagnated, growth even accelerated slightly (to 7.9 per cent during 1990-1992). As a result, per capita income in some developing countries of the region had surpassed that of many developed countries by the late 1980s.

This exceptionally rapid expansion in spite of recessionary conditions owed much to exports, especially of manufactures, which have shown remarkable dynamism in terms both of volume and of the pace of product and market diversification. The more industrialized developing countries of the region have succeeded in moving into the production of export items incorporating both high domestic value added and technological sophistication. Moreover, many ASEAN countries have succeeded in reducing significantly their dependence on primary exports; and the East Asian developing countries in general have increasingly become important markets for each other's exports, thus also providing some cushion against demand shocks from outside the region.

The countries of the region differ in size, natural resource endowments and economic history. However, most have enjoyed political stability, their labour force has been of relatively high quality, and they have been receptive to foreign technology. Moreover, by and large they have invested heavily in physical capital, registered a strong savings performance and ensured a stable macroeconomic environment (see table 46). Besides, Governments have intervened to promote growth, for instance by limiting risks to private investors and by lowering investment costs by fiscal and other means. Last, but not least, most of these countries have enjoyed steady and reliable access to foreign resources, especially during critical phases of their development. In general, the smaller economies have tended to concentrate on a few export industries in which they enjoyed a cost advantage, while the larger ones have tended to enter more readily into import substitution in intermediate and capital goods in order to reap economies of scale, using various incentives, as well as disincentives designed to penalize poor economic performance.

The robust growth performance of the region was both a cause and a consequence of a fast expansion of intraregional trade and foreign direct investment, including the increasing integration of China.

[116] This chapter reviews developments in ASEAN member countries, China, and the newly industrializing economies (NIEs) of the region, their intra-trade and trade with third countries, more particularly with Japan. NIEs are defined as Hong Kong, Republic of Korea, Singapore and Taiwan province of China. The members of ASEAN are Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore and Thailand. References to ASEAN-4 are to the members of that Association excluding Brunei Darussalam and Singapore.

Table 46

MAJOR ECONOMIC INDICATORS OF SELECTED ASIAN DEVELOPING COUNTRIES, 1980 AND 1990

(Per cent)

	Ratio to GDP of:									
	Savings		Investment		Exports		Share of manufactures in exports		Ratio of FDI to total investment	
Country	1980	1990	1980	1990	1980	1990	1980	1990	1980	1990
Hong Kong	31.7	34.0	33.6	27.6	88.0	135.0	95.7	94.5	4.0	11.1
Rep. of Korea	23.8	35.6	32.1	36.6	34.0	31.6	89.5	93.5	-	0.8
Singapore	38.8	44.9	40.7	38.0	205.0	226.0 [a]	43.1	71.7	3.9	29.4
Taiwan province of China	32.6	27.9	30.6	22.4	52.5	47.7	87.9	92.5	1.3	3.8
Indonesia	37.2	37.4	21.6	28.1	33.0	25.9	2.3	35.5	1.1	3.6
Malaysia	32.9	32.3	31.1	32.7	57.5	78.0	18.8	48.7 [a]	12.3	18.1
Philippines	26.6	18.3	27.2	21.0	23.6	27.8	21.1	34.3	-1.2	5.8
Thailand	21.0	31.0	25.2	35.5	24.3	36.8	25.2	63.1	2.3	8.6
Bangladesh	3.1	1.9 [a]	15.1	11.5 [a]	6.9	7.4 [a]	67.6	75.2 [a]	-	-
India	18.3	23.5	19.4	22.1	6.6	6.8 [a]	58.6	65.8 [a]	0.2	0.2
Pakistan	10.2	13.2	17.0	17.0	12.7	14.7	48.2	72.1	1.3	3.6
Sri Lanka	12.0	13.3	32.6	20.4	31.4	30.6	16.0	49.3 [a]	3.2	2.7

Source: UNCTAD secretariat calculations, based on national and international sources.
a 1989.

A. Recent developments

During the second half of the 1980s, there was a strong convergence of growth rates, with rates approaching, and in some cases even exceeding, the very high rates recorded during the 1970s (see table 47). Prior to this convergence, world economic conditions resulted in differentiated performances. The ASEAN economies suffered from depressed oil and other primary commodity prices. However, in the period immediately following the Plaza Accord the yen appreciated considerably, and since the currencies of most of the NIEs were pegged to the dollar, their manufactured exports became more competitive, particularly vis-à-vis Japan;[117] by contrast, the ASEAN countries were not able to exploit the currency realignment because of their narrower manufactured export base, and the yen appreciation also increased their debt burden. However, the export success of the NIEs provoked reactions in foreign markets. Not only were they made ineligible for GSP treatment under the United States scheme, but also they came under constant pressure to appreciate their currencies against the dollar. Besides, their large current account surpluses fuelled inflationary pressures

[117] However, due to the higher cost of yen-denominated imports, especially of components made in Japan, profit margins did not improve significantly in many export activities, including electronics, electrical machinery and transport equipment. Also, Hong Kong had benefited less from the yen appreciation because of its specialization in light manufacturing, which does not compete directly with Japanese exports.

Table 47

REAL GDP IN SELECTED ASIAN DEVELOPING COUNTRIES, 1970-1992

(Percentage change) [a]

Country	1970-1975	1975-1980	1980-1985	1985-1990	1991	1992
Hong Kong	6.6	12.3	5.6	7.6	4.2	5.0
Rep. of Korea	8.8	7.7	8.4	10.2	8.4	4.5
Singapore	9.5	8.6	6.2	8.0	6.7	5.8
Taiwan province of China	8.8	10.5	6.4	8.9	7.2	6.6
Indonesia	8.1	7.9	4.7	6.3	6.6	5.9
Malaysia	7.1	8.6	5.1	6.7	8.6	8.0
Philippines	6.1	6.2	-0.7	4.2	-0.9	-
Thailand	5.6	7.9	5.7	9.9	8.0	7.5

Source: UNCTAD secretariat calculations, based on national and international sources.
a Annual average or change over previous year.

(particularly in the Republic of Korea). This, together with labour market pressures, also reduced significantly their competitive edge. As a result, manufactured exports became much less buoyant after 1987.

In the more industrialized countries of the region, the changing cost structures and the successive currency realignments precipitated responses that accelerated the process of diversification taking place in terms both of technological upgrading and of resiting production in neighbouring countries with an abundant labour surplus. The regional economic landscape was transformed by the fast expansion of export-oriented foreign direct investment and complementary intraregional trade which followed. The performance gap between the persistently fast-growing exporters of manufactures and the more sluggish primary exporters in the region was consequently considerably narrowed.

Subsequently, especially beginning in 1987, the New Taiwan dollar, and later the won of the Republic of Korea and the Singapore dollar also went up much in value. The yen almost doubled in value in terms of the United States dollar between 1985 and 1988 (see table 48). As an immediate result, Japanese imports rose significantly, not only from Europe and the United States, but also from the Republic of Korea, Taiwan province of China and other Asian developing countries. On the other hand, exports became less buoyant. The declines in export/output ratios were most marked in the labour-intensive or low-technology sectors such as textiles or iron and steel, but much less so in the more high technology-intensive sectors such as electronics and biochemicals. Their rapidly changing competitive position led Japanese firms to strengthen their efforts to increase efficiency and secure market shares by establishing production and sales outlets abroad.[118] The fast-growing direct investment by Japanese firms went into relatively labour-intensive export production in a number of ASEAN member countries and into technology-intensive products in the more industrialized countries. Regional trade responded rapidly due to the highly export-oriented and regional bias of these flows (and similar flows from some NIEs). Available statistics show, for example, that the share of Asia in Japanese FDI in developing countries rose from 50 per cent during 1975-1979 to 60 per cent in 1980-1984 and to as much as 80 per cent during the second half of the 1980s. At the same time, the share of export activity in these investment flows also increased significantly, to reach over 40 per cent in 1986, i.e. more than 10 percentage points higher than at the beginning of the decade.[119]

[118] See, e.g. H. Kohoma and S. Urata, "The impact of the recent yen appreciation on the Japanese economy", *The Developing Economies*, vol. XXVI-4, December 1988.

[119] See Kenni Takouchi, "Does Japanese investment promote Japanese imports from developing countries?" (paper presented at the Second Convention of the East Asian Economic Association, Bandung, Indonesia, August 1990), as quoted in J. Reidel, "Intra-Asian trade and foreign direct investment", *Asian Development Review*, vol. 9, No. 1 (1991). Data for 1988 show that the export orientation of these investment flows was highest in resource-based sectors

Table 48

EXCHANGE RATES [a] OF SELECTED ASIAN CURRENCIES, 1970-1991

Year	Japan	Hong Kong	Republic of Korea	Singapore	Taiwan province of China
			Units of national currency per US dollar		
1970	360.00	6.06	310.56	3.06	40.00
1975	296.79	4.94	484.00	2.37	38.00
1980	226.74	4.98	607.43	2.14	36.02
1985	238.54	7.79	870.02	2.20	39.85
1986	168.52	7.80	881.45	2.18	37.84
1987	144.64	7.80	822.57	2.11	31.74
1988	128.15	7.81	731.47	2.01	28.59
1989	137.96	7.80	671.46	1.95	26.41
1990	144.79	7.79	707.76	1.81	26.89
1991	134.71	7.77	733.35	1.73	26.82
			Par value (1985=100)		
1970	150.9	77.8	35.7	139.1	100.4
1975	124.4	63.3	55.6	107.8	95.4
1980	95.1	63.9	69.8	97.3	90.4
1985	100.0	100.0	100.0	100.0	100.0
1986	70.6	100.2	101.3	99.0	95.0
1987	60.6	100.1	94.5	95.7	79.7
1988	53.7	100.2	84.1	91.5	71.7
1989	57.8	100.1	77.2	88.6	66.3
1990	60.7	100.0	81.3	82.4	67.5
1991	56.5	99.7	84.3	78.5	67.3

Source: National and international sources.
a Average of monthly rates.

The currency appreciations in many NIEs were also significant. By 1989 the New Taiwan dollar had risen by over 40 per cent, the won of the Republic of Korea by over 30 per cent and the Singapore dollar by close to 15 per cent (see table 48). Already by the end of 1986 exports from Taiwan province of China, especially to the United States, had started to decelerate steadily and at the same time its regional trade links became more substantial not only with Japan but also with other developing countries.[120] Exports to Hong Kong were particularly buoyant due to the expansion of indirect trade with China. Likewise, Hong Kong, which had also experienced a slowdown in its exports to the United States, increased steadily shipments of raw materials and semi-finished products for processing in neighbouring China. Investment flows were also increasingly directed to other developing countries in the region in order to exploit low-cost land and labour which were no longer available in the faster-growing NIEs.[121]

Following the steady loss of their competitive edge, the fast-growing NIEs also speeded up their efforts to improve productivity and to upgrade their industries by importing new technology. Thus, technology-intensive electronics, for example, grew rapidly in these countries and started to replace older industries, such as textiles, as the leading development sector. On the other hand, the relatively labour-intensive industries were increasingly relocated to the more labour-abundant countries in the region. Most notably, Hong Kong

(non-ferrous metals: 63.8 per cent; wood processing: 57.1 per cent; food processing: 42.3 per cent). It was also high in the relatively labour-intensive sectors (electrical machinery: 53.1 per cent; textiles and apparel: 51.6 per cent; precision equipment: 51.6 per cent). Export orientation, however, was rather low in the capital-intensive sectors (chemicals: 27.5 per cent; transport equipment: 22.9 per cent; iron and steel: 16.5 per cent).

120 Developments in intraregional trade are discussed in detail below.

121 For example, in 1990, Taiwan province of China was the largest foreign investor in Malaysia and outward investment from the Republic of Korea exceeded inward investment for the first time during the same year. See *World Investment Directory 1992*, vol. I- *Asia and the Pacific* (ST/CTC/66), United Nations publication, Sales No. E.92.II.A.11, p. 31.

manufacturers started to subcontract heavily in neighbouring China, as did those of Taiwan province of China. They also invested heavily in many ASEAN countries.

The Japanese economy had long been instrumental in fostering the region's growth, both as a supplier of capital and technology and as an export market. But increasingly it has been the interdependence of the developing economies of the region that has provided the impetus for their rapid development. Japan remains the most important investor, but the NIEs are also important: taken together, the Asian countries (both developed and developing) have become the major investors in their own region. On the one hand, as already mentioned, the more industrialized countries of the region find it advantageous to shift their more labour-intensive and technologically less sophisticated production to lower-cost neighbours, a trend which has accelerated rapidly in recent years with fast-mounting costs and currency realignments. On the other hand, the less developed economies in turn welcome this trend in order to speed up their own industrialization.

The developing countries of East Asia, especially those of ASEAN, not only were the main recipients of the large inflows of FDI seeking low-cost labour and natural resources, but also benefited from the fact that the traditional exporters of manufactures (the NIEs) had lost much of their attractiveness to Japanese investors because of rising domestic production costs and currency appreciations. The first major recipient of FDI was Thailand, subsequently joined by Indonesia, Malaysia, and the Philippines. Instead of being, as in the past, destined mainly for the exploitation of natural resources, FDI to these ASEAN countries went into manufacturing industry. The dependence of these countries on primary exports was much diminished in the process, the transformation being in some cases very rapid. For example, in Thailand, where manufactured exports used to consist mostly of processed agricultural products and textiles, electronics and electrical goods have emerged as leading export sectors in recent years. This rapid transformation followed massive FDI, especially since 1987, not only from Japan, but also from the Republic of Korea, Taiwan province of China and Singapore.[122] The new lines of manufactured exports included integrated circuits, home electronics, and also passenger cars. The manufacturing sector also became firmly established in Malaysia, with new activity in the fields of electronic components and electronic assembly. Non-oil exports from Indonesia also gained dramatically in relative importance and the country is well on its way to becoming an established exporter of textile goods and furniture. As exports of manufactures from many of these countries progressed, domestic investment in the manufacturing sector also rose in response, and growth rates of these economies began to approach those of the fast-growing NIEs.

The current pattern of regional development has been dubbed the "flying geese" pattern. It is based broadly on a vertical division of labour among countries at different stages of industrialization, with competitiveness in previously established export sectors continuously shifting the advantage from countries at the higher stages to those at lower ones, and with those at the higher stages continuously acquiring competitiveness in new product lines.

The opportunities for cross-border production also gave rise to promising "growth triangles" encompassing contiguous areas in different countries. Growth triangles can provide physical linkages between much of North and South-East Asia, with the more developed countries providing the needed capital, technology and management know-how, and the less developed ones providing land, labour and natural resources. The most notable are those comprising Singapore, Johor (Malaysia), and Riau (Indonesia), and/or the triangle formed by Taiwan province of China, Hong Kong and the coastal region of China. Indonesia, Malaysia and Thailand are currently seeking to develop a northern growth triangle covering the adjacent subregion of northern peninsular Malaysia, southern Thailand and northern Sumatra in Indonesia.[123] These will effectively form a link between North and South-East Asia.

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[122] The final output of these sectors was intended for the developed markets, but Thai industries also supplied inputs to manufacturers in the region, including Hong Kong, Taiwan province of China and Singapore. However, so far only relatively low domestic value added has been incorporated into the electronic assembly and electrical appliance sectors.

[123] At the fourth ASEAN summit (Singapore, 1992) the growth triangle concept was formally endorsed as a means of reinforcing regional economic cooperation. An ambitious scheme is envisaged for the Tuman delta, which will potentially involve six countries (Republic of Korea, Democratic People's Republic of Korea, Japan, China, the Russian Federation and Mongolia) in a multi-billion dollar trade and transport complex. The project will spread through the Democratic People's Republic of Korea, the Russian Federation and China's Jilin province.

B. A long-term perspective

It remains to be seen whether the wave of labour-intensive exports that resulted from such growth triangles will in any significant way alter the strategy of industrialization of the countries involved, which so far has been very much reminiscent of that adopted by the Republic of Korea and by Taiwan province of China. Their export of labour-intensive products was only the more visible half of a two-pronged strategy in which import substitution also played an important role in the preparatory phase of successive waves of export expansion. Many of their export lines thus emerged in the 1980s after a long period of gestation under State promotion.[124]

A more liberal policy was followed by Hong Kong and Singapore. The latter was an entrepôt for manufacturing and relied heavily on foreign capital for its development. Hong Kong was an even older entrepôt, importing raw material for China as well as for the assembly and export of manufactures. Entrepôt activities remained important for both and in Hong Kong they even expanded substantially in recent years with the emergence of China as an exporter of manufactures.

The traditional exporters of manufactures also differed in other respects. While industrialization in the Republic of Korea has benefited from the emergence of local entrepreneurs and managers since before the Second World War, Taiwan province of China (and Hong Kong) has had the advantage of an important inflow of entrepreneurs from the mainland in the postwar years. What the two had in common was a heritage of successful land reform. Mass rural poverty was thus almost non-existent in both, and rising productivity freed labour for manufacturing in subsequent drives at industrialization.[125] As in most other countries of the region (except the Philippines), savings rates were high (see table 48), favouring a corresponding high rate of capital formation, which was also stimulated by the relatively low cost of investment goods.[126] Ample savings, combined with a large share of exports in output, ensured that sufficient domestic resources and foreign exchange were available. In both countries there was also significantly more industrialization economy-wide than there was in the export-oriented sector, thanks to the existence of substantial domestic markets. In fact, not only labour-intensive but also some branches of capital-intensive industries in which they presumably did not have a comparative advantage at the start grew rapidly in the 1960s and 1970s in both countries.[127] The role of exports in industrialization was modest at first in many branches of activity. In fact, the direct contribution of the export sector paled in comparison with that of intermediate goods produced for the domestic market in response to growing opportunities in various industries, which often were capital-intensive, with significant backward linkages. Such industries usually enjoyed substantial protection and benefited from foreign direct investment. On the other hand, labour-intensive industries expanded rapidly in terms of both production and exports, backed by promotion policies based on incentives which included preferential tax and credit treatment and also multiple exchange rates. The resulting increase in demand for intermediate goods stimulated activity in industries producing these goods, including in particular capital-intensive ones. Thus, while

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124 Likewise, the products of Thailand's import substitution industries accounted for as much as 60 per cent of non-food manufactured exports by 1985; many of them have been promoted with government aid since the 1970s. For a recent analysis, see Alice H. Amsden, "Structural macroeconomic underpinnings of effective industrial policy: fast growth in the 1980s in five Asian countries", UNCTAD, 1993 (mimeo).

125 It is the norm in East Asia (not only in the Republic of Korea and Taiwan province of China, but also in Indonesia, Malaysia, and Thailand) that the distribution of land is relatively equitable. At the same time, the agricultural sector also receives considerable government support, with the consequence that food prices, and therefore wages, remain low, and thus contribute to keeping down labour costs in industry.

126 The prices of investment goods were lowered through appropriate monetary and credit policies or fiscal subsidies. See, e.g. C.I. Bradford, Jr., "Trade and structural change: NICs and next tier NICs as transition economies", *World Development*, vol. 15, No. 3 (1987).

127 In the Republic of Korea both labour-intensive and capital-intensive industries expanded rapidly: annual growth rates ranged from 14 per cent to 22 per cent in the former and from 16 per cent to 27 per cent in the latter during 1960-1977. In Taiwan province of China, however, capital-intensive final products tended to lag behind the production of intermediate products. See K. Ohno and H. Imaoka, "The experience of dual-industrial growth: Korea and Taiwan", *The Developing Economies*, XXV-4 (December 1987).

an export promotion strategy was chosen for industries in which the country had a static comparative advantage, import substitution was systematically pursued where competitiveness was expected to be attained later.[128] The pace of industrialization depended critically on the latter process.[129] Besides enjoying protection from imports, new industries also benefited considerably from export incentive measures. For example, performance standards, including export targets, played a crucial role in the allocation of subsidies.[130] The fast-growing developing exporters of manufactures in East Asia have thus become highly integrated economies with sophisticated technologies and have sometimes become equal partners with transnational corporations in developing new products for the world market, thanks to their success in diversifying into the more capital- and technology-intensive export industries.

An additional and major contributory factor to Asian regional economic integration as a whole has been the growing participation of China in the world economy. It has the potential to become an important and powerful export competitor, but also to provide a vast and rapidly expanding market that could provide a new source of growth for many developing countries in the region. China's rapid integration into the regional economy was much facilitated by the complementary character of its trade structure to that of other countries, which has accounted in no small part for the fast pace of expansion of intraregional trade and investment. It has joined other factors in increasing the importance of intraregional economic influences at the expense of extraregional ones: the increased import capacity of Japan, the steady rise of the NIEs as regional driving forces in terms of both import markets and regional investment, the liberalization of the Chinese economy, and the capacity of developing countries in the region to adapt to rapid change. Notwithstanding this major growth of intraregional trade, however, the United States remains the most important export market.

The sustainability of the region's development pattern depends on many factors, among which the evolving complementarity of the economies is an extremely important one. Admittedly, since the share of intraregional trade in total trade is still less than 40 per cent, external markets - in particular the United States and Western Europe - remain important. Reduced access to these markets could thus threaten the profitability of many of the investments made. On the other hand, there is still ample room for further expansion of intraregional trade (including the trade of Japan). In this respect, the ability and willingness of Japan, as the richest and most advanced country in Asia, to provide an outlet for the developing countries' exports will be important, as also will be specialization among the developing countries of the region. The catching-up process has been accompanied by growing competition among the economies of the region in third markets, as well as within the region, and recent evidence indicates that this process has been accelerating as many of the NIEs have gained ground in products of special export interest to Japan. To maintain export growth in the face of increasing competition, some of the economies, especially the more advanced among the developing ones, will need to continue to shift production to countries at a lower stage of industrialization, thus drawing other Asian economies, including no doubt those in southern and other parts of Asia (such as Viet Nam) into the regional network.

A favourable factor in the evolution of regional trade and cooperation has been the changing role of China. It also seems likely that the developing countries of the region will continue to grow since, unlike Japan, they are still at a relatively early stage of economic development. Nevertheless, obstacles to steady growth are far from being non-existent. Both economic and social disruptions are constant potential threats in some countries. Infrastructure bottlenecks could also seriously interrupt the continued fast expansion in many.

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128 At the sectoral level, import substitution activities might prevail in durable consumer goods or machinery and transport equipment, while some branches of processed foodstuffs and non-durables might be actively promoted for export. At the same time conditions close to free trade might exist for the mining industry and industries producing intermediate products. See, e.g. Neng Liang, "Beyond import substitution and export promotion: a new typology of trade strategies", *The Journal of Development Studies*, vol. 28, No. 3 (April 1992).

129 Other developing countries in the region also appear to have adopted the same broad strategy. Typically, the composition of their exports was found to have been far in advance of their "revealed comparative advantage", thus indicating a deliberate policy aimed at promoting simultaneously export promotion and import substitution. For details, see Alice H. Amsden, *op. cit.*.

130 Except for small economies such as Singapore and Hong Kong, complicated systems of incentives (such as those that prevailed in the Republic of Korea and Taiwan province of China) involved substantial administrative intervention. Thus, the capacity of the Government to run efficiently the incentive system was a prerequisite for the success of the strategy adopted. For a comprehensive account of the Government's role in East Asian industrialization, see, e.g. R. Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, New Jersey: Princeton University Press, 1990).

Furthermore, in some second-tier countries the industrial bases still lack depth and diversification, and the exports which provided much of the impulse for the recent expansion have remained very concentrated in product composition and thus especially vulnerable to external shocks.

Subregional division of labour is possible not only among economies at different stages of development, but also among those at the same stage. An example is the manufacture of semiconductors. Whereas the Republic of Korea and Taiwan province of China specialize in the highly capital- and technology-intensive process of wafer fabrication, Hong Kong and Singapore concentrate on the skill- and equipment-intensive stage of design and testing, while Malaysia, Thailand and the Philippines tackle the highly labour-intensive assembly stage. Similarly, Hong Kong and Singapore have diversified significantly into the service sector, where they enjoy a distinct competitive edge over other economies of the region.

The increasing degree of complementarity among Asian countries (including Japan) and its change over time, as indicated by revealed comparative advantage (RCA) indices, are shown in table 49. A country's RCA index in a given commodity group is defined as the ratio of the share of that commodity group in the country's total exports to the share of the same commodity group in world exports. An index with a value greater or less than unity thus denotes respectively a revealed comparative advantage or disadvantage. The various groups of factor intensity are defined in terms of specific SITC categories as follows:[131]

- Unskilled, labour-intensive: SITC 65, 664-666, 81, 82, 83, 84, 85 and 89 (except 896 and 897);
- Human capital-intensive: SITC 55, 62, 64, 69, 775, 78, 79, 885, 896 and 897;
- Technology-intensive: SITC 54, 56, 57, 58, 59, 752, 759, 76, and 77 (except 775), 88 (except 885);
- Physical capital-intensive: SITC 51, 52, 67, 68, 71, 72, 73, 74 and 751.

Interestingly enough, the development "style" of the Republic of Korea and Taiwan province of China closely resembles that of Japan, in contrast to that of the United States, Argentina and Mexico, when one compares the shape of the kite charts plotted for these countries using the following criteria of development:

- Consumption pattern, denoted by the density of passenger cars per thousand of population in 1980;
- Income equality, expressed as the ratio of the income of the poorest 40 per cent of the population to that of the richest 10 per cent during 1979-1980;
- International competitiveness, as measured by the ratio of exports to imports in the metal products and machinery sector (ISIC 38) during 1979-1980; and
- Long-term dynamism, indicated by the average annual growth of capita GDP during 1960-1979.

The causal connections between these indicators are not clear. The kites for Japan, Republic of Korea and Taiwan province of China "show high dynamics, high international competitiveness, low inequality, and relatively austere consumption," whereas those for the United States, Argentina and Mexico "show lower dynamism, lower international competitiveness in manufacturing, higher inequality, and exuberant consumption".[132]

Accompanying the currency realignments and shifts in comparative advantage noted above were significant changes in the structure of Asian trade. Table 50 presents bilateral merchandise trade flows of Japan and subregions of Asia with selected partner groups.[133] Noteworthy are the more rapid increases in exports for the various economic groups of the region relative to world trade, especially in the 1980s. During 1985-1989, the value of world trade grew at an annual average rate of 12.0 per cent. The growth of exports from Japan matched this figure, but exports rose annually by 19 per cent for the NIEs, 12.2 per cent for the ASEAN countries, 12.7 per cent for South Asia and 17.3 per cent for China. By way of comparison, regional exports for Latin America and Africa grew by only 5.6 per cent and 2.4 per cent per annum, respectively, in the same period.[134] From 1970 to 1989, the share of Japan in world trade increased from 6.1 per cent to 9.3 per cent, whereas that of the NIEs

131 The classifications are based on those given by K.Y. Chen, "Hong Kong's role in Asian and Pacific economic development", *Asian Development Review* (Asian Development Bank, Manila), vol. 7, No. 2 (1989), p. 37.

132 Wade, *op. cit.*, pp. 49 and 50.

133 Intra-Asian trade is discussed in detail in annex 3.

134 The discrepancy in export growth of the region and the growth of world exports becomes even more pronounced in real terms. Volume growth in 1985-1989 was 15.5 per cent for the NIEs, 16.0 per cent for ASEAN countries, 11.6

Table 49

REVEALED COMPARATIVE ADVANTAGE OF SELECTED ASIAN COUNTRIES, 1980, 1985 AND 1990

	Unskilled labour-intensive			*Human capital-intensive*			*Technology-intensive*			*Physical capital-intensive*		
Country	*1980*	*1985*	*1990*	*1980*	*1985*	*1990*	*1980*	*1985*	*1990*	*1980*	*1985*	*1990*
Japan	0.814	0.669	0.457	1.964	1.846	1.441	1.691	1.844	1.776	1.458	1.367	1.213
Hong Kong	6.349	5.615	3.921	1.015	0.875	0.769	1.146	1.130	1.233	0.104	0.148	0.200
Rep. of Korea	4.269	3.373	2.850	0.951	1.618	0.807	1.153	1.034	1.393	0.628	0.503	0.574
Singapore	0.695	0.628	0.642	0.432	0.385	0.312	1.436	1.677	2.285	0.457	0.560	0.567
Taiwan province of China	4.842	4.425	2.753	0.653	0.678	0.644	1.399	1.265	1.531	0.356	0.437	0.528
Indonesia	0.079	0.339	1.263	0.011	0.029	0.125	0.051	0.068	0.112	0.101	0.174	0.164
Malaysia	0.371	0.425	0.703	0.115	0.146	0.301	0.789	1.037	1.654	0.482	0.370	0.260
Philippines	1.202	1.196	2.155 [a]	0.089	0.070	0.169 [a]	0.156	0.479	1.282 [a]	0.213	0.417	0.286 [a]
Thailand	1.202	1.764	2.120	0.147	0.190	0.370	0.439	0.500	0.958	0.567	0.342	0.208

Source: UNCTAD secretariat calculations, based on data from the United Nations Compressed International Commodity Trade Data Base (COMTRADE), as well as national and international sources.

Note: For the measurement of comparative advantage see the text.

a 1989.

rose from 1.8 per cent to 6.7 per cent. Accompanying the rapid export growth during 1985-1989 was an equally fast expansion in imports, averaging annually 13.3 per cent for Japan, 20.3 per cent for the NIEs and 19.4 per cent for ASEAN countries.

Numerous bilateral flows in the region grew at more than twice the regional rate during the second half of the 1980s, in particular as regards the bilateral flows of Japan, the NIEs and ASEAN countries. From 1985 to 1989 exports from Japan to NIEs and ASEAN members increased respectively by 23.7 per cent and 21.8 per cent per annum. Similarly, exports of NIEs to Japan and ASEAN expanded respectively by an average annual rate of 25.9 per cent and 23.5 per cent. For flows of lesser absolute values, particularly high rates were registered for exports of NIEs to both ASEAN and China, as well as for exports of both South Asia and China to NIEs and ASEAN members.

As a result of these divergent bilateral trade flows, there were significant changes in the relative importance of trading partners in terms of export destination and the origin of imports. Particularly worthy of note, for the period 1985-1989, are:

- The growing importance of Western Europe and NIEs as markets for Japan, at the relative expense of North America. (The share of Western Europe rose from 14.8 per cent to 21.1 per cent, that of NIEs from 12.9 per cent to 19.3 per cent and that of North America fell from 40.3 per cent to 36.0 per cent);
- An increase in the share of both Western Europe (from 14.2 per cent to 17.9 per cent) and of Japan (from 11.0 to 13.7 per cent) in exports from NIEs, in contrast to a drop from 41.6 per cent to 36.2 per cent for North America;
- Increases in the share of Western Europe in the exports of ASEAN, South Asia and China, as well as in the share of NIEs in China's exports;
- A rise in the share of Japan in NIEs' imports from 23.4 per cent to 26.1 per cent; and
- Increases in the share of NIEs from 9.5 per cent to 14.5 per cent in Japan's total imports, from 21.3 per cent to 24.2 per cent in those of ASEAN countries, and from 6.7 per cent to 14.9 per cent in those of China, as compared to an increase from

per cent for South Asia and 11.3 per cent for China, as compared to only 6.7 per cent for world exports. The corresponding figure for Japan is only 2.4 per cent.

Table 50

BILATERAL TRADE FLOWS, 1970-1989

(Millions of current dollars)

From / To	Year	North America	Western Europe	Japan	Latin America	Africa	NIEs	ASEAN-4	South Asia	Other Asia [a]	China	World
Japan	1970	6579	2970	-	1100	1041	2642	1219	267	624	750	18657
	1975	12411	8353	-	4658	4347	6974	3834	936	5817	2477	54967
	1980	34085	22024	-	8525	5432	19117	9112	2101	13779	5596	129089
	1985	70562	25887	-	7686	3230	22562	7316	2965	11465	12879	175205
	1989	98835	58083	-	8905	3175	52874	16078	3737	8579	9978	274738
NIEs	1970	2142	1121	644	92	163	407	185	31	140	225	5422
	1975	6194	4317	2651	352	655	1606	832	166	1166	153	19102
	1980	19707	13828	7221	2239	2296	6355	6291	1605	5045	761	68424
	1985	40729	13848	10731	2238	1754	8536	7006	2352	4939	2445	97857
	1989	70928	35149	26958	2526	1893	21392	16288	3047	4880	6914	196137
ASEAN-4	1970	938	787	1259	30	26	846	143	22	74	41	4384
	1975	3450	2204	5124	514	123	2315	355	223	288	99	15091
	1980	9005	6859	16245	1132	396	8007	1499	605	979	443	46934
	1985	9425	5968	14130	473	521	9195	2065	977	1140	629	45792
	1989	15077	12171	18861	321	618	15406	3227	1526	1671	1615	72501
South Asia	1970	437	813	334	40	205	114	39	62	312	67	3010
	1975	670	1482	551	55	475	289	137	224	1176	88	6131
	1980	1293	3029	988	115	755	578	196	497	1932	429	11711
	1985	3298	3615	1540	80	542	906	235	418	1545	107	14575
	1989	5197	7323	2793	120	831	1879	595	585	1320	118	23493
China	1970	18	490	283	94	141	612	76	78	83	-	2304
	1975	203	1150	1538	158	450	1609	257	155	429	-	7033
	1980	1068	3469	4385	377	1112	4954	862	301	1144	-	20216
	1985	1904	2868	6327	647	526	9554	977	363	1821	-	28741
	1989	3736	6361	9283	677	1796	21102	1956	412	2841	-	54460
World	1970	51052	150957	15002	18347	10562	8486	4248	3525	6428	3502	303972
	1975	120838	392960	49146	56597	35552	26554	13345	9297	41603	8394	842762
	1980	287840	922253	122107	122304	71799	84774	38162	23357	97313	21178	1949829
	1985	387753	796329	112824	85741	56448	96523	32975	27578	78936	36480	1875585
	1989	559080	1381608	186212	114264	64199	202449	67196	34887	76487	46511	2946454

Source: As for table 49.
a Excluding China.

10.5 per cent to 12.7 per cent in those of North America.

The decline in the relative importance of North America in Asian exports appears to have continued in recent years. From 1986 to 1991, the share of the United States in the exports of Taiwan province of China fell from 47.4 per cent to 28.3 per cent, and from 40.0 per cent to 25.4 per cent in the case of exports from the Republic of Korea. With respect to Hong Kong, the drop was from 31.3 per cent to 24.2 per cent. Thus, with a share of 27.1 per cent in 1991, China became Hong Kong's largest export market.[135]

As the largest and most advanced economy in Asia, Japan plays a central role in the region, particularly in its relations with the NIEs. It has an income which is more than double all the rest of Asia.[136] The NIEs, as a group, however, have a combined income greater than that of China or South Asia, both of which have a population of more than one billion. The ASEAN-4 countries constitute the smallest bloc in Asia, with a combined income less than 10 per cent of that of Japan.

A breakdown of Japan's trade with the other Asian economic groups by major SITC categories is shown in table 51. As can be seen from the table, the largest single flow is Japan's exports of machinery and transport equipment to NIEs, followed by exports of other manufactured products, also to NIEs (in both cases in 1989). Also significant, though smaller in magnitude, are Japanese exports of all these commodities to ASEAN-4 and China. On the other hand, Japan's imports from the region are overwhelmingly constituted by manufactured products from the NIEs, and to a lesser extent by food, crude materials and fuels from ASEAN-4. What is significant is that these flows account for a higher share in trade in their own specific commodity category than in the overall trade total. Thus, Japan's exports of machinery and transport equipment to NIEs in 1989 accounted for 10.2 per cent of its total exports to those countries but for 15.7 per cent of its total exports of goods in this category. The corresponding figures for the export of non-machinery manufactures to NIEs in 1989 are 8.4 per cent and 25.2 per cent, respectively. Similarly, imports of non-machinery manufactures from NIEs accounted for only 8.2 per cent of total imports from those countries in 1989 but for as much as 23.9 per cent of all imports of goods in this category.

Japan's market integration with the NIEs, at a time of increasing threat of protectionism in both the United States and Europe when most Asian economies were unilaterally liberalizing trade, together with its FDI in Asian developing economies, has played a key role in fostering the horizontal division of labour in the region. As a consequence, the developing Asian economies, especially the NIEs and ASEAN, have become not only important markets, instead of being merely offshore production bases, for Japan but also an important source of Japanese imports.

C. The potential role of China

China's economic reforms, which began in 1978, must by any reasonable standards be regarded as a success. During 1978-1990, real GNP grew at an annual average rate of 8.5 per cent.[137] Over the same period, exports increased from $9.7 billion to $52.1 billion, or 15.0 per cent per annum, thereby expanding their share in GNP from 4.7 per cent to 14.3 per cent.[138] Underlying the rapid growth in production and exports was an increase in productivity. Prior

135 Computed from national trade statistics and also data given in *Nomura Quarterly Economic Review*, February 1993, pp. 31 and 33.

136 The 1990 GDP, in billions of dollars, for Japan, the NIEs, ASEAN-4, South Asia and China was $2,940, $506, $274, $373, and $302, respectively.

137 The growth rate is based on data in national currency, as presented in Dwight H. Perkins, "China's 'gradual' approach to market reforms", *UNCTAD Discussion Papers*, No. 52, December 1992, table 1. Official statistics, which are in dollar terms, can be misleading because of repeated devaluations of the renminbi.

138 This proportion, which is based on figures in national currency, is given in *Almanac of China's Foreign Economic Relations and Trade*, 1991/92, p. 399.

Table 51

TRADE OF JAPAN WITH OTHER ASIAN COUNTRIES BY MAJOR COMMODITY GROUPS, 1970-1989

(Millions of current dollars, f.o.b.)

		NIEs		ASEAN-4		South Asia		China	
SITC	Year	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
0+1	1970	153	150	42	114	28	45	4	67
	1975	133	669	39	945	1	143	1	202
	1980	347	1479	146	900	58	277	25	497
	1985	351	1938	70	998	15	371	24	884
	1989	630	4319	195	2550	8	479	30	1559
2+4	1970	105	172	28	806	4	211	16	133
	1975	238	205	81	1153	30	321	83	263
	1980	437	532	156	3934	118	508	197	529
	1985	413	621	113	2041	98	611	260	742
	1989	783	1359	209	4080	96	814	267	1316
3	1970	22	75	11	223	1	3	-	12
	1975	96	377	28	2745	2	-	2	737
	1980	148	553	44	10358	16	-	28	2339
	1985	164	1944	41	9496	20	70	18	3308
	1989	287	1834	90	8046	24	59	19	3228
7	1970	868	40	491	-	94	-	204	1
	1975	2547	259	1803	23	303	2	793	-
	1980	8029	770	4773	80	922	2	2276	4
	1985	10605	1578	3893	289	1646	10	6908	10
	1989	27981	4176	9450	690	2194	8	4450	32
5-9 (less 7)	1970	1495	208	648	116	141	75	525	70
	1975	3960	1142	1883	257	601	85	1597	335
	1980	10157	3888	3994	974	987	200	3070	1016
	1985	11029	4650	3199	1307	1187	478	5669	1382
	1989	23194	15271	6135	3496	1415	1433	5212	3147
0-9	1970	2642	644	1219	1259	267	334	750	283
	1975	6974	2651	3834	5124	936	551	2477	1538
	1980	19117	7221	9112	16245	2101	988	5596	4385
	1985	22562	10731	7316	14130	2965	1540	12879	6327
	1989	52874	26958	16078	18861	3737	2793	9978	9283

Source: As for table 49.

to 1978, expansion in output was achieved mostly through the extensive use of inputs, especially of capital, made possible by a very high level of domestic savings, but with hardly any increase in productivity. In agriculture, there was no significant increase in farm output per head in the two decades before 1978. In the second half of the 1980s, however, real value added in agriculture went up 7 per cent a year while the number of people working the land went down.[139] Similarly, total factor productivity in industry in the 1980s has been estimated to have grown by 2.5 per cent and 5 per cent a year, respectively, for State and non-State firms.[140]

Starting with agriculture and foreign trade, the reforms were gradually extended to the industrial sector. China has so far been able to accomplish a considerable degree of marketization without having to resort to any formal privatization of State-owned enterprises (see box 13). Also, reforms in China started under more favourable conditions than those encountered by other socialist economies in later years. In particular it did not need to implement an across-the-board stabilization programme such as was undertaken in the former socialist countries of Eastern Europe, the successful implementation of which continues to be a challenge. On the eve of reforms in China, there was neither any significant inflationary pressure, nor a substantial government budget deficit. There was no foreign debt of any consequence and the country had a relatively strong balance of payments position. Nor was it necessary for China to abolish any international trading arrangements.

In assessing the Chinese reforms, it is helpful to refer to a checklist of prerequisites for a well-functioning market system in a reforming centrally planned economy:[141]

- Prices must be stable enough to avoid politically induced State price-fixing and to prevent speculation;
- Goods must be made available through the market rather than through administrative allocation;
- Prices must reflect relative scarcities;
- There must be competition if there are to be gains in productivity; and
- Decision makers in producing units must behave according to the rules of the market.

These conditions were mostly fulfilled with respect to China's agricultural sector when prices were freed for most food items except grain and a few other key commodities. Prices were stable and farmers were basically price-takers. Replacing the agricultural communes by family households did not involve any fundamental reorganization or retraining of the producing unit and many agricultural inputs and outputs were already sold on the markets. There were price distortions, to be sure, but the distortion was small relative to industry. In any case, the direction of the distortion was clear and limited to only a few crops, affecting only the proportion that was marketed. The success of these reforms, which were largely accomplished within five years, laid the groundwork for sustained growth of agricultural output and generated surplus rural savings needed to finance the industrialization of the economy.

In pursuit of an "open door" policy, steps were initiated after 1978 to break up the State's monopoly over foreign trade by decentralizing authority to provincial and lower level foreign trade organizations. At the same time, four experimental "special economic zones" were set up, three in Quangdong province, neighbouring Hong Kong, and the fourth in Fujian province across the strait from Taiwan province. As indicated by their locations, these zones were intended to draw in foreign capital, companies and expertise mainly from the ethnic Chinese businessmen of Hong Kong and Taiwan province. Many of the rules that were originally designed to promote foreign trade and foreign direct investment in these zones were subsequently adopted for other cities.[142]

With the success of its East Asian neighbours as a model, China began to place greater importance on expanding exports of manufactures. In this respect, Hong Kong investors played a central role. In 1988 and 1989, Hong Kong alone accounted for 63 per cent of all FDI actually utilized, compared to a combined share of 21 per cent for Japan and the United States.[143] Since 1990, there has also been

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139 *The Economist*, 28 November 1992.

140 G. Jefferson, T. Rawski and Y. Zheng, "Growth, efficiency and convergence in China's State and collective industry", *Economic Development and Cultural Change*, vol. 40, No. 2, January 1992.

141 Perkins, *op. cit.*, pp. 8 and 9.

142 China's trade reforms are discussed at length in Nicholas Lardy, *Foreign Trade and Economic Reform in China, 1978-1990* (Cambridge: Cambridge University Press, 1992).

143 State Statistical Bureau, *Zhongguo tongji nianjian, 1990*, Statistical Publishers, Beijing, 1990, p. 654. As pointed out

Box 13

ECONOMIC REFORM IN CHINA

The outstanding success of the Chinese economy since it embarked on economic reform in 1978 has given rise to a new perspective on the introduction of markets and their role in the transformation of centrally planned economies. The Chinese experience, in particular, stands in sharp contrast to the more ambitious reform strategies of the countries of Central and Eastern Europe and the former Soviet Union. In many areas, the Chinese Government did not start out with a comprehensive blueprint, nor did it have in mind any particular sequence of reforms. More often than not, the dynamics of the initial reform measures generated forces which led to further reform, a process which is continuing to the present day.

Given the rapid growth of the Chinese economy in recent years, the overall approach to reform and the specific ways in which reforms have been implemented, a number of fundamental issues arise which have far-reaching policy implications. Particularly significant are those which appear to be contrary to mainstream economic thinking:

- The "gradual" approach to market reforms has been strongly denounced as impracticable for the transition from a centrally planned to a market-oriented economy by those in favour of a simultaneous and comprehensive or "big bang" transformation. Comparison of the Chinese experience with that of other countries, however, suggests that there may be considerable advantages in a gradualist approach;

- A great deal of marketization has so far been accomplished in China without any formal privatization of State-owned enterprises. Despite extensive and widespread marketization of the economy, there is relatively little private ownership of land and capital. Indeed, the Government has made clear its preference for the social ownership of the principal means of production. Apparently, privatization is neither necessary nor sufficient for markets to operate effectively. In place of clearly assigned individual property rights, policy measures were devised to change the system of incentives of industrial enterprises and their behaviour;

- The creation of town and village enterprises (TVEs) has been a particularly outstanding achievement. They represent an entirely new organizational form that is unique in that they are not privately owned and yet are able to behave according to the rules of the market. TVEs are indeed the most dynamic sector of the Chinese economy;

- In spite of its evident drawbacks, the dual price system, which is regarded as leading to inefficiency in conventional theory, has served not only to diminish gradually the role of price control in favour of a growing predominance of market prices, but has also spared China the need to implement price stabilization programmes, thus avoiding the current traumatic experience of many of the transition economies;

- According to conventional theory, free markets are essential for the efficient allocation of resources. In China, however, most markets are highly imperfect. In addition, although markets play a far greater role than before, it is still a limited one: product markets remain highly segmented; there is no labour market to speak of; and the capital market is at best embryonic;

- Close integration with the world economy is considered by conventional theory as essential for fast growth. In spite of its open door policy, however, China is very far from being closely integrated with the world economy. It has aimed at "strategic" rather than complete integration. To that end, it has continued to maintain a plethora of controls on imports and on capital movements. It has not yet reached the ultimate targets of a fully convertible currency and resumption of its status as a contracting party of GATT.

China has shown that it is possible to achieve higher growth by taking advantage of the complementarities between central planning and the market, and between State-owned enterprises and the market-oriented small-scale sector, rather than having to supplant the one by the other. But, in China - unlike Eastern Europe - the reforms were not preceded by collapse of the political system.

a rapid increase in investment from Taiwan province. Faced with rising wages at home, both Hong Kong and Taiwan were in effect relocating their labour-intensive industries, such as toys and shoes, to the low-wage areas of Quangdong and Fujian provinces.

In trade, Hong Kong played a major role as an intermediary between China and the rest of the world. The share of Chinese exports and imports which flowed through Hong Kong as entrepôt trade increased significantly, from about 4 per cent and 1 per cent, respectively, in 1965 to about 30 per cent and 22 per cent in 1988. From Hong Kong's perspective, the proportion of imports from China that was re-exported rose from about 20 per cent to 74 per cent in the same period. Accompanying the rapid increase in re-exports to China was a growing share of domestic exports in total exports to China, attributable to massive investments made by Hong Kong firms in Quangdong province which involved heavy use of domestically made intermediate goods and components. As a result, there was a resurgence of entrepôt trade in Hong Kong, which grew at an annual rate of some 30 per cent in the 1980s.[144]

It is not self-evident why a significant proportion of China's trade with North America, Europe and Asia was directed through Hong Kong, since there was no direct trade only between China and its Taiwan province or with the Republic of Korea. In 1988, for example, 50 per cent or more of China's exports to the United Kingdom, Canada, Australia and Indonesia were directed through Hong Kong. The share was only 39 per cent for exports to Germany but as much as 62 per cent for those to the United States. For exports to Japan and Singapore the proportion was only around 15-16 per cent. On the other hand, the proportion of Chinese imports from these same trading partners that was directed through Hong Kong was much lower, varying from 16 per cent to 23 per cent, except for imports from Germany, where it was less than 8 per cent.[145]

One explanation given for Chinese demand for Hong Kong's entrepôt services is the increase in transaction costs arising from the diversification of the commodity composition of China's exports and imports, in particular the diversification of exports away from homogeneous raw materials towards more heterogeneous manufactured products. However, judging from the fact that the share of Shanghai, the most logical competitor of Hong Kong, in China's total exports fell steadily from its peak of 29.7 per cent in 1980 to 11.6 per cent in 1986, it seems that the demand for Hong Kong's entrepôt services may lie less in its low transaction costs and more in its marketing know-how.

By the late 1980s, not only were profits becoming more important as a determinant of resource allocation but international prices were increasingly being passed through to producers and to the domestic market, making the Government increasingly aware of the importance of avoiding an overvalued exchange rate. Exporters were also allowed to retain a portion of their foreign exchange earnings to pay for their imported inputs. The Government also established foreign exchange adjustment centres or "swap markets" to make foreign exchange available initially to foreign investors but eventually also to domestic firms. In addition to measures to increase the convertibility of the renminbi, repeated devaluations have lowered the real effective exchange rate to about one third of its pre-reform value.

Following reforms in agriculture, reforms were introduced in 1984 and 1987 in the industrial sector. The extent of success, so far, can perhaps be more appropriately assessed once again with reference to the prerequisites of a market economy listed above. With respect to the first condition, on price stability, reforms are inherently inflationary, since they require adjustments in relative prices, which in practice means that average prices are certain to rise. In China, strong inflation has emerged on more than one occasion, and has led to the imposition of austerity programmes.

The second condition (availability of goods on the market) has been fulfilled to a large extent. There was no deliberate decision to abolish State allocation, but ever fewer goods, both intermediate inputs and final products, were being made available through the State as the share of the market rose steadily. Between 1982 and 1991, the number of pro-

by Perkins, these figures are based on data whose coverage is not as broad as that of the official estimates of total foreign direct investment (*op. cit.*, p. 12).

144 James Riedel, "Intra-Asian trade and foreign direct investment", *Asian Development Review*, vol. 9, No. 1 (1991), p. 136.

145 *Ibid.*, p. 139.

ducer goods distributed through the State plan fell from 837 to only 20.[146] Similarly, the total number of different kinds of material and equipment under a substantial degree of State control in 1990 was only 72, as compared to nearly 300 as recently as 1988.[147]

Similarly, substantial progress has been made with respect to the condition that prices must reflect relative scarcities. In 1985, the authorities adopted a dual price system whereby planned output is sold at prices fixed by the State while goods produced in excess of planned amounts are traded at negotiated or market prices. As more and more intermediate and final goods were channelled through the market and as more and more enterprises purchased substantial quantities of inputs on the market, the market portion of goods under the dual price system behaved increasingly like that with freely determined prices. However, the dual price system created opportunities for those with access to supplies at State prices to enjoy substantial windfall gains by reselling them on the market. By 1991, reform measures were mostly oriented towards raising State prices to the market price level, totally or partially, or towards removing goods from State allocation altogether. On 1 April 1991, for example, the dual price system for cement was abolished in favour of a single, market determined, price.[148] And since mid-1991, the Government has taken advantage of a period of price stability to raise State prices, like those for grain and coal, much closer to market levels.

The fourth condition (competition) was met by abolishing State monopolies and allowing enterprises to sell their products throughout the country, although mobility of labour remains restricted. With the prosperity of Quangdong before them,[149] provinces competed with each other not only to attract foreign investment but also to design and implement reforms. While foreign trade also played a part, the principal source of competition came from the non-State "collectives" which were established after villagers were permitted to engage in non-agricultural activities. Known as "town and village enterprises" (TVEs), they compete vigorously not only with each other but also with State firms and with other suppliers in foreign markets.

Meeting the fifth condition (observing the rules of the market) remains a challenge. Whereas farmers are natural profit maximizers, production managers of State-owned enterprises, being appointed and promoted by the government bureaucracies, tend to regard themselves as being mainly responsible to those bureaucracies. Moreover, State-owned enterprises are more concerned with output than with profits, and with the social welfare of their employees than with efficiency. Because the Government is reluctant to allow large enterprises to sink, State-owned enterprises operate, in effect, under a "soft budget constraint". Loss-makers are practically assured of State subsidies or cheap loans in order to safeguard workers' employment and welfare, with consequences for the State budget.

The town and village enterprises mentioned above, on the other hand, come close to behaving according to the rules of the market. In some provinces, they represent genuine local government ownership; in others they are really private companies registered as collectively owned in order to gain access to bank credit and more favourable tax treatment. The rapid growth of the non-State sector was singularly responsible for reducing the share of the State in the gross value of total industrial output from more than three quarters in 1978 to less than half by 1991.[150] TVEs also played a significant and increasing role in other sectors, such as construction, transport and wholesale and retail trade. By 1991 the State's overall share of GNP was no more than 25 per cent. The buoyant growth of the non-State economy is expected to continue during the rest of the decade. Meanwhile, Chinese planners have also taken steps to expand the service industries in order to absorb labour that should be released through the reform of State-owned industrial enterprises. Services in China presently account for a relatively low proportion of GDP in comparison to other Asian economies.[151]

146 Lu Zheng, "China's economic reform and development: historical review and future prospects", in Ross Garnaut and Liu Guoguang (eds.), *Economic Reform and Internationalization: China and the Pacific Region* (forthcoming); and Tang Zongkun, "Supply and marketing", in Gene Tidrick and Chen Jiyuan (eds.), *China's Industrial Reform.* (Oxford: Oxford University Press, 1987), p. 229.

147 *China Daily*, 4 December 1990, p. 1.

148 *Ibid.*, 17 May 1991, p. 1.

149 Exports from Quangdong rose from $3 billion in 1985 to $13.7 billion in 1991.

150 Perkins, *op. cit.*, table 6.

151 The share of services in GDP in China was 20 per cent in 1985. The corresponding share for other Asian economies in the same year, on the other hand, varied from 36 per cent in Bangladesh to as much as 68 per cent in Hong Kong. K.V. Swaminathan, "Technology transfer through foreign investment", in *Technology Transfer and Development in a*

While the economic reforms have transformed China's economy into one of the most dynamic in the world, they have also given rise to periodic episodes of macroeconomic imbalances and high inflation. In addition to the problem of corruption associated with the dual price system, the adoption of the "contract responsibility system" imposes a severe constraint on the Government's fiscal flexibility. Under this system, which applies to over 90 per cent of State enterprises, the management of an enterprise signs a contract with the Government, typically for a period of three to five years. The contract stipulates a certain amount of profit to be realized and tax to be paid each year; profits above the contractual amount are either retained by the enterprise or taxed at a lower rate. Thus, while the contract is in effect, the Government is unable to introduce new taxes or alter current ones in the face of changing economic circumstances. If "stop-go" cycles which may negate the benefits the reforms are intended to procure are to be avoided, it is essential that steps be taken to develop adequate macroeconomic instruments of control rather than continuing with the policy of "crossing the river by feeling the stones underfoot".

D. Prospects for Asian trade and investment

Prospects for the Asian economies, like those of other regions, are dependent on factors which are external and internal to the region as well as on the associated degree of uncertainty. Of more immediate relevance is the exact timing and extent of a more generalized recovery in the developed market-economy countries, individually and collectively. Short-term prospects in this regard are discussed in detail in Part Two, chapter I. In the longer run, the successful conclusion of the Uruguay Round remains uncertain, as are the effects arising from the formation of trading blocs in the western hemisphere and the enlargement of the European Economic Community.

For the economies of Asia, however, the more relevant and important question is whether the factors which have led to the generation of greater demand from within the region in recent years will continue to operate. If the growth rate differential between Asia and the rest of the world in the 1980s is maintained in the 1990s, Asia will become the world's largest market, with purchasing power exceeding that of North America or Western Europe by the year 2000.

In response to changes in the global economic environment and comparative advantage, Asian economies have undergone significant structural changes and readjustments in the last decade. With the development of a subregional division of labour, accompanied by rapid increases in intraregional trade and investment, the degree of interdependence of the economies in the region has been greatly enhanced. The evolution of the multi-stage catching-up process has greatly strengthened the linkages among Japan, ASEAN members and the NIEs, who are now in the process of finding their own niches in the production of goods and services for the world market. As the NIEs are induced to move up in export markets, they will open up opportunities for exports from other Asian developing economies as long as serious infrastructure bottlenecks can be avoided. The horizontal division of labour between Japan and the NIEs in the 1980s may well then be replicated in the trading relationships between the NIEs and other Asian developing economies. And as the economies of the NIEs become more sophisticated, they will also become important sources of capital, investment goods and technology.

At the same time, the large Asian countries, especially China and India, with their growing economies, have the potential of providing larger export markets for the NIEs and Japan, thereby further reducing their dependence on North America. Indeed, the linkages between China, Hong Kong and Taiwan province of China have become so close that these economies are regarded as constituting the "Chinese Economic Area" (CEA) which is becoming arguably an additional growth pole of

Changing International Environment: Policy Challenges and Options for Cooperation (UNCTAD/ITP/TEC/21), United Nations publication, Sales No. E.91.II.D.19, p. 29.

the global economy.[152] China, in fact, is embarking on a new stage in its economic relations not only with the Republic of Korea, following the establishment of diplomatic relations in August 1992, but also with its Taiwan province in as much as barriers to investing directly in the mainland have been eliminated. Both of these economies, like Hong Kong before them, will undoubtedly use China as an offshore production base for the manufacture of labour-intensive products. Thus, as long as China keeps to its open door policy, there will be a high demand for capital goods and semi-manufactures. The crucial question is whether the pace of economic growth in China will be more or less smooth or characterized by violent stop-go cycles. In any case, intra-Asian trade is likely to continue to increase, and where conditions favour it they will also favour complementary intra-Asian flows of FDI. It seems likely that Asia, as a region, will continue to outperform the rest of the world during the remaining years of the current decade.■

152 For a discussion on the characteristics of a "fourth growth pole" and its global significance, see *Global Economic Prospects and the Developing Countries* (Washington, D.C.: The World Bank, 1993), pp. 66-67 and box 7-2.

Chapter V

COLLAPSE AND TRANSITION IN CENTRAL AND EASTERN EUROPE

A. Introduction

In less than two years enthusiasm and optimism for the transition of the former socialist countries of Eastern Europe[153] have turned into disappointment and pessimism. As pointed out recently, "for many people in the eastern countries the dominant issue is not so much the 'transition process' as immediate survival".[154] Neither the people and policy-makers in those countries nor outside experts and international financial institutions foresaw all the troubles that were in store.

What went wrong? The nature of the reforms initiated reflected the assumption, widely accepted in both East and West, that a partial and gradual reform of a socialist economy was neither feasible nor desirable (see, however, the reform experience of China, discussed in box 13). It was argued that since many attempts had been made in the past at creating "market socialism", and ended in total failure, to give effect to market incentives and to ensure the irreversibility of reform it was necessary to dismantle the structures of central planning and abandon State ownership. The goal should therefore be to create a "market economy" by deregulating markets and prices and privatizing public property. It was, moreover, argued that this required a "big bang" rather than piecemeal reform, since distortions and imbalances were so pervasive and interrelated that to obtain positive results in one area required success in many others. Reform programmes have therefore included both supply-side measures designed to alter incentives and demand-side measures to limit the destabilizing effects of decontrol.

However, a properly functioning market economy cannot spring up spontaneously with the dismantling of the command-and-control system. Governments need to act not only to dismantle the old structures of central planning but also to intervene in new ways to give shape to the new market system, and to cushion the transition from one system to another. These tasks have not figured prominently on the reform agenda. Instead, reformers have chosen to give overriding importance to dismantling the old system. Consequently, the old system of command-and-control has disintegrated while many of its most negative elements remain in place. A market system has not filled the vacuum, but many of its most negative elements have emerged.

153 In accordance with previous practice in UNCTAD, the classification "Socialist countries of Eastern Europe" includes the USSR. In the present Report these former socialist countries as a group are referred to as "Central and Eastern Europe". See also the Explanatory Notes at the beginning of this Report.

154 Economic Commission for Europe (ECE), *Economic Survey of Europe in 1992-1993* (United Nations publication, Sales No. E.93.II.E.1), p. 1.

B. Recent economic performance

The decline in output in the transition economies other than the former Soviet Union started in 1989-1990. For these countries taken together, domestic production in 1992 was about 30 per cent lower than in 1989. However, in the course of 1992 the contraction in Hungary and Czechoslovakia[155] slowed down, and in Poland there was even a small increase in output, giving rise to expectations that in these three "early starters" an upturn in production was under way. By contrast, output contraction accelerated in Romania, while Bulgaria suffered another sharp drop of more than 20 per cent.[156] The former Soviet republics witnessed a sharp drop in output during their first year of extensive reforms in 1992. Excluding the Baltic States, it amounted to about 20 per cent, against 10 per cent in the previous year, so that since beginning of the decade the loss of output has amounted to almost one third. The Baltic States suffered even greater losses, with the average rate of contraction exceeding one third in 1992 alone. Sharp drops also occurred in some other former Soviet republics, where serious civil tensions and ethnic conflicts added to the disruption of the economy.

Despite the diversity of experience, there appears to be a pattern in the behaviour of output. First, the output loss has so far been higher in countries which had more rigid central planning in the past - e.g. Bulgaria (52 per cent) and Romania (36 per cent) - than in those which had experimented with enterprise autonomy and price liberalization (such as Hungary and Poland, where the loss was around 18 per cent). Past reforms have at least taught enterprises how to resist shocks. Second, the decline in output has also been less drastic in countries where the State did not really loosen its grip on the economy. For instance, output fell by around 11 per cent in Belarus and 14 per cent in Kazakhstan, where the State continued to control economic activity, against 20 per cent in Russia, and 30-45 per cent in the Baltic States, where ambitious reform programmes were adopted. Retaining State control may simply mean postponing difficult policy decisions and shocks, in which case sharp declines may be expected sooner or later. But it can also provide an opportunity to design a transition process that avoids such declines.

The figures cited above may, however, overestimate the true extent of output losses because many newly emerging private activities (for instance in the services sectors) are not accounted for. Available statistics indicate that in many countries the share of services in GDP increased rapidly during 1989-1991. However, the contractionary effects of the transition are clearly indicated by the behaviour of industrial output, where there is very little private activity. Industrial output has fallen by more than 40 per cent since 1989 in the transition economies as a whole. While declines were only to be expected in some sectors, such as heavy industry (including defence), they have not been offset by increased output elsewhere, even in sectors with chronic excess demand under central planning. Indeed, contraction is pervasive across the industrial sector, including light industries, food processing and oil. Similarly, agricultural output fell by 10-13 per cent in 1992 not only because of drought but also because of difficulties in obtaining inputs and credit.

One important consequence of the precipitous drop in economic activity has been mass unemployment. Unemployment was traditionally low in the former socialist countries, barely reaching 2 per cent in the late 1980s in most cases. It has since risen rapidly in all countries (other than the former Soviet Union and the Czech Republic), reaching the double-digit levels typical of Western Europe in recent years. Unemployment continued to rise rapidly even when the contraction of output slowed down. For example, in Poland industrial employment continued to fall in 1992, despite the upturn in output.

In the former Soviet republics, including the Baltic States, unemployment has thus far

155 Czechoslovakia separated into the Czech and Slovak Republics in January 1993. Separate reference is made to each of these two Republics whenever the analysis extends beyond 1992 and relevant information is available.

156 The data used in this section are from ECE, *op. cit.* Chapter 3 of that document provides a more detailed account of recent policies and performance in the transition economies.

remained low, at around 1 per cent, despite the sharp contraction. This suggests that there is considerable labour hoarding by firms (disguised unemployment) and that unemployment can therefore be expected to rise sharply in the course of 1993 and 1994 as enterprises are subjected to tighter financial constraints.

Inflation accelerated rapidly during 1990-1991, with monthly rates reaching two-digit levels in Poland, Bulgaria and Romania following the liberalization of prices. However, 1992 witnessed a marked slowdown in all countries, with the exception of Romania (where it exceeded 200 per cent per annum) and the former Soviet Union. In Czechoslovakia inflation fell in 1992 after a sharp rise in 1991, but has started to accelerate since the separation into two States in January 1993. Inflation rose even more sharply in 1992 in almost all the republics of the former USSR, particularly towards the end of the year. With the exception of a few Central Asian republics, prices rose by multiples of 15-20 in 1992, much higher than the rates experienced by other countries of the region at any time during their transition. In the Baltic States, however, the rise had been reduced by the end of 1992 and early 1993 to about 4 per cent per month.

There appears to be a positive correlation between contraction in output and acceleration in inflation: countries which suffered big losses in output have generally had higher inflation rates. This suggests that supply shocks have been more important than demand restrictions. However, initial macroeconomic imbalances have also played a major role. For instance, in Czechoslovakia where the imbalances were moderate, annual inflation did not exceed 10 per cent and the contraction of output was relatively small.

Real wages have fallen sharply almost everywhere, especially during the first year of transition (by 25-30 per cent in Poland, 40 per cent in Bulgaria, and in a range of 30 to 50 per cent in Ukraine, Belarus and Russia). In the former Soviet Union, however, family incomes were to some extent maintained thanks to second jobs in the informal sector and increased labour force participation. In other countries nominal wages started catching up with inflation in 1992 as the latter slowed down; indeed, real wages rose in Czechoslovakia, Bulgaria and Hungary.

C. A review of reforms

The aim of reforms in the transition economies has been to eliminate immediately central control over the production and pricing of goods and services and the allocation of resources, and quickly thereafter to transfer economic decision making to the private sector by creating a new capitalist class through privatization. Since privatization cannot be completed all at once, an important element of the reforms has been to put pricing and production decisions in the hands of enterprises and to treat public and private enterprises on an equal footing. Deregulation of markets, including trade liberalization and an independent banking system (ultimately made up of private banks), has been considered essential for an efficient allocation of resources. Finally, the severance of the link between enterprises and the State budget has made it necessary to reform the fiscal system. Thus, price liberalization, privatization, banking reform, trade liberalization, and fiscal reform have received most emphasis.

There are, however, considerable variations in the timing and extent of implementation of these reforms in different countries. In Hungary, where the liberalization process had started in the 1960s, the reform strategy has been gradual. In the former Soviet republics, as in many other countries in Central and Eastern Europe, the break with the past has been much sharper. Some countries, notably Poland, have combined orthodox stabilization policies with liberalization and deregulation, whereas others, which have experienced even greater macroeconomic instability, in particular Russia, have thus far failed to put together a coherent stabilization policy alongside reforms.

1. *Price liberalization*

In most of the economies, especially the former Soviet Union, the system of administered prices had begun to disintegrate even before price liberalization. After the change of political regime, price liberalization was the first step taken to dismantle the command-

and-control system. Starting with Poland in January 1990, most countries have rapidly dismantled price controls on a large number of goods and services. Liberalization was abrupt in Czechoslovakia, Bulgaria and Poland, but was spread over a year in Romania. Hungary also chose to liberalize prices gradually, keeping transitory administrative control on many key prices, so as to avoid sharp swings in both absolute and relative prices and to give market participants time to adjust. Price liberalization came rather early in the Baltic States, but much later in Russia (in January 1992), followed by the other former Soviet republics. Again, liberalization included all prices except those of a certain number of goods and services such as foodstuffs, medical care, education, rents, transport, energy and fuels. However, contrary to past practice, the prices of these items are continuously adjusted, even though some of them are still subsidized. Price liberalization in Russia was implemented in spurts, creating a speculative environment.[157]

In some countries inflation had already been high before price liberalization, as in most of the former Soviet republics, where it had reached the three-digit level. However, almost everywhere prices shot up as soon as they were freed. They rose extremely fast in Russia, partly because the liberalization generated speculation and inflationary expectations and partly because repressed inflation was greater than elsewhere.

Liberalization confronted managers with the task of setting prices and deciding the level of production, matters which were beyond their authority under central planning. However, it has not resulted in a system of prices that correctly reflects cost and/or demand conditions and so constitutes signals for achieving an efficient allocation of resources. The primary concern of managers has been to cover current costs without due regard to capital costs or the return on assets; but, where possible, they have also been quick to exploit their monopoly power. Lack of experience in marketing and distribution, and ignorance of conditions of demand and supply, often resulted in the emergence of excess supply or demand as well as a wide dispersion of prices among different segments of the market.

2. *Privatization*

Unlike price liberalization, privatization of public enterprises (PEs) has progressed much more slowly than originally intended and proved much more problematic. This is often seen, by Western and Eastern Governments alike, as a main impediment to transition. Indeed, reforms have come to be judged according to the speed with which property rights have been transferred. Almost everywhere there has been a mushrooming of new private enterprises, especially in services. In some countries (e.g. Hungary and Poland) this process had already been taking place under central planning, but the transition to a market economy gave it a new momentum. However, by the same token it has become more difficult to sell the existing public assets, since there exists this alternative outlet for private wealth.

There has been widespread small-scale privatization in all the economies although the process is far from complete. Again, it has involved mostly service establishments with few employees (e.g. shops, restaurants and taxis). It has often taken the form of employee and/or management buy-outs (notably in Russia) even though public auctioning has also been used. Leasing has also been practised, particularly for establishments located on valuable land. Similarly, there has been widespread privatization of State farms and agricultural cooperatives in most countries, though progress has been somewhat slower in most of the former republics of the USSR. Private ownership in agriculture had already been widespread in Poland. Elsewhere (e.g. Bulgaria, Hungary and Romania), privatization has been affected through land reform and restitution. In several countries tenants had already been allowed to purchase the dwellings owned by the State; those left under public ownership have been transferred to their occupants, often without charge.

Serious problems have arisen in the privatization of large-scale PEs. One difficulty is the valuation of their assets given the absence of developed capital markets and the complex web of inter-enterprise loans. Furthermore, net

[157] There was first an announcement that prices would be freed on 16 December 1991. This led to a precipitate rise in prices several weeks before the date set for liberalization. Liberalization was then postponed in response to requests from other republics. Well before the liberalization, State stores were emptied of goods selling at the administered prices. In 1992 the Government continued to liberalize the prices of basic foodstuffs despite stiff opposition. In January 1993 the new Government tried to reinstate profit ceilings on a number of basic foodstuffs, but retreated in the face of strong opposition. On the evolution of price liberalization and prices in Russia see V. Koen and S. Phillips, "Price liberalization in Russia", *Occasional Paper* No. 104 (Washington, D.C.: IMF, June 1993).

private financial wealth (i.e. claims against the State plus net foreign assets) is very small compared to the stock of publicly owned assets. Accumulated private savings have also been eroded by inflation. Hence, widespread privatization of PEs through sales to residents fetches very low prices.[158]

However, the most important difficulty encountered in the privatization of large-scale PEs is how to reconcile equity and social justice with corporate governance. Equity calls for returning the public assets to the people at large, which implies distributing property independently of the ability of individuals to pay, i.e. a free distribution. In that way privatization does not become a process of validating the illegal accumulation of wealth under the former command-and-control system, and of promoting an unequal distribution of wealth from the beginning in the new system - something that would undermine popular support for reform. Corporate governance, by contrast, requires owners to have effective control over the enterprise, and this cannot be secured through dispersed shareholding, particularly when ownership is acquired without risking one's own resources.[159]

The obvious way out is for the State to sell the assets to foreigners, thereby ensuring corporate control without violating equity or raising questions regarding the source of funds. Moreover, the proceeds from such sales would be channelled to the public via budgetary spending on public goods. However, while some foreign investments and joint ventures, notably in Hungary in 1992, have been financed in this way, foreign interest in privatization in the transition economies has so far been limited. Moreover, a serious political reaction has set in against selling to foreigners, in consequence of which the Government of Hungary was obliged to facilitate the purchase of shares by residents through the grant of concessional credit.

Equity considerations have encouraged resort to the free distribution of titles to ownership, for instance through the issue of vouchers (first in Czechoslovakia and subsequently in a number of other countries, including Russia and Ukraine). The process in Czechoslovakia has been lengthy and cumbersome: vouchers distributed by October 1991 only started to be converted into shares in spring 1993. In Russia the voucher system is used alongside public auctions, where priority is usually given to managers and employees. However, the vouchers are tradeable, and have indeed been extensively traded in secondary markets at significant discounts. In both Czechoslovakia and Russia a number of intermediaries (the so-called investment funds) emerged, issuing obligations to acquire these vouchers from the public. While some of these funds are controlled by State banks, others are private. There is a strong speculative element in these transactions and there have been widespread irregularities, fraud and failures. Concern that the concentration of vouchers in the hands of investment funds would give them monopsonist power in auctions led the authorities in Czechoslovakia to limit such holdings to 20 per cent.[160]

Another method of mass privatization is the distribution of free shares of investment funds established under State control, usually through the State-owned banks. This is the Polish and Romanian version of the voucher scheme: a number of PEs are converted into shareholding companies and their shares distributed among the investment funds. The investment funds are thus in a position to exert control over the management of PEs, but the governance of the investment funds remains a problem.

Rather than mass privatization, Hungary has adopted a case-by-case approach, first turning its PEs into corporate entities (i.e. giving them a legal status). However, so far there has been very little privatization in the domestic market, largely because of the importance attached to securing both equity and governance; but the Government recently started to distribute compensation vouchers to the pre-confiscation owners.

So far privatization in the transition economies has resulted neither in tangible increases in government revenue nor in better corporate governance, nor even in equity. Receipts from sales, whether direct or through public auctions, have been relatively small. Mass privatization through vouchers does not appear to have produced greater equity or bet-

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158 See P. Bolton and G. Roland, "Privatization policies in Central and Eastern Europe", *Economic Policy*, No. 15 (1992); S. Gomulka, "Polish economic reform, 1990-91: principles, policies and outcomes", *Cambridge Journal of Economics*, vol. 16 (1992); A.-R. Nikpay, "Privatization in Eastern Europe: a survey of the main issues", *UNCTAD Discussion Paper*, No. 59, May 1993.

159 For a discussion of corporate governance under different systems of ownership see *TDR 1991*, Part Two, chaps. I and III, and *TDR 1992*, Part Three, chap. II.

160 See P. Bolton and G. Roland, *op. cit*; and M. Carlin and C. Mayer "Restructuring enterprises in Eastern Europe", *Discussion Paper* No. 700, Centre for Economic Policy Research (London), July 1992.

ter governance, and some of the new owners are members of the *nomenklatura* and/or criminals ("the mafia" in Russia).[161] Privatization has stirred acute conflicts among the stakeholders of enterprises, i.e. employees, incumbent managers and the Government, as well as the "new business class" emerging from the old system, particularly since the monopolistic position of many PEs gave them economic and political power. Hence, the prevailing public mood has soured.

One important consequence is that PEs have been undergoing an "ownership shock" in many instances. The demise of central planning and the subsequent vacuum in ownership and control have frequently compounded the inefficiency of PEs. Ambiguity regarding property rights and uncertainty over job security has weakened the managerial commitment to the future of enterprises and encouraged short-termism, including destructive behaviour such as asset stripping. Consequently, many enterprises have been living on their assets while disregarding costs and liabilities.

3. Financial liberalization

Reform of the financial sector has consisted primarily of breaking up the monobank system to establish a two-tier system. Under the old monobank system the central bank not only was a monetary authority, but also acted as a commercial bank vis-à-vis enterprises. There were also specialized banks allocating credits according to guidelines set by the central bank: development banks for financing investment projects, foreign trade banks for trade financing, sectoral banks for agriculture and industry, and savings banks to collect household savings and extend housing credits. Specialized banks relied on transfers from the budget and from savings banks. Household and corporate finances were kept separate, with no direct intermediation between the household and enterprise sectors.

A number of countries had already started to reform this system, separating central and commercial banking (e.g. Hungary in the 1980s), allowing savings cooperatives to take deposits and extend loans, and giving enterprises greater freedom in placing their deposits (Hungary and Poland in the 1980s). With the transition to a market economy, branches of central banks and specialized banks have been converted into State-owned commercial banks and the commercial operations of the central banks have been curtailed. This two-tier banking system now prevails in almost all the economies.

There has been virtually no privatization in the banking sector. However, new private banks have mushroomed, and foreign banks now operate almost everywhere. Private banks are generally very small and the banking system continues to be dominated by State-owned banks. The market is highly segmented: banks have very close relations with a small number of old customers, concentrating their activities on certain sectors and regions.

The banking system now has many characteristics typical of developing countries.[162] It has large amounts of non-performing loans and a weak capital base. Both interest rates and spreads are very high and maturities are short. Prudential regulations and effective supervision are grossly inadequate and there is very little protection of depositors. The weaknesses of the banking system largely mirror those of corporate finances. The two-tier system was created without any restructuring of the balance sheets of banks or, for that matter, those of their debtors, the enterprises. Non-performing loans have increased rapidly as enterprises ran into increasing financial difficulties, and by the end of 1992 they constituted 15-20 per cent of bank assets in Czechoslovakia and Hungary, 20-30 per cent in Poland and 40 per cent in Bulgaria.[163] Banks are often unwilling to reveal their bad loans and start bankruptcy procedings.

Financial reforms have also included deregulation of interest rates. In most countries deposit and lending rates are now freely determined, although in some there are limits on spreads or ceilings on deposit rates. The sharp rise in interest rates has caused great difficulties for debtors. Spreads have tended to rise as assets have become non-performing and banks have passed the cost of bad loans onto other borrowers. Since most bad loans belong to the

161 See M.I. Goldman, "Needed: a Russian economic revolution", *Current History*, October 1992; and R. Rose "East Europe's need for a civil economy", in E. O'Brien (ed.), *Finance and the International Economy* (Oxford: Oxford University Press, 1992).

162 See *TDR 1991*, Part Two, chap. III; and Y. Akyüz, "Financial liberalization: the key issues", *UNCTAD Discussion Paper*, No. 56, March 1993.

163 See G.A. Calvo and M.S. Kumar, "Financial markets and intermediation", in "Financial sector reforms and exchange arrangements in Eastern Europe", IMF *Occasional Paper*, No. 102, February 1993, p. 13.

established customers, this tends to discriminate against new and more profitable borrowers. Moreover, the exposure of banks is highly concentrated; their solvency consequently depends on the viability of a few enterprises. Banks are often caught between government policies of keeping insolvent enterprises afloat until privatization and of pursuing monetary austerity.[164] Since lending policies are largely dictated by the survival needs of enterprises, banks are unable to exert financial discipline over them. This aggravates the governance problem, especially in Russia, where most banks are still wedded to enterprises: of the 2,000 new banks established, four fifths are controlled by a single PE or a handful of PEs - i.e. the so-called "ministerials" established by old branch ministries and big PEs.

The problem of bad loans is closely connected with that of mounting inter-enterprise credits. Such credits were a feature of the command-and-control system, but they have grown out of control in recent years as a result of tight ceilings on bank credits. In some countries (e.g. Poland) they now exceed the volume of bank credits. Arrears on inter-enterprise credits also affect the quality of bank assets. Since insolvent enterprises fail to pay others, the latter fall into arrears on debt to banks. In Russia inter-enterprise credits have been monetized by the central bank, largely through the intermediation of banks controlled by PEs.

Central bank and commercial bank balance sheets have been hit by currency devaluations, because enterprises did not carry the exchange risk. In Hungary, the National Bank suffered losses on this score amounting to around 30 per cent of GDP in 1990.[165]

Bad loans pose a serious problem in view of the undercapitalization of most banks. Poland and Hungary aim to meet the BIS standards in the coming years, but given the quality of assets and the difficulties in raising capital, there could well result a credit crunch, thereby slowing down considerably the restructuring of enterprises. Czechoslovakia and Romania have already taken steps to write off some loans, but their scope is generally limited in view of the prevailing fiscal austerity. In Romania and Russia central bank credits have been used for inter-enterprise settlements, with attendant consequences for the money supply and inflation. Bank failures have started to occur in many countries (e.g. Estonia, Hungary and Poland), and if bankruptcy laws are passed and/or effectively implemented, such failures can easily snowball. Indeed, widespread bankruptcies have occurred among enterprises in Hungary since the introduction of a bankruptcy law in early 1992.

4. External trade and payments

Since an important objective of reform has been integration into the international economy, trade and exchange arrangements have been reformed drastically in all countries in transition. However, greater openness has given rise to balance of payments problems and revealed significant weaknesses in the ability of industry to compete internationally. Part of the initial liberalization of trade has therefore had to be reversed.

Poland was the first country to rapidly decentralize foreign trade and dismantle import barriers, reducing the protection given to industry. Reforms in all countries included replacing quantitative restrictions by tariffs and lowering and unifying tariff rates. Initially, tariff rates were reduced to very low levels and to zero on some items. There did not follow a surge in imports because of the decline in income and the impact of devaluation. However, as currencies started to appreciate in real terms due to rapid inflation, imports rose relative to domestic demand and started to hurt domestic industry, which was unable to adapt quickly to change. Consequently, trade barriers had to be raised again; tariffs have been increased and new quotas imposed in a number of countries. However, average tariff rates remain low, ranging in 1992 from 6 per cent to 18 per cent in Bulgaria, Czechoslovakia, Poland and Romania.[166]

In Russia trade policy towards non-CIS countries has swerved even more. Tariffs were changed constantly throughout 1992 and more recently the mood has been towards greater protection. As the rouble depreciated rapidly,

164 See J. Kregel and E. Matzner, "Agenda for the reconstruction of Central and Eastern Europe", *Challenge*, September-October 1992.

165 See L.J. Brainard, "Strategies for economic transformation in Central and Eastern Europe: role of financial market reform", in H. Blommestein and M. Marrese (eds.), *Transformation of Planned Economies: Property Rights Reform and Macroeconomic Stability* (Paris, OECD, 1991), pp. 100-101; and Z. Polanski, "The financial system in post-communist countries: the Polish lessons", *Intereconomics*, November/December 1992, p. 262.

166 See ECE, *Economic Bulletin For Europe*, vol. 44 (United Nations publication, Sales No. E.93.II.E.2), p. 56.

certain imports (e.g. food and medicine) were subsidized through a preferential exchange rate.

Except in Russia, free access to foreign exchange for current account transactions (i.e. current account convertibility) was authorized at an early stage in the reform process, either at a stroke (e.g. in Bulgaria, Czechoslovakia and Poland) or gradually over a year (Hungary and Romania), simultaneously with import liberalization and devaluation. Exchange control for capital transactions has been maintained for residents, as have surrender requirements for export proceeds (although there are some retention schemes). However, access of residents to foreign exchange assets has eased considerably in all countries, allowing and even encouraging foreign currency deposits in resident banks (leading to "dollarization"). Exchange rate arrangements have varied among countries and over time, and have included adjustable pegs and managed floating.[167] Russia introduced a multiple exchange rate system at the beginning of 1992, but later in the year abolished it in favour of a unified system of managed floating. Limited current account convertibility was also introduced in 1992. The rouble/dollar rate is determined in auctions, where banks' participation is by authorization through a licensing procedure. The foreign exchange market is higly segmented and subject to sharp swings.

The most important change in international trade and payments arrangements has resulted from the collapse of CMEA (Council for Mutual Economic Assistance), which was a major setback to most of the economies. At the end of the 1980s exports to other CMEA countries had accounted for 25 per cent of total exports of Romania, about 40 per cent of Czechoslovakia, Hungary and Poland, and 60 per cent of Bulgaria and the former Soviet Union.[168] Switching to hard currency markets has not always been easy, as enterprises lacked the necessary marketing and other skills for competing in world markets. Furthermore, with the collapse of intra-CMEA trade enterprises faced major changes in the prices of their inputs and outputs. In particular, the Baltic States and other former CMEA members no longer had access to imports of raw materials, especially of energy from the remainder of the former USSR, at prices well below world levels. For these countries, therefore, the collapse of CMEA was as much a supply shock as a demand shock.

Trade between the former Soviet Union and the other former socialist countries has not declined as much as trade among the latter. Poland, Czechoslovakia and Hungary have resorted to barter and used national currencies for payments among themselves in order to mitigate the adverse effects of the change, and signed in December 1992 a Central European Free Trade Agreement providing for a gradual removal of barriers. Implementation of the Agreement has been hampered, however, by the separation of former Czechoslovakia into two independent States as from 1 January 1993, which has reduced the level of trade between them. Slovakia has been blocking payments in hard currencies for non-essential imports while the decline in trade is threatening to disrupt production in the Czech Republic.

Attempts by the former European CMEA countries to find alternative export outlets in Western Europe have met with stiff resistance from the latter. EEC is subjecting their major exports (agricultural products, steel and textiles) to quotas and tariffs. Although this has not prevented a rapid expansion of exports to the West, the trade balance of these countries (excluding the former Soviet Union) worsened significantly, by about $7.5 billion, from 1989 to 1992.[169]

The trade of the former Soviet Union with the West also fell. An important consequence of the dissolution of the Soviet Union has been the collapse of the rouble zone: the Baltic states and Ukraine have left the zone while a number of other republics have introduced parallel currencies. The monopoly of Russia over the issue of roubles created frictions among CIS members over the fairness of the distribution and the appropriation by Russia of seigneurage. Russia has linked its oil export price to the currency question, allowing CIS members to import oil and raw materials at the subsidized prices charged within Russia in return for their accepting the rouble as the national currency or pegging parallel currencies to the rouble. Although the agreement to this effect was signed by the majority of CIS members, this arrangement has come under strain with the continued decline of Russian oil production. Moreover, the decision to create a

167 See E. Borensztein and P.R. Masson, "Exchange arrangements of previously centrally planned economies", in the IMF *Occasional Paper* mentioned in footnote 163 above.

168 These figures are based on ECE, *Economic Survey of Europe in 1992-1993*, chart 3.3.1. There are considerable differences among various estimates of these trade shares; see, e.g. E. Borensztein and P.R. Masson, *op. cit.*, tables 1 and 2. These differences appear to be due to problems associated with currency conversion factors. Nevertheless, the ordering of the countries according to their dependence on CMEA trade is broadly similar.

169 ECE, *op.cit.*, table 3.3.2.

CIS-wide central bank has not yet been put into effect; nor has there been any agreement on the principles of a common monetary policy.

Because of the dismantling of central planning and distribution, trade among the CIS members has declined drastically, at least as much as that of the former Soviet Union with the rest of world (i.e. including the other former European CMEA members). Efforts to circumvent the difficulties through bilateral arrangements have had only limited success.

5. Fiscal reform

Under central planning most production and investment transactions involved, one way or another, the government budget. Deficits of enterprises arising from current operations and/or investment were financed by transfers from the budget funded from the surpluses transferred from more profitable enterprises. Ordinary budget revenues depended heavily on taxes on enterprise incomes. The commercialization and privatization of PEs have severed this link between the budget and enterprises, and, together with the emergence of new private enterprises, necessitated a restructuring of public finances through a reform of the tax system and a review of public expenditure and of the method of financing budget deficits.

On the revenue side the tendency has been to broaden the tax base by introducing a value added tax (VAT) and a personal income tax, and so move away from excessive reliance on the taxation of enterprises. VAT was first introduced in Hungary in the late 1980s, followed by Czechoslovakia, Russia and other former Soviet republics. Other countries (e.g. Bulgaria, Poland and Romania) have also taken steps to introduce VAT. Together with increased tax revenues from foreign trade (particularly from taxes levied on mineral exports in Russia), this has raised the share of indirect taxes in budget revenues in almost all the economies.

Nevertheless, after an initial boost to enterprise profits and corporate taxes from price liberalization, government revenues have dropped sharply throughout the former Soviet Union as recession deepened. Moreover, with the weakening of governmental authority, an ethic of tax evasion has set in, as much of the private sector is unregistered. Furthermore, in Russia local authorities and autonomous republics have been resisting the transfer of tax revenues to the centre.

The transition to a market economy has given rise to major shifts in the structure of budgetary expenditures in all countries. Investment spending has fallen almost everywhere, defence expenditure has been slashed and price subsidies sharply cut. Much of the decline in public investment will, however, have to be reversed, since promotion of the private sector will require new infrastructure and investment in human resources. Public expenditure on social security has risen rapidly because of mounting unemployment, though there have recently been considerable cuts in benefits. Governments have continued to subsidize enterprises, particularly in the former Soviet Union, in order to keep them afloat. Much of this subsidization in fact represents disguised social security spending aimed at avoiding a wholesale shedding of labour. No country has been able to devolve the pension claims from enterprises and organize them in new institutions, largely because the existing schemes are underfunded. Instead, there has been a tendency to transfer the burden to the budget.

The most radical change has been in the way budget deficits are financed. Under central planning such deficits were usually small, and financed automatically by the monobank system, but with the passage of time they steadily increased and ultimately gave rise to a rapid monetary expansion, particularly in Bulgaria, Poland and the former Soviet Union. The rising deficits during the first years of transition continued to be financed by the central banks in the former republics of the USSR, as well as in Romania. However, other countries generally chose to finance them by borrowing from commercial banks and selling government paper to the public. Thus, the Governments of Poland, Hungary and Bulgaria borrowed from domestic commercial banks; Czechoslovakia floated securities in 1992 as the budget surplus of 1991 turned into a deficit. This shift in deficit financing reinforced the sharp increases in interest rates resulting from financial liberalization. The tendency to accumulate costly domestic debt will be reinforced if recovery is delayed and budget deficits continue to widen. Besides, as long as real interest rates stay above the rate of growth of income, domestic debt will rise in relation to GDP even if primary deficits are eliminated through further austerity. Budgetary considerations explain why the Russian Government has been reluctant to raise interest rates on savings bank deposits.[170]

[170] See J. Sachs and D. Lipton, "Russia: towards a market-based monetary system", *Central Banking*, vol. 3, No. 1, 1992,

D. Stabilization policies

The immediate impact of price liberalization on macroeconomic stability has depended on the extent of the monetary overhang (i.e. generalized excess demand for goods that had been kept on leash by price controls and rationing). While repressed inflation was general, its degree varied among the economies, depending, *inter alia*, on the extent of price controls earlier in force. The monetary overhang and initial macroeconomic imbalance appear to have been greatest in Bulgaria, Romania, Poland and, above all, in the former Soviet Union, and least in Czechoslovakia and Hungary. The impact on prices has also depended on the pace of price liberalization, being most powerful where it constituted a "shock therapy" (Poland, Bulgaria and Czechoslovakia) and milder where it was introduced gradually (Romania and, particularly, Hungary).

Stabilization policies were needed not so much to prevent a rise in prices, which was inevitable, as to ensure that the one-time adjustment needed to eliminate excess liquidity did not set off an inflationary spiral. However, even in countries where liberalization was combined with tight stabilization policies in the context of a "shock approach" (initially Poland and subsequently Bulgaria, Czechoslovakia and the Baltic States) inflation did not disappear, though it did fall considerably after the initial hike (as discussed further in section E below).

As noted above, control over the budget was greatly weakened with the onset of the transition process. Deficits became largely endogenously determined, by such factors as the need to contain social discontent and mobilize popular support for the reform programmes. Indeed, even where fighting inflation was made the primary policy objective (e.g. in Bulgaria and Poland) deficits increased considerably after the first year of reform, largely due to falling revenue rather than increased spending.[171] Although government spending fell in real terms, the size of government increased relative to the rest of the economy because of the collapse of output. In Russia, despite the austerity budget of January 1992, which included drastic cuts in food subsidies and in arms procurement as well as new taxes, the budget deficit exceeded by a wide margin the limit agreed with IMF. According to the latest IMF estimates, it rose to 22.6 per cent of GDP in 1992. A few countries (e.g. Romania and some of the former Soviet republics) have succeeded in keeping deficits within narrow limits, but Czechoslovakia was the only country able to maintain low inflation and a balanced budget.[172]

Consequently, to control demand and reduce inflation Governments had to rely almost exclusively on monetary policy. There was also great confidence in the ability of monetary policy to overcome inflation because of the monetary overhang. Since most countries had ceased monetizing budget deficits, monetary restriction in practice meant containing credit expansion to the private sector (primarily enterprises) through the banking system.

Owing to the rudimentary state of money markets, indirect instruments of monetary control were not initially available or else were ineffective. Governments therefore resorted to direct credit ceilings set individually for each bank.[173] Romania, Hungary and Czechoslovakia used credit ceilings initially, while Bulgaria and Poland have continued to apply such ceilings since 1990. Poland also relied on moral suasion to restrain credit expansion during the first half of 1990. Reserve requirements have also been used (e.g. in Bulgaria, Hungary and, above all, Poland) to absorb excess bank liquidity.

Most countries have by now introduced open market operations. Bulgaria issued one-

p. 42; and D.M. Nuti and J. Pisani-Ferry, "Post-Soviet issues: stabilization, trade and money", *Economic Papers*, No. 93, Commission of the European Communities, Directorate-General for Economic and Financial Affairs (May 1992), p. 7.

171 See IMF, *World Economic Outlook*, May 1990, table 17.

172 *Ibid.*, and ECE, *Economic Survey of Europe in 1992-1993*, table 3.4.1.

173 For the instruments used see Calvo and Kumar, *op. cit.*, table 4.

year bonds at the end of 1990 and later short-term treasury bills; in Hungary the inter-bank market became very active in 1990-1991 with the issue of bills and bonds; and in Poland treasury bills have been auctioned weekly since mid-1990. In Czechoslovakia, where the inter-bank market was more limited, treasury bills have been issued since 1992. There has also been a shift towards a greater use of the central bank base lending rate (i.e. the refinancing rate) to influence deposit and loan rates. The base rate was occasionally pushed above the rate of inflation during 1991-1992 in Bulgaria, Czechoslovakia and, above all, Poland, resulting in much higher real rates for bank loans.

Typically, in a situation of repressed inflation and excessive liquidity, the stock of money and credit in real terms drops sharply after price liberalization, especially since prices tend to overshoot and inflationary expectations raise the velocity of money; but it tends to rise again as inflationary expectations are subdued. The credit and money stock did indeed fall sharply, not only in real terms but also relative to GDP (which declined absolutely). In Poland the credit stock fell from about 26 per cent of GDP in 1989 to 12.5 per cent in 1990, when the liberalization-*cum*-stabilization programme was initiated. As the credit squeeze continued in 1991, however, both central bank money and the credit stock continued to fall in real terms, which suggests that the squeeze was excessive. This was also the case for Bulgaria in 1991-1992. The decline was somewhat more moderate in Hungary, and even more so in Czechoslovakia. The contraction in real balances was very sharp in Russia, where central bank money and the credit stock rose about 10 times during 1992 while the price level rose more than 25 times.[174]

In conducting exchange rate policy, almost all countries faced a hard choice between domestic price stability and international competitiveness. They all devalued their currencies initially, often in many rounds over a short period, while liberalizing prices. The amount of national currency per dollar ended up 23 per cent higher in Hungary and 80 per cent in Czechoslovakia; in Romania it was multiplied by a factor of 2.5, in Bulgaria and Poland of 7-8, and in Russia by one of about 60.[175] The depreciations helped to boost exports to non-CMEA areas (particularly in Poland, and, to a lesser extent, in Czechoslovakia); they also contributed greatly to the hike in prices.

After the initial devaluations, Poland and Czechoslovakia pegged their currencies in order to provide a nominal anchor to price expectations and help disinflation by lagging import costs behind domestic prices. Trade balances started to deteriorate as the currencies appreciated in real terms. Poland devalued in May 1991 and shifted to a crawling peg later in the year, with monthly depreciations. In Czechoslovakia the nominal exchange rate was virtually stable from early 1991 to late 1992, helping to attain greater price stability. Romania initially adopted a dual exchange rate system and used the official rate to contain inflation; subsequently, it unified the rates and moved to managed floating in late 1991, with a substantial devaluation. In other countries the emphasis has been on external competitiveness: Hungary has used an adjustable peg, while Bulgaria chose to float its currency, with the central bank intervening and using interest rate policy to support the currency.[176]

As noted above, Russia has been unable to formulate and implement a coherent stabilization policy. The shock stabilization-*cum*-liberalization therapy of early 1992 failed primarily because of inadequate political support for financial discipline over enterprises and for fiscal discipline.[177] After a short-lived success in reducing inflation from an annual rate of 250 per cent in January to 22 per cent in April through a credit squeeze, the programme quickly ran aground because price liberalization was not allowed to eliminate the monetary overhang through a one-time jump in prices: new liquidity was being created through monetization of both budget and enterprise deficits (and, to a lesser extent, through credits to other central banks in the rouble area). Consequently, the real money stock could only decline via an acceleration of inflation. Floating the rouble (and an absence of control over wages and prices) also meant lack of a nominal anchor. The pressure on prices was thus aggravated as inflationary expectations were largely governed by the movement of the rouble.

174 *Ibid.*, table 3; and ECE, *op.cit.*, tables 3.4.2 and 3.4.4.

175 ECE, *op. cit.*, table 3.4.7.

176 See Borensztein and Masson, *op. cit.*, pp. 47-50.

177 For a detailed account of the failure of the Gaidar programme see ECE, *op. cit.*, chap. 3, sect. 7(iv).

E. Liberalization, stabilization and stagflation

Instability and depression in Central and Eastern Europe have been produced by far-reaching and sudden changes in the rules of the game, superimposed on a fragile economic system. These changes or shocks have affected both the demand for and the supply of goods and services. However, it is extremely difficult to identify demand-side and supply-side shocks separately because they occurred simultaneously and so rapidly; this explains the considerable confusion in the literature on the definition of supply and demand shocks, and the inconclusive debate on their relative contributions. However, the central fact that declines in output have been associated with rapid inflation suggests strongly that supply shocks have played the greater role.

Perhaps the most important reason why there was much more disruption than expected lies in the vacuum left by the disintegration of the political basis of the economic system at every level of management, from the ministries to the shop floor. This "management void" explains why in most countries growth began to decline and prices to get out of control before major economic policy changes were introduced. The fact that there was no longer any discipline either of the plan or of the market, together with much uncertainty regarding ownership and control, made the economic system highly susceptible to shocks.

1. *Aggregate and structural imbalances*

One reason for the collapse of output is that liberalization of prices has brought into the open not only the repressed demand and monetary overhang but also the structural mismatch of productive capacity and the labour force.

According to one theory, in a planned economy employment in PEs tends to be pushed above the level which would be compatible with profit maximization in a capitalist firm; in other words, labour productivity is too low and/or wages are too high. Consequently, liberalization tends to reduce employment and wages, and resistance by wage earners results in more unemployment and inflation than would otherwise be necessary, while delaying the needed redistribution of income from wages to profits. (It may be noted in passing that this is very much like the conventional explanation of the rise in unemployment in Western Europe in the 1980s, when liberal policies made labour shedding easier).[178] While it is true that the level of output and employment associated with a given rate of labour productivity and real wages may be higher in a socialist economy, this does not fully explain the decline in output and employment and the rise in inflation. As yet, only a small proportion of enterprises in the former socialist countries behave like profit-maximizing capitalist firms, and in these countries output has fallen much faster than employment; as already noted, in the former Soviet Union there has been very little unemployment despite the collapse of output.[179] The inconsistency between full employment and profit maximization will become more apparent in the future as enterprises are exposed to market and financial disciplines. To avoid falling into the same unemployment trap as in the West, it will be necessary to accelerate capital accumulation so as to raise labour productivity and build new capacity.

With the liberalization of prices and elimination of plan targets, considerable structural imbalances emerged between supply and demand, particularly in those countries where prices had long been fixed and had no significant role in the allocation of resources. First, excess demand for a number of consumer durables came into the open. Second, as firms reduced investment expenditures, excess supply emerged in many industries producing capital and intermediate goods. Finally, cuts in defence-related government spending added to the structural mismatch between supply and

178 For an explanation along these lines see P. Bofinger, "The output decline in Central and Eastern Europe: a classical explanation", *Discussion Paper*, No. 784, Centre for Economic Policy Research (London), May 1993.

179 Nor is this state of affairs compatible with socialist planning, which required firms to use their labour force fully to meet the plan targets (*ibid.*, p.13). This is an area where the disintegration of the old system bequeathed its negative elements only.

demand, creating excess supplies in defence and heavy industries.

These excesses of demand and supply have tended to change relative prices and the profitability of different industries. However, the process has led to an overall decline in output since, while production and employment were reduced in enterprises that became less profitable, a quick supply response was not possible from sectors producing goods that were in excess demand.

Such structural imbalances cannot be eliminated by simply shifting the existing equipment from arms or heavy industry to consumer durables and reshaping it in order to adjust the supply capabilities according to emerging demand patterns. Expansion of capacity typically requires considerable new investment and takes time even under the best possible corporate governance. In the economies in transition investment and adjustment are further delayed because of widespread uncertainties. Since the beginning of the transition there have been sharp drops in aggregate fixed investment in all countries, ranging from 15 per cent in Poland, 30 per cent in Hungary and Czechoslovakia, and 50 per cent in Bulgaria and Russia to as much as two thirds in Romania.[180] These imbalances also generate inflationary pressures. Where they can, industries resist decline by using their monopoly power to raise prices or by borrowing, thus setting off an inflationary spiral.

It is difficult to be precise on the contribution of structural imbalances to the collapse of output and the rise in inflation. In the former Soviet Union, for instance, employment and incomes have been kept high even in declining industries, since enterprises continued to enjoy easy access to credit. In such sectors there has been a tendency to keep on producing for stocks, even though demand has fallen sharply. By contrast, some enterprises have tended to curtail production of inputs in high demand in order to be able to charge higher prices and increase profits, thereby creating or exacerbating shortages. Such practices have been widespread because 30-40 per cent of industrial output is controlled by monopolies.[181] Imposing price controls does not necessarily solve the problem, since it may discourage higher production, as has been the case for oil in Russia.[182]

In the other transition economies structural imbalances and relative price changes may have played a much greater role because of tighter budget constraints on enterprises. In some sectors production fell in response to a deterioration in relative prices, as happened, for example, in Poland in 1990, when input prices for agriculture rose relative to output prices.[183] Nevertheless, a study of Bulgaria, Czechoslovakia and Romania for the year 1991 found very little evidence of output decline due to sectoral shifts, suggesting that "this shock is still to come".[184] There are, indeed, signs that in all countries disparities in the performance of various branches of industry have widened as the recession has deepened.[185]

2. *Trade shocks*

Declines in aggregate output and disparities in sectoral performance have also been due to the collapse of both intra-CMEA and intra-CIS trade. As already noted, for the non-CIS countries the collapse of intra-CMEA trade was as much a shock to supply as to demand, since it involved not only the loss of major a market but also a worsening of the terms of trade. For the former Soviet Union, however, there was a gain in the terms of trade through higher prices for oil exports.

Exports from non-CIS transition countries to the former Soviet Union fell by 60 per cent from 1990 to 1992. The largest decline took place in Bulgaria and Czechoslovakia, whereas in Hungary and Poland it was more moderate. According to some estimates between one half and the entire fall in output in the exporting countries has been due to the "Soviet trade shock".[186] These countries suffered severe cuts in oil deliveries from the for-

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[180] ECE, *op. cit.*, table 3.1.5.

[181] See M.I. Goldman, *op. cit.*, p. 317; O. Havrylyshyn and J. Williamson, *From Soviet disUnion to Eastern Economic Community?* (Washington, D.C.: Institute for International Economics, 1991), p. 19; S. Fischer, "Stabilization and economic reform in Russia", *Brookings Papers on Economic Activity*, No. 1, 1992; and Nuti and Pisani-Ferry, *op. cit.*

[182] See *Economic Trends in Eastern Europe* (Berlin), vol. 1, No. 2, 1992, p. 74.

[183] Polanski, *op. cit.*, p. 267.

[184] E. Borenzstein, D.G. Demekas, and J.D. Ostry, "An empirical analysis of the output declines in three Eastern European countries", *IMF Staff Papers*, vol. 40, No. 1, March 1993, p. 16.

[185] See ECE, *op. cit.*, chap. 3.1(iv).

[186] See M. Bruno, "Stabilization and macroeconomics of transition - How different is Eastern Europe?", *Economics of Transition*, vol. 1, No. 1, 1993; D. Rodrik, "Making sense of the Soviet trade shock in Eastern Europe: a framework

mer Soviet Union due to falls in production. Moreover, because of the Persian Gulf conflict Iraq was unable to keep up oil deliveries which it had been making in payment of debt service.[187] In some countries energy shortage seriously constrained industrial output; it was particularly important in the decline of Bulgarian exports to non-CMEA countries. The sharp increase in energy prices exerted a major negative influence on industrial output in almost all countries.

In Poland and Hungary, the decline in exports to the former CMEA countries was more than offset by increased exports to the West; such exports in 1992 were about 10 per cent higher in value than in 1989. By contrast, Bulgaria and Romania suffered sharp drops in exports, by one third and one half, respectively, from 1989 to 1992. The success of Hungary, Poland and Czechoslovakia in diverting exports to western markets does not imply that the overall effect of the contraction of trade on output was negligible. The diversion was achieved by massive devaluations and cuts in domestic absorption; there was relatively little increase in aggregate output. Indeed, there was no tendency for resources to be transferred to sectors with greater comparative advantage,[188] largely because of lack of investment to bring about the structural change necessitated by the change in relative prices of traded and non-traded goods.

Trade liberalization has also played an important role in the decline of industrial production. Currency depreciations could only provide a temporary and partial relief. The preference for foreign goods became pervasive on account of the pent-up demand under central planning, and threatened to disrupt the industrial base. This is the main reason for the recent shift towards greater protection in some countries.

Thus, like the liberalization of prices, changes in the direction of trade and in exchange rates, as well as in trade policy, have confronted enterprises with a completely new set of prices for their inputs and output. Consequently, the capital stock in many lines of industry has suddenly become obsolete. A swift adaptation has not been possible, not least because these changes also produced conditions unfavourable to new investment.

As regards the former Soviet Union, its trade fell not only with the other former socialist countries but also with the rest of world: total exports in 1992 were 45 per cent lower than in 1989 and total imports fell even more. Equally important was the decline in intra-CIS trade, primarily because of the breakdown of the distribution system. Different approaches to price reforms also explain this decline: shortages, especially of consumer goods, have encouraged moves to impose export restrictions and taxes.[189] Furthermore, ethnic conflicts have disrupted trade through blockades and the disruption of transport facilities. The President of Kazakhstan has stated that 60 per cent of the production decline in CIS countries was due to such trade disruption, and 20 per cent to the fall in intra-CMEA trade.[190]

The supply-side effects of trade-related changes have also played an important role in the persistence of inflationary pressures. Devaluations continued to raise import costs and prices in most countries (the notable exception being Czechoslovakia and, to a lesser extent, Poland) even after the initial adjustment of exchange rates. Large and repeated increases in energy prices were a source of inflation almost everywhere. The shortages created by the breakdown of the distribution system and ethnic conflicts in the former Soviet Union gave rise to considerable increases in prices, as well as to profiteering.

3. Credit squeeze

As noted above monetary policy has been the main instrument of stabilization in the transition economies other than the former Soviet Union. Credit restrictions were particularly important in Poland in early 1990, when industrial output fell by almost one quarter. They depressed output not so much by reducing effective demand as by restricting supply (since enterprises were highly dependent on credit-in-advance). The credit squeeze thus reduced capacity utilization in the same way as a shortage of energy or any other physical

and some estimates", *Discussion Paper*, No. 705, Centre for Economic Policy Research (London), 1993; and IMF, *World Economic Outlook*, October 1992.

187 See J. Williamson, *The Economic Opening of Eastern Europe* (Washington, D.C.: Institute for International Economics, May 1992), p. 14.

188 See Borenzstein, Demekas, and Ostry, *op. cit.*, p. 23.

189 See Goldman, *op. cit.*, p. 315.

190 *Literaturnaya Gazeta*, 9 December 1992.

input.[191] For this reason, it was both deflationary and inflationary, creating shortages of output rather than effective demand - something quite independent of the effect on prices of the high cost of credit. Resort to inter-enterprise credits did not help reduce the liquidity crisis in Poland since, in contrast to the former Soviet Union, they were not monetized. Stabilization policy thus created a credit crunch which hit not only PEs but also many small-scale private enterprises. The effect of monetary policy was less severe in other countries either because the squeeze was not so tight (Hungary), enterprises had a better initial financial position (Czechoslovakia) or the accumulation of arrears among enterprises forced the authorities to relax their policy (Romania).

F. Conclusions

There were primarily two roles that the State was expected to play in the transition economies: to restore macroeconomic stability and to create a market economy based on private property. In many countries reforms were applied as a "big-bang", the aim being to create an efficient market economy at one stroke through liberalization, deregulation and privatization. This was often accompanied by a shock stabilization programme, since price liberalization resulted in rapid inflation.

Perhaps the most important lesson to be drawn is that while a serious macroeconomic disorder, such as hyperinflation, may require shock therapy, the same approach to structural and institutional change causes more shock than therapy.[192]

The immediate issue in most economies in transition today is how to reduce instability and restore growth. The situation is particularly difficult in Russia since economic decline has not yet bottomed out and the extent of macroeconomic instability is much greater. A return to stability depends on establishing control over money and credit, measures which are also necessary to bring enterprises under financial discipline. This calls for ending the control by enterprises of the so-called in-house banks and restricting lending by the latter. Fiscal discipline is an essential part of a credible stabilization programme. Furthermore, since many enterprises continue to enjoy monopolistic power, it may be extremely difficult to reduce inflation without price controls, which will be needed in any event until conditions of competition are created. As financial constraints over enterprises are tightened and monopolistic price abuses prevented, much of the fictitious employment, output and income at the enterprise sector may well disappear. Consequently, there may well be a sharp increase in open unemployment and an intensification of depression. It is thus very important to prepare the ground for sustained recovery and growth.

In all countries, recovery and growth, as well as stability, depend on the performance of industrial enterprises. The real challenge is how to attain the requisite financial and technological restructuring. Experience thus far suggests that rapid privatization alone will not be enough to meet this challenge, not only because it does not ensure adequate corporate governance, but also because the domestic private sector does not yet have the means and capabilities. It is therefore important to ensure that enterprises that remain in public ownership are subject to effective competition and financial discipline, and that appropriate incentives and disincentives are given to management. The experience of many newly industrialized countries suggests that the objective of creating a market economy is perfectly compatible with the presence of a large public sector on a transitory basis, so long as it operates on commercial principles. The real issue is how to use public ownership and intervention to develop a market economy. Promoting new private enterprises and private capital accumulation could be much more effective in creating genuine owners and also enterpreneurs than transferring the ownership of existing enterprises.■

191 See G. Calvo and F. Coricelli, "Stabilization in Poland", *Economic Policy*, vol. 14 (1992).

192 For a penetrating criticism of shock therapy see ECE, *op. cit.*, chap. 1.

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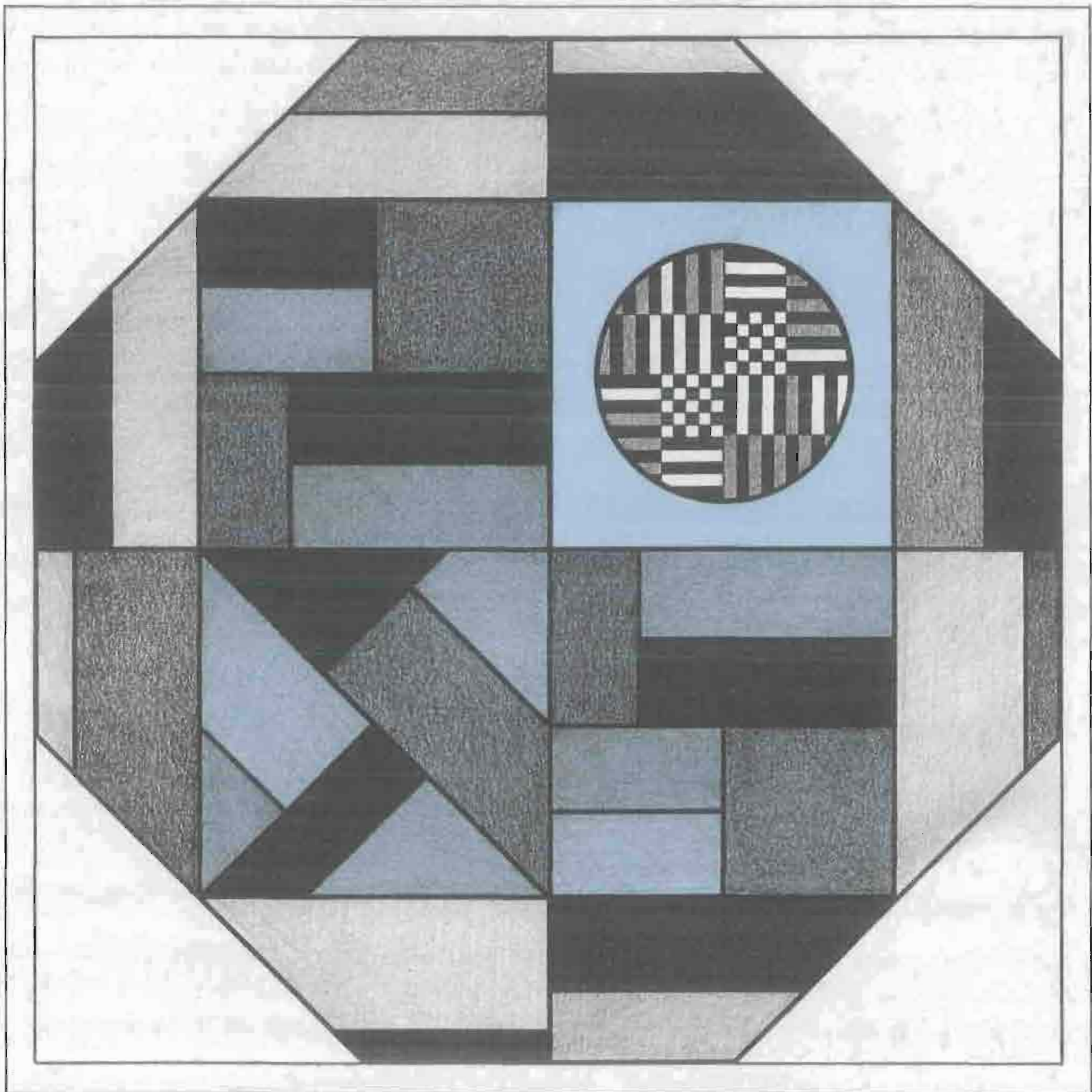
DEBT



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Chapter I

THE DEBT CRISIS IS NOT OVER

A. Introduction

The year 1992 symbolically marked the tenth anniversary of the international debt crisis. This has triggered a lively debate among scholars and policy makers: Is the debt crisis really over? If not, what remains to be done, and by whom? It is worth recalling that the debt crisis has had global ramifications, with repercussions on a variety of actors besides the debtor countries themselves, including creditor countries, commercial banks and international financial institutions (IFIs). The end of the debt crisis means different things to different actors. The crisis may be over for some, but not for others. According to one interpretation, the crisis is over because the international financial system is no longer in danger. Over the years, commercial banks have been able to reduce significantly their exposure to troubled debtor countries, increase their capital, and build comfortable loan loss provisions. In debtor countries, the debt crisis has taken several dimensions. Typically, it started as a financial crisis and subsequently turned into an economic and social crisis. All these dimensions have to be examined before declaring victory.

A troubled debtor country may be said to have graduated from - or grown out of - the debt crisis, only when it has restored normal creditor-debtor relations and achieved external financial viability while experiencing a satisfactory growth rate. External viability means no longer needing exceptional financing in the form of accumulation of arrears or debt rescheduling; it implies that creditors are now confident in the country's capacity to service its debt over time under different plausible scenarios. For middle-income countries, an additional test for graduation is whether they have recovered their access to international capital markets.

B. Recent evolution of the debt crisis

Over the past four years, the international debt strategy has evolved considerably, by accepting the concept of debt overhang and recognizing the need for debt and debt service reduction. This is the main thrust of various international initiatives that have been launched, from the Brady plan in 1989 to the treatment of the Polish and Egyptian bilateral debt and the adoption of the enhanced Toronto terms in 1991. Nevertheless, the implementation of these initiatives has not yet brought about a significant net reduction in the stock of debt, except for Poland and Egypt.

Since 1989, the evolution of the debt crisis at the country level has been characterized by three main developments: (a) a substantial improvement in the creditworthiness of a num-

ber of major Latin American debtors; (b) a deterioration, or at best stagnation, of the debt indicators for sub-Saharan Africa; (c) and the emergence of serious debt servicing difficulties in the Russian Federation.

The major Latin American debtors (Argentina, Brazil, Chile, Mexico and Venezuela) are currently experiencing a resurgence of private capital flows and positive net transfers, and, with the exception of Brazil which has yet to finalize its Brady deal, a much improved growth performance. The recovery is, however, still fragile for some of these countries. While secondary market prices for their commercial bank debt have increased significantly, for most of them these prices remain well below face value, a sign that private investors do not perceive these countries as having fully graduated from the crisis. Similarly, while their ratings in international capital markets have shown a strong improvement, they still do not match those of countries such as the Republic of Korea, Thailand or Malaysia, whose creditworthiness was not impaired by debt crises. Much of the improvement of debt service ratios in these countries is due to the fall in dollar interest rates, since the share of variable-rate debt remains high, notwithstanding the fixed-rate bonds issued under Brady deals.

Despite strenuous adjustment efforts in many countries and several international initiatives, sub-Saharan Africa's debt crisis shows no sign of abatement. The ratio of debt to GNP has stabilized at over 100 per cent. This ratio is by far the highest of the developing regions, even when expressed in present value terms so as to take account of the high degree of concessionality of the debt. Over the past few years, actual debt service payments as a percentage of exports have declined somewhat, but arrears have grown rapidly. As a result, contractual debt service obligations (i.e. actual debt service plus arrears) had climbed to a staggering 80 per cent of exports by 1991. At the same time, as already discussed in Part Two, chapter II, the region has suffered from a continued decline in per capita income and a severe deterioration in the terms of trade. Medium-term prospects are not favourable, particularly given the poor outlook for commodity prices, especially coffee and cocoa.

Since the breakup of the Soviet Union, the debt problems of the Russian Federation have grown significantly. That country has accumulated huge arrears with official and private creditors, and its debt has become a major new challenge for the international community. Following several deferrals, the Paris Club recently rescheduled official bilateral debt worth $15 billion, one of the largest amounts in the Club's history.

C. An analysis of countries with debt servicing difficulties

In mid-1993, as many as 61 developing countries and countries in transition were still experiencing debt servicing difficulties, as they had accumulated significant arrears and/or were expected to seek rescheduling of their debts (table 52). With an aggregate debt of about $550 billion, shared almost equally between official and private creditors, countries with debt servicing difficulties (CDSD) - a category which excludes Brazil, which will soon finalize a Brady deal - account for over one third of debt owed by non-OECD countries and contain about 20 per cent of the world's population. In the late 1980s, there were 74 CDSD holding about 60 per cent of the debt of non-OECD countries. Thus, only about a dozen countries - most of them in the middle-income category - had graduated out of the debt renegotiation cycle by the early 1990s. The main factor contributing to this graduation has been the debt reduction packages with commercial banks under the Brady initiative. Comprehensive reschedulings in the Paris Club, including exceptional debt reduction agreements, such as the one dealing with Egypt's debt, have also been significant. In short, the debt crisis has lessened but has not yet been overcome.

Three out of four CDSD are classified by the World Bank as severely indebted countries, and most of the remainder as moderately indebted. As discussed in chapter III below, 40 countries are in arrears with IFIs, of which 23 with the major multilateral creditors. The largest debtors among the CDSD are the Russian Federation ($78 billion), Poland ($53 billion), and Nigeria ($35 billion).

The CDSD differ in the extent of their debt servicing difficulties (see box 14) as well as in their level of income and development:

- Thirty-five are low-income countries, mostly in Africa. Two thirds of their debt is with official creditors, and virtually half with bilateral creditors alone. With the

Table 52

DEBT BURDEN OF COUNTRIES WITH DEBT SERVICING DIFFICULTIES (CDSD)

Country group	Number of countries [a]	Debt stock at end-1992		
		$ billion	Per cent	Official debt as percentage of total
Total CDSD	61	548.6	100.0	53.2
Low-income countries [b]	35	174.4	31.8	68.8
Severely indebted [c]	26	154.4	28.1	72.7
Moderately indebted [d]	6	6.9	1.2	89.2
Other	3	13.1	2.4	12.2
Middle-income countries [e]	26	374.1	68.2	52.8
Severely indebted [c]	16	238.1	43.4	61.0
Moderately indebted [d]	7	119.6	21.8	37.7
Other	3	16.5	3.0	43.0
By region				
Africa	31	163.6	29.8	64.5
Asia	10	135.2	24.6	67.0
Central and Eastern Europe	5	147.0	26.8	38.2
Latin America	12	102.8	18.7	63.4
Memo item:				
All non-OECD debtors [f]	123	1 509.0	100.0	45.8

Source: UNCTAD secretariat calculations, based on World Bank, *World Debt Tables, 1992-93*, Washington, D.C., 1992; and OECD, *Financing and External Debt of Developing Countries, 1991 Survey*, Paris, 1992.

a Situation in mid-1993.
b Countries with 1991 GNP per capita below $635.
c Countries with an average ratio of present value of debt service to GNP above 80 per cent or with a ratio of present value of debt service to exports above 220 per cent in 1989-1991.
d Countries with an average ratio of present value of debt service to GNP of 48-80 per cent or with a ratio of present value of debt service to exports of 132-220 per cent in 1989-1991.
e Countries with 1991 GNP per capita between $635 and $7910.
f Developing countries and countries in transition.

exception of Nigeria, these countries benefit - or are likely to benefit - from the enhanced Toronto terms for their Paris Club debt. Their debt indicators have recently worsened and since the mid-1980s the ratio of debt to GNP has risen rapidly. The actual debt service ratio has stabilized because of the accumulation of massive arrears, but the contractual debt service ratio had risen to 79 per cent by 1991;

- Twenty are middle-income countries, mainly in Latin America (notably Costa Rica, Peru, Ecuador, Dominican Republic, and Jamaica) and Africa (e.g. Cameroon, Congo, Gabon and Côte d'Ivoire). Many of these countries are eligible for the Houston terms - i.e. longer maturities in their reschedulings with Paris Club creditors - but not for concessional treatment. All are heavily dependent on multilateral flows. They also have a large stock of commercial bank debt, but, with the exception of Costa Rica, they have not benefited from Brady deals. Several of these commodity-dependent countries have been hit by a sharp deterioration in their terms of trade, which has both impaired the sustainability of their adjustment programmes and worsened their debt problems;

- The rest are countries in transition (notably Bulgaria, Poland and the Russian Federation).

Many of these countries will require further debt restructurings, including reductions in their commercial and official bilateral debt, as well as technical assistance in debt management (for the latter, see box 15).

Box 14

A TYPOLOGY OF COUNTRIES WITH DEBT SERVICING DIFFICULTIES

Countries with debt servicing difficulties can be grouped into four categories, according to the degree of their debt servicing difficulties:

- Countries which have largely cleared their arrears but have not yet completed the cycle of reschedulings, notably with bilateral creditors;
- Countries which have cleared arrears with official creditors (both bilateral and multilateral), but not with private creditors, with whom they are negotiating debt reduction agreements. Further reschedulings of bilateral debt may also be expected;
- Countries which are accumulating significant arrears with both official and private creditors, and whose economies are in severe decline. These countries have obtained a number of reschedulings in the past, but are now typically engaged in protracted negotiations with IMF, which delay the conclusion of further rescheduling agreements;
- Countries which have been accumulating massive arrears on all types of debt for several years and have been unable so far to regularize their position with creditors. Most of these countries have been ravaged by civil war. Some are making significant progress towards their re-integration into the international financial system.

D. Conclusions

The debt crisis of the early 1990s is substantially different from that of the early 1980s. For a number of major middle-income debtors it has become much less acute, though only at a high price in terms of development progress forgone and falling per capita income. Commercial bank loans to the large debtors, mainly in Latin America, are no longer the most significant issue. The seven countries that have so far concluded Brady deals - together with Chile and Brazil - account for about 90 per cent of the commercial bank debt rescheduled in the 1980s. At the global level, the major problem is debt owed to official creditors, both Governments and, to an increasing extent, IFIs. The growing share of multilateral debt has made the debt structure less flexible than in the 1980s.

The current crisis mainly affects low-income countries, most of them in Africa. But there are also several lower middle-income countries, mostly in Africa and Latin America, which have yet to graduate from the debt rescheduling process. While the major Latin American debtors are leaving the rescheduling scene, the Russian Federation has entered it. However, although the latter's debt is as large as Mexico's in 1982, it does not constitute a threat to the international financial system. In the light of the foregoing, it would be an oversimplification to characterize the current global debt situation as involving only Africa. Equally, the debt crisis of the 1980s was not only a Latin American one.

It would likewise be misleading to conclude that debt problems are confined to the CDSD. There are 15 countries with a heavy debt burden which have consistently honoured their debt servicing obligations, at a high cost in terms of reduced consumption and lower investment and growth. Three of them have been classified by the World Bank among the severely indebted and 12 among the moderately indebted. They come from all regions - Africa (e.g. Algeria, Burundi, Ghana), Latin America (Colombia), Central Europe (Hungary) and, especially, Asia (Bangladesh, India, Indonesia, Pakistan and Sri Lanka). Over the past seven years, these countries' stock of debt has been

Box 15

UNCTAD TECHNICAL COOPERATION IN DEBT MANAGEMENT

In many instances problems that developing countries encounter when monitoring their external debt stem from organizational difficulties. Debt data may not be recorded comprehensively in a central location, leading to fragmented and disorderly treatment of data and incomplete information on the country's debt situation. Procedures for disseminating debt-related information among the relevant institutions can be cumbersome and involve considerable delay. Other problems stem from managerial and data-processing difficulties. In some countries recording and reporting of debt are still done manually, which can be very time-consuming and impede up-to-date recording and analysis, especially when staff are constantly replaced. Analytical facilities, including those for projections of financing gaps or debt servicing, may be lacking.

Acting on the recommendations of the report of a group of independent experts to UNDP (known as the Kalderen report), UNDP, UNCTAD and the World Bank established in 1991 a joint programme to provide technical cooperation in debt management to developing countries. This partnership is designed to draw on the complementary resources and experiences of UNCTAD and the World Bank in helping developing countries establish appropriate environments for debt management.

The core of UNCTAD's technical cooperation programme consists of helping developing countries surmount their organizational and managerial difficulties by:

- Improving their capacity to define and select appropriate external borrowing strategies;
- Assisting them in developing appropriate structures for more effectively managing external debt, including the legal, institutional and administrative aspects;
- Assisting the debt management units in Ministries of Finance and Central Banks to operate more efficiently through the strengthening of their technical capacity and, more generally, their staffing and other resources;
- Improving the capacity of national authorities in all operational functions of debt management - in particular, those concerned with the operation, information, analysis and control of external debt; and
- Promoting a better understanding among developing countries of all aspects of effective debt management.

UNCTAD's debt management and financial analysis system

The installation of UNCTAD's specialized computer software, called the Debt Management and Financial Analysis System (DMFAS), plays a key role in this technical cooperation programme by providing accurate and timely debt information for the purpose of debt management. By mid-1993, the system had been installed and was operational in 20 countries. The current system (4.1 Plus) has three modules: the Debt Monitoring System (DMS), the Debt Reorganization Subsystem (DRES) and the Debt Projections and Balance of Payments Linkage System (DPS). DMFAS also has the function of reporting to the World Bank's Debtor Reporting System and of serving as an interface to its Debt Strategy Module.

One of the major activities under the joint programme of UNCTAD and the World Bank is the development of a new computer-based debt management system known as DMFAS 5/SAGE (Système d'Aide à la Gestion de la Dette), designed to be more user-friendly and to capture and handle all debt instruments currently in use. When it becomes available at the end of 1994 it will replace the current DMFAS.

Official bilateral debt renegotiations

Since 1978, the UNCTAD secretariat has participated, as an observer, in about 200 Paris Club meetings concerning some 60 countries. At such meetings, the representative of the Secretary-General of UNCTAD presents an analysis of the economic situation and future prospects of the debtor country, and assesses the need for debt relief in the overall context of the country's adjustment and development efforts and its long-term external financing requirements. The UNCTAD secretariat has also provided technical assistance to several debtor countries in their negotiations with the Paris Club.

rising relative to both GNP and exports. Their debt servicing obligations have become so large - averaging one third of exports - as to leave little margin for slippage in macroeconomic and external debt policies. Their economies are still very vulnerable to the vagaries of the international economic environment and, in some, the weather. Several of these countries have recently undergone severe external financial stringency. In a number of cases prompt international action, involving creditor Governments and international financial institutions, has averted the emergence of arrears.

The following chapters deal with the different categories of debt (bilateral, multilateral and commercial) and attempt to identify the "unfinished business" in respect of each. The specific debt problems of the Russian Federation are also analyzed.■

Chapter II

THE PARIS CLUB: A GROUP OF DEBT COLLECTORS OR A DEVELOPMENT-ORIENTED INSTITUTION?

A. Recent improvements in Paris Club practices

The Paris Club was created in the late 1950s to deal with the liquidity problems then faced by a small number of debtor countries, mostly in Latin America. The debt crisis of the 1980s caught the Paris Club unprepared and its response was slow. Until 1987, it operated, by and large, under the tenet of "business as usual". It continued to apply virtually the same terms to all rescheduling countries, insisting on a short-leash approach and directing relief toward meeting immediate cash flow requirements. Non-concessional debt was consistently rescheduled at market interest rates.

Over the past six years, however, Paris Club practices have substantially improved. The first big step was the Toronto agreement of 1988, whereby creditor Governments recognized the need for reducing the non-concessional official debt owed by low-income countries. The main improvements since that time have been:

- The introduction of debt reduction for the entire stock of debt, rather than only for arrears and maturities falling due during a relatively short "consolidation" period. This approach, first used in the "exceptional" cases of Poland and Egypt, will eventually benefit the low-income countries under the enhanced Toronto terms adopted in December 1991;

- The reintroduction of multi-year rescheduling agreements, up to three years, linked to IMF programmes (extended arrangements, SAF and ESAF). This development has reduced the number of repeated reschedulings and associated bilateral agreements following the Paris Club multilateral negotiations (see box 16);

- Increasingly differentiated treatment of debtors, resulting in the emergence of three distinct categories: low-income countries (enhanced Toronto terms); lower middle-income countries (Houston terms, i.e. maturities of 15-20 years) and other middle-income countries (standard terms: 10-year maturities);

- Increased flexibility in the coverage of rescheduling, with a higher proportion of debt service obligations being consolidated. Official creditors, unable to provide appropriate terms within their given guidelines, have made concessions on previously rescheduled debt and most recently with regard to moratorium interest and post-cutoff date debt.

Box 16

PARIS CLUB BILATERAL AGREEMENTS
The experience of eight African countries

Three stages can be distinguished in official bilateral debt rescheduling: (a) negotiation of an adjustment programme supported by IMF; (b) a multilateral negotiation, in a Paris Club meeting, generally concluded by the signature of an agreed minute outlining the broad terms of the rescheduling; and (c) negotiation of bilateral agreements with Paris Club creditors. These agreements are the legal documents defining the new financial obligations of the debtor country.

Information on bilateral agreements is very scarce. A study made of the bilateral agreements signed by eight African countries (Guinea, Mozambique, Nigeria, Senegal, Togo, Uganda, United Republic Tanzania and Zambia) between 1980 and 1991 throws some light on this phase of the negotiation process. [1] The study shows that it is very slow: of the 360 bilateral agreements examined, only 59 per cent were concluded within eight months following the signature of the agreed minutes, while about 20 per cent had not yet been signed one year after the Paris Club meeting. Delays varied considerably among creditors as well as among debtors. Four creditors (Belgium, France, Spain and Switzerland) had signed over four fifths of their bilateral agreements within eight months following the signature of the agreed minutes, while six others (Canada, Italy, Japan, Norway, Sweden and the United Kingdom) had signed less than one third. Delays were relatively short for Senegal and Togo, which went nine times each to the Paris Club, but they often exceeded one year for other debtor countries.

The most important issues in bilateral agreements are the precise loan amounts to be rescheduled and the interest rates. As regards loan amounts, data reconciliation was often very difficult for the first Paris Club rescheduling, especially in respect of arrears on short-term debts and publicly-guaranteed private debts. To facilitate negotiations, specific measures could be taken to improve debt statistics and reconcile different data, to increase transparency and provide timely information on technical issues, as well as to simplify the monitoring of the rescheduled debt. Technical assistance has an important role to play in this respect.

The determination of the interest rates applicable to the rescheduling of non-concessional debts is particularly important in bilateral agreements, since the agreed minute only refers to "the appropriate market rate". The study found that the rates applied on these credits averaged 8.8 per cent. Such interest rates are not sustainable when export earnings stagnate, as they did in the countries in question during the period studied. The result was bound to be repeated reschedulings, an exponential growth of the stock of debt and, consequently, a constantly increasing probability that the debt would never be repaid in full. In addition, successive reschedulings have made the conclusion of bilateral agreements increasingly burdensome, severely taxing the human resources of the Central Banks and Finance Ministries in a number of cases.

Although the negotiation of bilateral agreements has remained time-consuming, the margin left for negotiation in concluding such agreements has recently become rather limited, especially for countries eligible for Toronto terms. In most cases, interest rates can be negotiated within a margin of less than one half of one percentage point and, in some cases, there is no margin at all.

To simplify the implementation of the Paris Club reschedulings, the study also suggests that a special account be established into which the debtor country could make deposits in accordance with a schedule of payments to creditor countries which would be drawn up at the Paris Club meeting. The following year the payment schedule should be adjusted on the basis of the bilateral agreements signed in the preceeding 12 months. This would significantly alleviate the burden falling on the external debt units of debtor countries, which is particularly heavy for African countries. In addition, in signing the agreed minute, the debtor country would know precisely what its financial obligations are in the year ahead, and uncertainties regarding the extent of the debt relief in the programme year would be removed.

It should be stressed, however, that the key decisions are taken when the IMF-supported programme concerning the debtor country is being negotiated. It is at that time that the margin for debt negotiation is greatest. Hence, more work should be devoted to the preparation of the rescheduling when the adjustment programme is being designed, well before the Paris Club meeting.

1 See the study by L. Goreux referred to in footnote 197 of the text.

B. A new agenda

Despite recent improvements, the terms of Paris Club reschedulings are not yet well adapted to debtors' capacity to pay and are therefore likely to lead to further pressures on external payments. This applies to all income categories of debtor countries. Bolder action is needed in two key areas: debt reduction and the institutional framework for official debt relief.

1. Debt reduction

The concept of debt and debt service reduction has been more widely applied within the Paris Club since 1988. There are, however, several aspects that require further improvement: the scale of debt reduction; eligibility criteria; and the appropriate time frame for implementation.

(a) Scale of debt reduction

In December 1991, the low-income countries were granted the enhanced Toronto terms, which provide for a 50 per cent reduction in the net present value of the amount of arrears and debt service payments due during the consolidation period. Paris Club creditors also agreed to consider a reduction of the entire stock of debt three or four years after the first agreement under the new terms. Some creditor countries (United States and Australia) have not yet accepted to grant the new concessional treatment and continue to apply extended maturities (25 years) and market-related interest rates. The United States Administration, however, has recently sought Congressional approval for legislative and budgetary measures to allow the United States to reduce low-income countries' debt.

An assessment was made in *TDR 1992* of the likely impact of the enhanced Toronto terms on the projected debt service ratios of 22 low-income countries which are eligible for the new treatment.[193] It concluded that the new terms would help reduce considerably the debt service obligations of half of the potential beneficiaries to a level compatible with their capacity to pay. For the other half, however, debt burdens would still remain too high.[194]

The European Communities and the Nordic countries have publicly acknowledged the inadequacy of the new terms and are ready to adopt the Trinidad terms, implying a two thirds debt reduction. The Nordic countries would be willing to go as far as a reduction of 80 per cent. Such a favourable creditor attitude could be concretized if all Paris Club creditors (including the United States and Australia) were to agree on the need for additional debt relief measures for low-income countries and adopt the Trinidad terms as a benchmark, with further reductions when needed. Non-Paris Club creditors, such as Russia and the countries members of OPEC, should consider the implementation of comparable measures.[195]

(b) Eligibility criteria

Countries currently eligible for debt reduction are the debt distressed IDA-only countries undertaking IMF adjustment programmes. For low-income countries, eligibility criteria should be widened to include all heavily indebted countries that are IDA recipients even if they borrow on non-concessional terms from the World Bank (e.g. Nigeria).

The bilateral debt burden also poses a serious problem to a number of middle-income countries, and has recently received increased attention from creditor countries. While the lower middle-income countries with high levels of official debt benefit from the Houston terms (longer maturities and grace periods), they do not qualify for debt reduction, apart from a limited amount of voluntary debt swaps (see box 17). Important advances involving a 50 per

193 See Part Two, chap. II, sect. H, of that report.

194 A similar conclusion has been reached by the World Bank. (Cf. World Bank, *World Debt Tables, 1992-93* (Washington, D.C., 1992), vol. I, pp. 8-10 and 58-59.)

195 Russian claims on developing countries are discussed in chapter V below.

cent debt reduction have been made in the treatment of the official bilateral debt of Poland and Egypt (see *TDR 1992*, box 2). The debt reduction needs of other middle-income countries with a high burden of official bilateral debt should not be neglected.

The strong desire to restrict concessional debt rescheduling in the Paris Club to low-income countries is to be explained by the fact that in a number of creditor countries funds for concessional reschedulings have to come from aid budgets. Consequently, aid agencies naturally insist that such rescheduling should not divert (or at most divert only very little of) funds from existing recipients. It is also argued that scarce concessional resources should be reserved for the poorest debtors. This approach is quite different from national procedures regarding firms facing debt servicing difficulties, which recognize the desirability of allowing such firms to restructure their obligations. The case for restructuring its debt, rather than liquidating the firm, is that by writing down some of its obligations and reorganizing the remainder, it can regain financial viability, and that creditors would be better off by taking the limited losses implied by debt reduction than by pursuing alternative solutions. At no point in this process does the level of income of the firm's management, staff or stockholders influence decisions on the extent of the write-down. Likewise, the income level of the debtor plays no role in determining eligibility for debt reduction under the Brady initiative. In both cases, the objective is simply to take those steps necessary to restore the debtor, as quickly as possible, and at minimum cost to all involved, to a position of financial and economic viability.

The same approach should be brought to bear when addressing the problem of the debt of middle-income countries, which is owed mainly to official creditors, and whose medium-term economic prospects are seriously diminished because of excessive indebtedness. Debt reduction by official creditors has a role to play in such circumstances, and it needs to be recognized that its rationale is completely distinct from that governing aid and aid allocations.

The same issue arises in somewhat different form for middle-income countries whose debt is owed mainly to commercial banks. Here, Governments have recognized that creditors may have to accept losses and grant debt reduction, but they do not themselves participate in the process. It is true that in such countries debt owed to official creditors is often a small fraction of the total, and that in principle an adequate amount of debt reduction could be achieved without government participation. By assigning to themselves the role of privileged creditors, however, creditor Governments significantly reduce their own capacity to exert leadership. Whatever may be the carrots and sticks at their disposal, the admonition to "do as I say, not as I do" is not helpful in encouraging banks to be forthcoming with debt reduction. Here, too, creditor Governments should participate directly in the overall process of bringing claims on debtors into line with their capacity to meet them.

(c) Time frame for debt reduction

Even if the case for more widespread debt reduction were accepted, there would still be a question as to whether it should be granted all-at-once. Until quite recently, the practice had been to limit the writing down of debt obligations to those falling due in the consolidation period. Debt forgiveness for Egypt and Poland, however, took a somewhat different course, involving reductions in the stock of debt, although these are to be implemented in stages linked to performance criteria under IMF programmes. The enhanced Toronto terms also provide for reduction in the stock of debt, but the modalities have not been worked out.

The debate on whether to shift the focus of Paris Club activity from the consolidation period, however defined, to the stock of debt, and how to do so, is likely to be intense in the period ahead. The underlying elements of this debate will be familiar. One side will argue in favour of maintaining strong links between creditor action and IMF programmes - i.e. the short-leash approach. The other side will argue for facing up to the mismatch between debt service obligations and present and prospective debt service capacity, i.e. in favour of acting to normalize creditor-debtor relations immediately.

There are two prototype situations (and numerous combinations thereof) in which the latter approach would be warranted. The first is one in which a debtor country has been engaged in IMF programmes for an extended period, and which are beginning to show solid results, but cannot achieve external equilibrium without debt reduction. In such circumstances, debt reduction would be the only means of "graduating" the debtor from the Paris Club. The debtor may continue to have programmes with IMF, but they would no longer assume further Paris Club reschedulings. Or, the debtor might be able to dispense with IMF

Box 17

CONVERTING OFFICIAL BILATERAL DEBT [1]

In September 1990 the Paris Club agreed on the principle of reducing official bilateral debt through clauses stipulating the conversion of part of the obligations into local currency. The so-called Houston terms for lower middle-income countries allowed each creditor to engage in such conversions on a voluntary basis up to 100 per cent of a debtor country's concessional debts and up to 10 per cent of its non-concessional debts or $10 million (exceptionally $20 million), whichever was the higher. These conversions include debt-for-nature, debt-for-aid, debt-for-equity, or other local currency debt swaps. These provisions have been extended to low-income countries and the exceptional cases of Poland and Egypt. So far, clauses allowing for the conversion of official bilateral debt have been included in more than 30 Paris Club rescheduling agreements.

The experience with commercial debt indicates that the scope for effective debt-equity swaps in severely indebted developing countries is greater when there is a programme for large-scale privatization and domestic capital market development. When foreign debt is swapped into assets, such as equity in privatized enterprises, without requiring an intermediate swap into local currency, the money supply need not be increased. Thus, when such swaps are restricted to privatization programmes, the impact on inflation is neutral, or is even positive in as much as the asset sales allow the Government to reduce the public sector deficit.

The main value of debt-for-development swaps, such as debt-for-aid and debt-for-nature, lies in highlighting areas of high priority in social and environmental spending and in shifting resources to such areas. However, local currency redemption of converted debt involving an up-front disbursement of cash at face value can be inflationary unless the amount involved is marginal. The swap should, therefore, to the extent possible, be made in the form of debt instruments with medium-term maturities and bearing interest at rates which do not pose immediate or long-term threats to budgetary control.

Several creditor countries, including Belgium, Canada, France, Germany, Spain, Switzerland, the United Kingdom and the United States, have introduced measures to allow the conversion of their official claims on debtor countries. Since the inception of its Enterprise for the Americas Initiative in June 1990, the United States has reduced a portion of PL-480 debt of a number of Latin American countries (Argentina, Bolivia, Chile, Colombia, El Salvador, Jamaica and Uruguay) and allowed payment of interest on the remaining debt in local currency to finance environmental programmes. These conversions are expected to generate nearly $155 million in local currency funds. Under Canada's debt conversion initiative (introduced at the Rio Earth Summit in June 1992) 10 Latin American countries (Brazil, Colombia, Costa Rica, Cuba, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Peru) are eligible for conversion of about Can$145 million in outstanding ODA debt in exchange for support to domestic environmental programmes. The French Treasury has auctioned its claims on the Philippines, United Republic of Tanzania, and Honduras. In May 1993, the French export credit agency Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE) started auctioning about F500 million of claims on Egypt through the Treasury. The United Kingdom's Export Credits Guarantee Department is reported to have sold about £100 million of debt between September 1992 and April 1993. Among debtor countries, Poland's $3 billion environmental fund established in 1991 is certainly the most ambitious. Contributions to the fund have been made by the Governments of the United States and France.

Despite the increasing number of deals, a secondary market for official bilateral debt does not yet exist. Debt sales are made by export credit agencies (ECAs) directly to end-users and through intermediaries. Some features of ECA claims do make them inherently less tradeable on secondary markets than commercial bank debt. Examples are the diverse nature of the claims, their unsecured "tail" portions and their ownership and transferability, as well as legislative limitations.

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1 For a full discussion of this subject, see the two (forthcoming) studies prepared for the UNCTAD secretariat by Percy Mistry and Stephany Griffith-Jones, *Conversion of Official Bilateral Debt*, and by Owen Stanley Financial Inc., *Regulatory and Budgetary Issues in the Conversion of Official Bilateral Debt.*

programmes altogether, a development that would be welcomed by all.

The second situation is when a country has been in and out of IMF programmes for an extended period and its debt has been repeatedly rescheduled by the Paris Club, but where the combination of domestic and international efforts, together with external circumstances, has not permitted much progress to be made. What is needed then is to cut back obligations to levels that are more realistic in terms of medium-term growth and payments prospects. In scaling back obligations, care should be taken to ensure that any improvement in the country's financial situation flowing from intensified policy effort would benefit mainly the debtor country, rather than its creditors. Even after debt reduction, the country would need to continue with IMF programmes, and may even need further debt rescheduling from the Paris Club. But the magnitude of its obligations would allow a genuine debt "work-out" to be within its grasp economically, financially, and politically.

In practice, of course, there will invariably be considerable uncertainty about how much debt reduction is required to bring obligations reasonably into line with prospective servicing capacity. If debt policies are to be fully effective, this uncertainty should not become a rationale for minimalist approaches to debt reduction, but be resolved in ways that allow the debtor country to plan ahead. For middle-income debtors substantial debt reduction might be accompanied by provisions for "value recovery" or "recapture" by the creditor in the event that economic and financial circumstances of the debtor improve unexpectedly to a significant degree. In devising such arrangements, care must be taken to ensure that the bulk of the improvement accrues to the debtor.

In conclusion, debt reduction is most effective when implemented in a single operation that removes once and for all the disincentives to investment associated with the debt overhang and the uncertainties generated by repeated rescheduling. If a "tranche" policy is adopted instead, the extent of creditors' commitment to debt reduction should be made explicit from the start and the bulk of total forgiveness given up-front.

The modalities of debt reduction remain a pressing issue for low-income countries benefiting from the enhanced Toronto terms. The Paris Club should review these modalities in accordance with the Trinidad terms, which call for debt reduction to be granted in a single operation.

2. *Institutional framework*

For quite some time, many analysts of Paris Club policies and practices, including the UNCTAD secretariat, have advocated closer coordination between the Paris Club and donor groups (such as the consultative groups and aid consortia chaired by the World Bank and the round tables chaired by UNDP) or even shifting to such forums the official bilateral debt rescheduling for low-income countries.[196] Calls for such institutional changes reflect the fact that donors tend to be more sympathetic than creditors to a fully fledged assessment of a country's need for debt relief and new flows, as well as a desire to give development institutions at least equal weight with monetary ones.

The Paris Club gives pre-eminence to IMF's analysis of the debtor country's financial situation. Since this is undertaken in the context of the debtor's request for IMF support, the need for rescheduling is considered in the light of the projected financing gap over a 1-3 year period, after taking into account disbursements from other known sources of external financing, including IMF. This approach, focusing on flows, tends to neglect the evolution of the debt overhang and its adverse impact on the debtor country's external financial viability. Besides, lending institutions appear to err on the low side in estimating the external resources required for structural adjustment, especially in low-income countries.[197] In a sense, therefore, the Paris Club is more a means of cofinancing stabilization programmes than of dealing with debt problems in a context of growth and development. In considering the scale and terms of debt relief, it is essential to

[196] See UNCTAD, "Review of the implementation of the guidelines contained in Board resolution 222 (XXI)" (TD/B/1167), paras. 70-71; C. Lancaster, *African Economic Reforms: The External Dimension* (Washington, D.C.: Institute for International Economics, 1993); P. Mistry, "African debt revisited: procrastination or progress?", *African Development Review*, December 1991; Parliamentarians from African and Northern countries, "Abidjan Declaration on debt relief recovery and democracy in Africa", *ibid.*

[197] In the view of a former IMF senior official, "such an institutional bias is unavoidable when there is strong pressure for concluding an arrangement, because that arrangement cannot go through if the projected balance of payments does not show that the programme can be financed". See the report prepared for the UNCTAD secretariat by L. Goreux, *Paris Club Bilateral Agreements: A Study of Eight African Countries* (forthcoming).

take due account of both the debt overhang and liquidity constraints.

Giving the responsibility for rescheduling official bilateral debt to a donor group would also bring other benefits:

- It would be possible to detect and act on a country's debt servicing difficulties at an early stage, before arrears start to accumulate. The new institutional framework could thus meet the needs of countries that have managed to honour their debt servicing obligations;
- The built-in development orientation of a donor group could be expected to lead to a more differentiated treatment of debtors, eventually resulting in a genuine case-by-case approach. Such an approach might break the rigid rules of the Paris Club with regard to the consolidation of post-cutoff date debt and moratorium interest;[198]
- Since 1988, the Paris Club, by granting concessional debt relief, has *de facto* become an aid provider, increasing the need for close coordination, or merger, with donor groups. These forums could also monitor the additionality of debt relief measures and encourage non-Paris Club creditors to grant comparable treatment;
- A single meeting on debt and finance would considerably reduce the high "transaction costs" currently borne by low-income countries with scarce financial and managerial resources in the extensive preparation, negotiation and monitoring for separate, uncoordinated meetings of the Paris Club and donor groups.[199]■

[198] According to an authoritative former Paris Club participant, "the sausage machine has become highly automated, and negotiation follows a fairly standard pattern with surprising speed". See P. Mountfield, "The Paris Club and African debt", *IDS Bulletin*, April 1990.

[199] For an account of these "transaction costs" see M. Martin, *African Debt Negotiations: No Winners* (London: Macmillan Press, 1991).

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Chapter III

THE MULTILATERAL DEBT PROBLEM

A. The scale of the problem

Since the collapse of private lending in 1982, multilateral debt has grown rapidly, both in absolute terms and as a percentage of total debt. From 1982 to 1992 multilateral debt owed by all developing countries more than trebled, from $98 billion to $304 billion, reaching 18 per cent of total debt. Severely indebted low-income countries (SILICs) owe almost 25 per cent of their debt to IFIs, compared to 14 per cent for severely indebted middle-income countries (SIMICs).[200] However, for the former, 58 per cent of multilateral debt is concessional (partly because IFIs have provided large amounts of concessional loans to refinance SILIC non-concessional debt service informally), whereas for the latter, the proportion is only 5 per cent.

In principle, debt service obligations to IFIs cannot be rescheduled, refinanced or reduced. IFIs are "preferred creditors" (i.e. are given first call on the debt servicing capacity of each country), and the penalties for arrears are severe. Arrears with the Bretton Woods institutions can lead to suspension of rescheduling agreements with bilateral creditors and of new aid. Most developing countries have therefore fulfilled their multilateral debt obligations on schedule, while bilateral and commercial creditors have had to tolerate additional arrears and grant debt relief.

Multilateral debt thus bulks large in the total of debt service payments actually made in recent years. For all developing countries, multilateral debt service payments more than quadrupled between 1982 and 1992. As a proportion of total debt service payments they rose to almost 18 per cent, and for as many as 43 countries above 40 per cent. Over 30 per cent of payments effected by SILICs was to IFIs in 1992, compared to 24 per cent of those made by SIMICs. The key problem is non-concessional debt: almost 80 per cent of SILIC, and 100 per cent of SIMIC, debt service is non-concessional. Multilateral debt service has also become more important relative to total scheduled debt service and export earnings. For 1992-1994 it makes up 22 per cent of total scheduled debt service for the severely indebted groups and 8 per cent of their 1991 export earnings.

New lending from IFIs has not been enough to offset this debt service. Multilateral net transfers nose-dived from $13.9 billion in 1982 to only $2.4 billion in 1992; they were negative during 1987-1989, and averaged virtually zero in 1987-1992. This trend emerged at a time when the IFIs should have been offsetting negative net transfers on other creditor accounts. The collapse was more pronounced for SIMICs, with cumulative negative net transfers since 1987 of $15.9 billion (more than one third of the total negative transfer on all SIMIC debt), of which IMF accounted for $10 billion and the World Bank for $5 billion. Although net transfers to SILICs also fell sharply, they were never negative.

As a result of these trends and the declining debt servicing capacity of many coun-

200 See footnotes to table 52 for a definition of these country groups.

tries, arrears with multilateral creditors grew dramatically. From under $1 billion in 1982, they rose to a peak of over $9 billion in 1991, before falling back to $7 billion in March 1993.

Overall figures are only one indication of the scale of the problem. The key question is the number of countries for which multilateral debt constitutes a heavy burden. At the beginning of the 1980s, arrears with IFIs barely existed, but in mid-1993 as many as 40 countries were in arrears. However, of these, only 14 had arrears with IMF and/or the World Bank and 23 with either of those institutions and/or regional development banks (mostly with the African Development Bank (AfDB)). The remaining 17 countries had accumulated arrears with other IFIs, such as the OPEC institutions. This indicates the extent to which the "less preferred" IFIs - especially AfDB and the OPEC institutions - have suffered from arrears as countries struggle to pay IMF and the World Bank. In 1991, of 18 countries in arrears with the major IFIs (the Bretton Woods institutions and the regional development banks) for which data are available, nine had negative net transfers from these IFIs as a whole and 12 from IMF alone.

The servicing of multilateral debt is also a problem for countries that have not fallen into arrears with IFIs. There are, for example, eight countries (mostly SILICs) which have remained so far current on their payments to the Bretton Woods institutions and the regional development banks but whose annual multilateral debt service in 1992-1994 exceeds, on average, 20 per cent of their 1991 export earnings. In addition, there are two countries currently in arrears with IFIs which also face scheduled multilateral debt service above the 20 per cent threshold.

Therefore, even if arrears with OPEC institutions are not taken into account, there are over 30 severely or moderately indebted countries with a heavy multilateral debt burden (table 53). The scale of the problem can no longer be belittled, as it affects about half of the 61 countries with debt servicing difficulties identified in chapter I. The problem concerns above all about 20 low-income countries, most of which are in Africa. Their multilateral debt burden stems principally from non-concessional debt contracted during the 1970s and early 1980s, when concessional funds were limited and commodity price projections led IFIs to judge that a number of low-income primary producers were sufficiently creditworthy to undertake "hard-window" borrowing.

In the next few years, as bilateral creditors provide mostly grants and, together with commercial creditors, cancel growing portions of debt, most of low-income countries' debt will be to IFIs. This will be a major problem unless export prospects and overall net transfers improve significantly.

B. Alleviating the multilateral debt burden

Multilateral creditors have taken steps to alleviate the burden of multilateral debt since the late 1980s, either by dealing with existing arrears or through schemes aimed at avoiding the emergence of arrears. Each of these two measures, and possible future steps, are discussed below. The focus is on low-income countries, which were seen above to be the most seriously affected, but similar steps may be justified in particular cases for lower middle-income countries.

1. Dealing with arrears

Until 1988, countries cleared arrears using either their own funds or bridging loans from central banks in OECD countries or from commercial banks. In April 1988, IMF agreed that countries in arrears should follow "shadow programmes" for a year, while bilateral donors provided more aid through "support groups" to finance the adjustment programme and clear arrears. Though Guyana and Honduras successfully used this method in 1989-1990, it put an excessively heavy burden on bilateral aid and proved inadequate for countries with massive arrears.

In 1990-1991, IMF and the World Bank adopted new approaches for large protracted arrears. Under the Fund's Rights Accumulation Programme (RAP) and a similar arrangement at the World Bank, countries accumulate rights towards future disbursements up to the equivalent of arrears outstanding at the outset of the programme. Such accumulation is contingent upon sustained performance during the multi-year programme. By April 1993, RAPs had been agreed for Peru, Sierra Leone and Zambia, and the World Bank

Table 53

COUNTRIES WITH MULTILATERAL DEBT PROBLEMS

(Number of countries, mid-1993)

Country group [a]	*Multilateral debt service*		
	Above 20 per cent of exports [b]	*In arrears* [c]	*Total*
Low income			
Severely indebted	9	12	19 [d]
Moderately indebted	-	3	3
Middle income			
Severely indebted	1	4	5
Moderately indebted	-	1	1
Other	-	3	3
Total	10	23	31 [d]

Source: UNCTAD secretariat calculations, based on data of the World Bank's Debtor Reporting System.
a For the definition of country groups see table 52.
b Annual average debt service in 1992-1994 exceeding 20 per cent of 1991 exports.
c Arrears with IMF, World Bank and regional development banks.
d Two countries are both in arrears with IFIs and have an annual average debt service in 1992-1994 exceeding 20 per cent of 1991 exports.

scheme had been applied to Guatemala, Nicaragua, Panama, Peru and Sierra Leone. The experiences of Peru and Zambia are described in box 18.

Although the Fund and the Bank see these approaches as successful, they could be improved in three ways:

- The net transfer is negative during the programme because the country has to pay interest on arrears and current maturities,[201] while receiving no new disbursements. All debt servicing obligations falling due during the programme should be consolidated, thus achieving the modest goal of zero net transfers. At a minimum, current maturities should be rescheduled, following standard Paris Club practices;
- Eligibility for RAP is limited to countries with protracted arrears in 1989, thus excluding five new cases. Improved versions of RAP should be made available to all countries with protracted arrears. A similar scheme should be considered by AfDB, which has 15 countries in arrears;
- The success of the new approach in Peru may not be repeated in other countries (see box 5). RAP performance requirements are front-loaded, but the financing is back-loaded. This is at odds with the Fund's own policy of matching adjustment and financing.[202] Even if the RAP is improved along the lines described above, the lack of positive net transfers from IMF and the World Bank can put excessive demands on other donors, make programmes less growth-oriented in design and implementation, and undermine countries' commitment to implementation. Stronger debt relief measures may be needed if current RAPs fail.

Improved schemes for handling arrears are unlikely to have a negative impact on IFIs' credit ratings and financial position, especially

[201] These are new debt servicing obligations falling due during the programme.

[202] See R. Feinberg, "The Bretton Woods agencies and sub-Saharan Africa in the 1990s: facing the tough questions", in I. Hussain and J. Underwood (eds.), *African External Finance in the 1990s* (Washington, D.C.: The World Bank, 1991).

Box 18

CLEARING MULTILATERAL ARREARS OF MULTILATERAL DEBT: THE EXPERIENCES OF PERU AND ZAMBIA

Zambia and Peru are two examples of the new approach towards clearing arrears of multilateral debt. Their experiences have varied considerably, owing to differences in the design of their adjustment programmes, the implementation of economic policies and exogenous factors, notably flows of external finance.

In April 1991, Zambia was the first country to benefit from IMF's Rights Accumulation Programme (RAP) for SDR 837 million, although it had to repay $125 million of IMF arrears using aid resources and thus make the RAP feasible. It also cleared World Bank arrears up-front with conventional methods, partly with bilateral support and the rest with a bridge loan from the Bank of England. This made possible new World Bank adjustment credits, which enabled Zambia to repay immediately the bridge loan. Peru used new procedures with both the World Bank and IMF. In July 1991, the World Bank applied its new arrears strategy to Peru and, during the first half of 1992, approved three adjustment loans totalling $1 billion. In September 1991, IMF approved a RAP of SDR 610 million.

Peru made rapid progress in meeting the conditions in the Fund and Bank programmes. By December 1992 it had successfully completed the RAP and fulfilled the Bank's adjustment conditions, and in March 1993 it became the first country to clear multilateral arrears under the new approach. To that end, it used short-term bridging credit extended jointly by the United States Treasury and Japan's Eximbank to clear Fund arrears. This made possible an arrangement with IMF under the Extended Fund Facility (EFF) - the first credit by IMF to Peru in seven years. Most of the first tranche of the EFF loan was used to pay back the bridge loans. Peru also cleared its World Bank arrears through bridging finance from the same sources, which immediately activated World Bank credits. The bridge loans were repaid with funds from the three World Bank loans approved in 1992.

Zambia's experience has been less positive. Its RAP had to be formally revised in 1992 after the 1991 programme collapsed; at the same time, it returned to non-accrual status with the World Bank and had to use a commercial bank loan of $51 million to clear the new arrears in January 1992. Under the new RAP, accumulation has been waived for two quarters out of five. At the current rate of accumulation, its RAP will last four years.

The designs of the two RAPs were very different. First, the Peruvian programme was considerably shorter than the Zambian one (18 months and 36 months, respectively, for the RAP; 27 months and 45 months including the pre-RAP IMF-monitored programme). This, in turn, reflected smaller arrears compared with IMF quotas (200 per cent, compared to 300 per cent) and Peru's better adjustment record during the pre-RAP period. Second, Zambia's programme was less growth-oriented in design. Though both programmes foresaw an annual GDP growth of 3 per cent, the Peruvian programme envisaged steep increases in external financing and imports, while Zambia's programme envisaged falling imports and net external finance.

The Peruvian Government showed strong commitment to the programme, implementing all of the IMF targets and the World Bank structural measures three months ahead of schedule. In 1991, GDP grew for the first time in several years, but declined again in 1992 as a result of a severe drought. The Zambian Government failed to implement many of its IMF targets and World Bank structural adjustment conditions in 1991, reflecting partly the holding of a multiparty election. The new Government is firmly committed to adjustment and has made major progress in this regard, but success in stabilizing the economy has been more limited.

Financial support from bilateral donors differed dramatically in relative size. For Peru, the support group of bilateral donors provided $422 million for 1991 and $500 million for 1992, compared to imports averaging $3.8 billion. Japan provided most of these funds, followed by the United States, the Netherlands, Switzerland, Sweden and France. Zambia's programme was much more dependent on donor aid: $750 million a year for 1991 and 1992, equivalent to about half of imports. Both countries suffered shortfalls in donor disbursements. Disbursements from the support group to Peru fell below the country's net transfers to multilateral institutions. However, due largely to unexpected factors, the Peruvian programme turned out to be over-

Box 18 (concluded)

financed. Reserves rose by about $800 million in 1991-1992, mainly as result of unexpected inflows of private capital (returned flight capital and investment in privatization) estimated at about $2.7 billion. In Zambia, despite strong efforts by donors, aid disbursements fell more than $150 million short in each year, with no offsetting private inflows.

The vulnerability of the Zambian programme to shortfalls in donor flows - which were themselves partly due to uncertainty over the implementation and results of the adjustment programme - indicates that methods of clearing multilateral arrears which rely on donor flows to offset negative net transfers from multilateral institutions are inappropriate for low-income countries where adjustment policies have smaller catalytic effects on private flows. Additional measures to consolidate interest on arrears and current debt service may be especially necessary in low-income countries.

if they involve countries accounting for a minor share of their portfolio. Indeed, it could be argued that the regularization of outstanding obligations may strengthen the financial situation of creditors. However, any proposal involving multilateral debt or debt service reduction to clear arrears should be carefully assessed against the borrowing countries' common interest in maintaining the financial viability of these institutions. The funding of debt reduction by donor contributions, SDR allocations and, to a large extent, IMF gold sales would meet that requirement. A problem may arise when IFIs' own hard window resources are used for this purpose, but it could be avoided if debt reduction is financed, for example, through the earmarking of the transfer of the net income of hard windows to soft windows.

The quality of the major IFIs' portfolio has substantially improved with the strengthening of the major Latin American economies and the removal of their debt overhang. It might consequently now be possible for the World Bank, for example, to reduce the annual increase in its reserves without impairing its credit rating, and to finance debt reduction schemes for multilateral debt, along the lines of its funding of IDA's Debt Reduction Facility for commercial bank debt.

2. *Avoiding the emergence of arrears*

IFIs have also taken a number of measures to help avoid the emergence of arrears. IMF has introduced the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF). These facilities were initially welcomed as a method of informally refinancing low-income countries' non-concessional debt to the Fund on concessional terms. However, disbursements from ESAF were extremely slow, amounting by the end of February 1993 to only SDR 2.1 billion of its total resources of SDR 6 billion. This was equivalent to only 40 per cent of low-income countries' non-concessional debt service to IMF during 1988-1993. The main reason for the disappointing disbursement rate is that the conditionality attached to the enhanced Facility is much greater than that tied to the original Facility.

ESAF expires in November 1993 and negotiations are currently under way for a successor:

- The targeted size for the new facility is SDR 6 billion, to be committed in three years. This represents only about 4 per cent of the aggregate financing needs of eligible countries;
- The new facility will probably again be temporary, although the external financing requirements of low-income countries are longer term;
- Among the options for financing the new facility, a continuation of the current ESAF trust-funding structure, based on donor loans and grants, seems to be favoured. This would preclude the use of additional sources, such as IMF's General Resources Account, profits from the Fund's gold sales, and SDR allocations;
- The maturity of loans (10 years) is expected to show no change whereas IDA credits are repayable over 40 years;
- Conditionality is also likely to remain unchanged, although it has delayed both agreements and disbursements.

More generally, in order to avoid the accumulation of arrears, the priority need is for a substantial increase in net transfers from all IFIs. This can be effected by expanding disbursements, reducing debt service burdens and raising the concessionality of the hard window/soft window blend. There is some scope for increasing net disbursements by improving absorptive capacity, reviewing and streamlining disbursement procedures, and lengthening loan maturities and grace periods. The latter also applies to IMF's own resources and, within certain limits, is compatible with their revolving character.

An increase in concessional lending calls for adequate replenishments of IDA, and the soft windows of the regional development banks, particularly the African Development Fund. While IDA-10 resources have been kept constant in real terms, as compared to IDA-9, they are still inadequate for a number of reasons:

- Many IDA recipients are reaching their existing commitment ceilings and still require more loans for gap filling in growth-oriented adjustment programmes;
- The number of new claimants has increased considerably. Some middle-income countries (such as Nigeria, Egypt, Honduras and Nicaragua) have retrogressed into low-income status, increasing the demand for IDA credits, either as IDA-only countries or as "blend" countries (recipients of both IDA credits and the non-concessional World Bank loans);
- New claimants also include some countries that were republics of the former USSR, as well as those which may again become IDA recipients as a result of economic and political disruptions.

The same increased demands are faced by the soft windows of the regional development banks, particularly AfDB. With insufficient soft window funds to cover African countries' needs, this institution has had to continue lending hard window funds to most low-income countries, thus exacerbating their debt problem.

All in all, current trends in the replenishments of the concessional facilities for low-income countries do not bode well for the achievement of sizeable net transfers from the IFIs that would avoid the emergence of new arrears.

For many countries, increased disbursements from IFIs will not be enough. Debt or debt service reduction is also required. This has been already achieved, albeit on a very limited scale, through IDA's "fifth dimension", providing interest rate subsidies on originally non-concessional World Bank loans by earmarking a portion of IDA repayments. Disbursements of $520 million, together with grants from Finland, Norway, and Sweden, have enabled the Bank to refinance 90-100 per cent of interest due from IDA-only countries implementing adjustment programmes. The scheme will continue under IDA-10, but if it is to cover concessional refinancing of principal payments as well, as is desirable, it will need additional resources. Furthermore, the African Development Bank could consider establishing a similar programme.

3. Conclusions

Multilateral debt has hitherto been treated as taboo. The issue is extremely complex because of the built-in cooperative nature of the underlying creditor-debtor relationship. But the time has come to give much closer attention to the extent to which it represents a problem, the implications for debtors and creditors, and the various options available to IFIs to deal with the arrears now and avoid the emergence of arrears later.

Arrears have an adverse impact not only on the countries concerned, but also on the financial position of IFIs and all their members, including the vast majority of borrowers that are meeting their debt servicing obligations. IFIs' preferred creditor status should not be impaired. Otherwise, their special role of lenders of last resort could be jeopardized. Nevertheless, all efforts should be made to explore how the preferred creditor principle can be applied in a flexible, pragmatic manner, in order to allow more comprehensive indirect rescheduling and, in exceptional circumstances, an effective, rather than formal, debt reduction. This would be limited to SILICs, where the major cause of their debt overhang is multilateral debt. In most cases, resources from the IFIs concerned would need to be complemented with more expeditious resource mobilization by support groups, in order to ensure adequate rescheduling or debt reduction in the context of a fully financed growth-oriented programme.

Avoidance of arrears with IFIs is an issue concerning all heavily indebted borrowers, which should be examined in the context of

their overall external financing requirements, and in particular in the framework of net resource transfers from IFIs. Bilateral concessional resources channelled through IFIs are becoming increasingly inadequate relative to the financing needs of low-income countries. In a climate of aid fatigue and financial difficulties in donor countries, calls for increased funds to soft windows may be met with an offsetting decline in bilateral aid. Additionality can be ensured only by resort to new sources of funds, such as SDR allocations and IMF gold sales. These sources could also be used to help countries to clear existing arrears.■

Chapter IV

COMMERCIAL BANK DEBT: AN ASSESSMENT OF THE BRADY DEALS

A. Introduction

Seven countries (Argentina, Costa Rica, Mexico, Nigeria, Philippines, Uruguay and Venezuela) have completed debt and debt service reduction agreements with commercial banks under the Brady plan launched in March 1989.[203] The plan allows banks to choose from a menu of options, which include both debt reduction mechanisms and (usually) a facility for new lending. The principal debt reduction mechanisms are either cash buy-backs of debt - at a discount - or exchange of previous claims for new, "enhanced" instruments involving a cut in either face value (discount bonds) or interest rates (par bonds). "Enhancements" of new instruments have taken the form of collateral against future payments of principal and interest provided by debtors. Debtors have financed the enhancements out of their own reserves and with loans provided by the IFIs and Governments of creditor countries (notably Japan), within the framework of adjustment programmes supported by the IFIs. Banks which do not accept reductions in their loans have chosen the option of lending new money at a predetermined ratio to their outstanding exposure. In some cases, banks have been persuaded to choose collectively more of one particular option, in order to make the deal more advantageous to the debtor country.[204] "Free riding" has been, by and large, avoided through a variety of mechanisms, including financial engineering and moral suasion by Governments of creditor countries.

B. Financial impact

The deals completed so far have had the following financial effects :

- The average *net reduction in the face value of commercial bank debt* was 11 per cent.[205] The reductions were largest for Costa Rica and Nigeria; the Philippines actually experienced a slight increase in the face value of debt in its first cash buy-back, as new money exceeded the debt reduction involved (see table 54);
- In order to gauge the *effective reduction in commercial bank debt*, the concept of debt

[203] At the time of writing, the Brazilian operation had not been finalized. Details of the term sheet agreement are described in Part One, chap III, sect. B.

[204] This was the case with the recent deal of Argentina where, with the fall of dollar interest rates, the par bonds carrying fixed interest rates, became more attractive to banks. See Part One, chap. III, sect. B.

[205] Net reduction in the face value of commercial bank debt equals debt reduction from buy-backs or discount bonds minus new money provided by banks. Par bonds do not affect the face value of debt.

Table 54

DEBT REDUCTION RESULTING FROM BRADY OPERATIONS

(Millions of dollars, unless otherwise indicated)

	Total external debt [a]	Face value of eligible bank debt	Net reduction in face value of bank debt		Effective reduction in bank debt (debt reduction equivalent)		Effective reduction in total debt	
	(1)	(2)	(3)	(4) = (3)/(2)	(5)	(6) = (5)/(2)	(7)	(8) = (7)/(1)
Country				(Per cent)		(Per cent)		(Per cent)
Argentina	61 875	28 486	2 318	8	8 580	30	4 821	8
Costa Rica	4 603	1 571	833	53	1 016	65	790	17
Mexico	95 416	48 098	6 112	13	21 060	44	15 153	16
Nigeria	34 497	3 310	1 986	60	1 986	60	305	1
Philippines I	28 468	1 337	-46	-3	-46	-3	-2	-
Philippines II	31 897	4 600	471	10	1 389	30	364	1
Uruguay	3 707	1 284	141	11	487	38	108	3
Venezuela	23 491	19 598	119	1	4 527	23	3 359	14
Total	255 486 [b]	108 284	11 935	11	38 999	36	24 898	10

Source: UNCTAD secretariat calculations, based on S. Claessens *et al.*, "Recent Experience with Commercial Bank Debt Reduction" (WPS 995) (Washington, D.C.: The World Bank, 1992); and *World Debt Tables 1992-93* (Washington, D.C.: The World Bank, 1992).

a Before Brady operations.

b Excluding Philippines I.

reduction equivalent[206] is useful, as it captures in one single measure the net reduction in face value described above as well as the debt service reduction resulting from par bonds and the impact of the collaterals. (These collaterals, being financially equivalent to cash, amount to a prepayment of a portion of debt). The effective debt reduction, was, on average, 36 per cent, which is much higher than the reduction in face value. It ranged from 65 per cent for Costa Rica to a negative 3 per cent for the first Philippine deal;

- The overall direct financial effects can be measured in terms of the *effective reduction in total external debt*. This notion takes into account not only the effective reduction in commercial bank debt, but also the new official debt contracted to finance the enhancements and the use of debtors' foreign exchange reserves for the same purpose. The average effective reduction in total debt was only 10 per cent, much smaller than that in commercial bank debt. It ranged from 16-17 per cent for Mexico and Costa Rica to 1 per cent or less for Nigeria and the Philippines;

- Since countries entering these operations are liquidity-constrained, the size of the *short- and medium-term cash flow savings* is crucial. As shown in table 55, these savings are measured as the difference in annual net transfers to commercial banks before and after the Brady deal. Such savings, as a proportion of exports, are on average small (3 per cent), varying from 6 per cent for the second Philippine deal to virtually zero for Argentina. Furthermore, they are also small relative to the up-front costs incurred by the debtor country,[207] which amount on average to four times the annual savings in net transfers. Although only a portion of the up-front costs generate immediate net payments to banks, these additional payments -

206 This concept was introduced by S. Claessens *et al.*, in "Recent experience with commercial bank debt reduction" (WPS 995) (Washington, D.C.: The World Bank, October 1992).

207 Up-front costs consist of cash for buy-backs and partial settlement of arrears and of collateral purchases, net of new money from banks.

Table 55

FINANCIAL SAVINGS RESULTING FROM BRADY OPERATIONS

(Millions of dollars, unless otherwise indicated)

Country	(1) Cost of operation	(2) Pre-deal annual net transfer [a]	(3) Post-deal annual net transfer [b]	(4) Annual savings (2)-(3)	(5) Annual savings as per cent of exports [c]
Argentina	3 759	1 285	1 279	6	0.04
Costa Rica	226	53	37	16	0.71
Mexico	5 909	3 704	2 755	949	2.09
Nigeria	1 681	634	77	557	4.15
Philippines I	-44	769	525	244	1.65
Philippines II	1 025	1 098	189	909	6.15
Uruguay	379	217	80	137	5.73
Venezuela	1 168	2 048	1 318	730	3.97

Source: UNCTAD secretariat calculations, based on E. Fernandez-Arias, "Costs and Benefits of Debt and Debt Service Reduction" (a forthcoming PRE Working Paper of the World Bank); and *World Debt Tables 1992-93* (Washington, D.C.: The World Bank, 1992).

a Average annual transfer to commercial banks in the four-year period prior to the deal.
b Average annual net transfer to commercial banks in the four-year period after the deal.
c 1991 exports of goods and services.

together with full compliance with post-deal debt service - have resulted in some cases (notably Argentina, Costa Rica and Nigeria) in a sharp increase in total net transfers to banks in the first year. It may also be argued that the entire up-front costs have a negative impact on the country's overall cash flow, whether they are financed by reserves or by official loans. In this latter case, the assumption is that the official financing of Brady deals does not in fact add to what would have been forthcoming.

To sum up, while the Brady deals brought about a small net reduction in the face value of commercial bank debt, the effective reduction was substantial (more than one third), but the corresponding reduction in the total debt stock was only one tenth. The short- and medium-term cash flow savings were more than offset by sizeable up-front financing costs of the deals.

The financial impact of the Brady deals may be compared with the debt reduction proposal made by the UNCTAD secretariat in 1988, well before the Brady plan was launched.[208] That proposal called for a 30 per cent reduction in total commercial bank debt (both medium- and short-term) owed by highly indebted middle-income countries, in order to raise their per capita growth to 3 per cent annually. Although the Brady deals have achieved an effective debt reduction in *eligible* bank debt of 36 per cent, the corresponding reduction in *total* bank debt is roughly 30 per cent, or as much as the UNCTAD proposal. However, the UNCTAD proposal envisaged no enhancements and associated official borrowings. Thus, since at that time private creditors accounted for about 80 per cent of total debt of eligible countries, the 30 per cent cut in bank debt would have resulted in a 25 per cent reduction in the entire stock of debt, as compared to the average of 9 per cent achieved in the Brady deals.

[208] See *TDR 1988*, Part One, chap. IV, sect. B.

C. Developmental impact

A number of countries which have completed Brady deals have recently experienced higher growth rates and a turnaround in private capital inflows, as a result of a return of capital flight, significant foreign direct and portfolio investment and renewed access to international bond markets.[209] To what extent can these developments be attributed to the Brady deals?

An appraisal of the impact of the Brady deals on the economic performance of the countries concerned and on creditors' posture toward them is clouded by the influence of a variety of concomitant factors. Besides such deals, many of these countries have adopted far-reaching economic policy reforms. Like countries that have not finalized Brady deals, they are benefiting from a major shift in foreign investor sentiment towards Latin America. This shift is explained principally by a bandwagon effect and wide arbitrage margins, partly due to lower dollar interest rates. The latter has also had a broader influence on domestic and external financial performance. The fall in dollar interest rates has been a key factor in reducing debt service ratios in these countries, since they have a high share of variable-rate debt, in spite of the fixed-rate bonds issues under the Brady deals.[210]

Many analysts have concluded that the main benefits of the deals do not stem from the reduction in net transfer to banks, but rather from their confidence-boosting effects and positive impact on external capital flows. The lessening of domestic and foreign investors' uncertainty over the debtor country's macroeconomic policies, especially in the fiscal and external payments areas, should result in an expansion of investment and the return of flight capital.

However, in most deals, the reduction in total debt stock was not large enough to trigger, by itself, a major increase in private capital inflows or a significant improvement in economic performance. Nevertheless, the Brady plan has provided a framework for settling claims in an orderly way. If debtor countries go through this process, investor perceptions of country risk improve. Debt regularization has been a contributing factor to the process of improved creditworthiness initiated by the domestic economic reforms which underlie those deals.

Notwithstanding this improved creditworthiness, secondary market prices for commercial bank debt owed by countries that have concluded Brady deals show that major uncertainties about their debt servicing capacity persist. Although these prices have risen much faster since 1989 than those of the other SIMICs, in March 1993 they were still only in the region of 60 per cent. Furthermore, their rising trend was in part due to lower dollar interest rates.

Another benefit that could be expected from the normalization of debtors' relations with commercial banks is the resurgence of voluntary lending with lower spreads. Commercial banks, however, have been reluctant to resume lending beyond short-term trade credits and project financing. The aftermath of the prolonged debt negotiations and the banks' financial difficulties - for reasons other than developing country debt - may explain this behaviour. On the other hand, debtor countries' demand for commercial bank loans has been much reduced by the availability of other sources of external finance, some of which, such as Eurocommercial paper, were at lower cost than bank loans. The improved creditworthiness of countries such as Argentina, Mexico and Venezuela is also reflected in the volume and terms of their recent external bond issues, for which yield spreads have recently declined. However, none of them has received investment-grade ratings from major rating agencies, although these ratings have tended to improve.[211]

Foreign investors' favourable perceptions of economic prospects for this group of countries also emerge from the periodic surveys

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[209] The recent economic performance of Latin American countries is described in Part Two, chap. III, and major developments in international capital markets in Part One, chap. III.

[210] The decline in currency-weighted interest rates between 1989 and 1992 resulted in savings in interest payments by SIMICs in the latter year equivalent to 5 per cent of exports.

[211] For a discussion of the sources and terms of bank lending and other credits to Latin American countries, see Part One, chap. III.

conducted by *Institutional Investor* among international bankers. These surveys show that from March 1989 to March 1993 their ratings rose by 6 points to 31.5 (on a scale of 0 to 100), the largest increases being registered by Mexico and Argentina. Nevertheless, in all cases ratings are still well below those for Asian countries that have escaped the debt crisis, such as China, Indonesia, Malaysia, Republic of Korea and Thailand, most of which have regularly been awarded well above 50 points.

There is evidence that the reversal of capital flows has not been always associated with improvements in economic performance, or with a successful Brady deal. Brazil, for instance, has not completed its negotiations for a Brady deal, neither has it succeeded in bringing down its rate of inflation, which since mid-1991 has been running at a monthly rate of between 20 per cent and 26 per cent. Nevertheless, in 1992 capital inflows reached a level of $17 billion, equivalent to about 4 per cent of GDP. What is true, however, is that the country did liberalize access by foreign investors to the domestic capital markets in 1991.

Many commentators have stressed that another effect of the Brady deals should be the reduction in domestic interest rates and the risk premium on domestic public debt, as a consequence of both the positive fiscal impact of debt reduction and changes in private sector perception of country risk. The record is far from conclusive.[212] In any event, it is again extremely difficult to disentangle the impact of the deals on interest rates from other factors.

D. The unfinished business

Brady deals have frequently resulted in significant up-front costs to debtor countries, which have outweighed the direct cash flow relief and eroded the reduction in the overall stock of debt, because of the associated borrowing. In future, the financial cost to debtor countries should be minimized in order to maximize their overall net benefits. This requires debtor countries to have a stronger bargaining power. The role of Governments of creditor countries and of IFIs is vital in this respect.

These considerations are particularly relevant for the protracted negotiations involving several middle-income countries (such as Bulgaria, Congo, Côte d'Ivoire, Ecuador, Jordan, Panama, Poland and Peru) which have not yet concluded a Brady deal, more than four years after the launching of the scheme. The slow pace of progress on commercial debt reduction is partly due to banks' reluctance in reaching agreement in cases where they are highly provisioned and discounts in secondary markets are deep, and where the countries involved account for a very small share of their loan portfolio. The policy issue is whether this process should be left entirely to debtors and banks or whether official intervention is required. The conclusion of Brady deals could be accelerated by measures such as appropriate regulatory and tax provisions and, more important, moral suasion by Governments of creditor countries to induce banks to agree to debt reduction.

The Brady plan was essentially conceived for middle-income countries with sizeable debts and resources to finance up-front costs. Many of the smaller countries hold extremely low international reserves and have limited access to funding for such operations. Furthermore, they are unlikely to attract new private flows to the same extent as big debtors. For these countries, a case could be made for lower up-front financial costs and larger debt reduction than those negotiated by countries such as Mexico and Argentina. With the conclusion, or virtual conclusion, of all deals for major debtor countries, the risk of setting a precedent no longer exists.

The reduction of commercial bank debt owed by low-income countries has been treated outside the framework of the menu-based ap-

212 In Mexico, real interest rates dropped by 20 percentage points in the three months following the preliminary agreement of July 1989, an improvement that was maintained subsequently. The experience of Venezuela was almost the opposite: real rates shot up during the first year of the agreement, becoming positive, and have since been oscillating between zero and 20 per cent. In the other countries, real interest rates show no clear trend; if anything, they have tended to increase, except for Costa Rica in 1992.

proach characterizing the Brady plan. Although commercial bank debt accounts for only 10 per cent of low-income countries' total external debt, arrears to commercial banks have had an adverse impact on badly needed trade financing.

Only four countries (Bolivia, Mozambique, Niger, and Uganda) have to date virtually extinguished their commercial debt in buyback operations financed by IDA's Debt Reduction Facility (DRF) for low-income countries, which was established in 1989. Guyana is expected to complete these operations in the near future. In comparison, by late 1992, as many as 17 countries had expressed interest in using this facility.

The DRF lending limit of only $10 million per country and delays in starting DRF operations and mobilizing sufficient bilateral donor support are among the main institutional factors responsible for the slow progress. To speed up the conclusion of debt reduction agreements, the following measures are required: expansion of DRF operations through increased multilateral and bilateral funding; higher DRF lending limits; and enlargement of eligibility from IDA-only countries to all affected low-income countries.■

Chapter V

THE RUSSIAN FEDERATION: DEBT BURDEN AND EXPORT CAPACITY

A. Recent trends

The Russian Federation has inherited from the former Soviet Union an external debt which represents a heavy burden on its economy. Soviet debt more than doubled from 1985 to 1990, as a result of increased import needs, decentralized foreign borrowing, and the eagerness of official and commercial creditors to provide loans to a country with an impeccable repayment record. Most of the accumulated debt was at relatively short maturities. A liquidity crisis emerged in 1989-1990 as the country started building arrears and commercial banks drastically reduced their exposure. Bilateral creditors, particularly Germany, acted as lenders of last resort.

In 1992, with the political and economic turmoil following the breakup of the Soviet Union, debt servicing difficulties worsened, reflecting the collapse of exports and the rapid depletion of foreign exchange reserves. In the face of mounting arrears, Russia approached its official and commercial creditors for a rescheduling. Negotiations with the Paris Club, which lasted more than a year, were concluded in April 1993 and resulted in a debt relief of $15 billion for 1993 (see box 19). Negotiations with commercial banks are still under way, although they are expected to receive substantial impetus from the signature of the Paris Club agreement.

B. Debt burden

After the failure of a sharing arrangement among the former Soviet republics, Russia assumed responsibility for servicing the entire debt of the USSR. Russia accounts for somewhat less than four fifths of total exports from the former Soviet Union. It also controls the latter's foreign assets, most of which are claims on developing countries. These claims have a face value of $143 billion, twice as much as its own debt, but the bulk relates to countries which themselves have severe payments difficulties and have accumulated substantial arrears. The net present value of the amount likely to be recovered is a fraction of the nominal amount.

By the end of 1992, Russian external debt had climbed to $78 billion, the third largest among non-OECD countries after Brazil and Mexico. With the withdrawal of commercial banks - coupled with the activation of guarantees by official export credit agencies and new

Box 19

THE PARIS CLUB AGREEMENT ON RUSSIAN DEBT

Following several deferrals of debt service payments, in April 1993 the Government of the Russian Federation signed its first rescheduling agreement with Paris Club creditors. One of the main obstacles to the conclusion of such an agreement was the allocation of the foreign assets and liabilities of the former Soviet Union among the various republics. Under an initial arrangement, the signatory republics took joint and several responsibility for the debt and were allocated a share of total debts and assets (61 per cent for Russia). This arrangement, however, encountered difficulties. Russia then proposed the so-called zero option, whereby it would assume the entire external debt, while the other republics would renounce their share of assets. This proposal was accepted by all CIS States, except Ukraine, which holds 16 per cent of the total debt, and for some smaller republics. This obstacle was surmounted in the Paris Club meeting itself. The Paris Club agreement contains a new legal framework under which Russia assumes the totality of the debt. This, however, does not prejudge discussions between it and the other republics on their arrangements regarding the debt and assets of the former Soviet Union.

Another major obstacle to the Paris Club agreement was the absence of an upper credit tranche arrangement with IMF. Indeed, over the years, one of the essential features of the operational framework of the Paris Club has been the requirement that a rescheduling country must first conclude an arrangement with IMF. This agreement is one of the rare exceptions to this rule, since creditors eventually agreed to reschedule debt in the absence of such an arrangement. However, a pull-back clause is included in the agreement, whereby creditors may declare its provisions null and void if the Government has not concluded an upper credit tranche arrangement with IMF by 1 October 1993.

In accordance with traditional Paris Club practices, the agreement consolidates medium- and long-term official bilateral debt contracted before 1 January 1991 (the cutoff date). The agreement reschedules principal and interest arrears (including late interest) as at 1 January 1993 and debt service obligations falling due during 1993. As regards debt which was previously deferred, only arrears are rescheduled. The terms applied are also standard: maturity is 10 years, including 5 years of grace. As with other rescheduling countries, interest rates on rescheduled debt will be determined bilaterally on the basis of the appropriate market rates.

Beyond the norm, however, the agreement also deals with short-term debt, some post cutoff-date debt and moratorium interest (i.e. interest due on consolidated amounts). More precisely, it reschedules: (a) arrears and 1993 debt service on short-term debt; (b) 50 per cent of arrears and all 1993 debt service on debt contracted during 1991 (the year following the cutoff-date); and (c) 60 per cent of the moratorium interest accruing during 1993. All these debts are rescheduled over six and a half years, including a grace period of two years.

The agreement also includes a goodwill clause stating that creditor countries agreed in principle to meet again to consider the debt service obligations falling due in 1994.

The debt consolidated totals $15 billion. This is the largest amount rescheduled in Paris Club history, with the exception of the debt reduction packages for Poland and Egypt. The debt service payments resulting from the agreement are sizeable, increasing from about $1 billion in 1994 to $3.5 billion in 1999.

bilateral loans - the share of medium- and long-term debt owed to official bilateral creditors, negligible until the late 1980s, had risen to 55 per cent by 1992, while the commercial bank share stood at 35 per cent (the rest being suppliers' credits and bonds). About half of the bilateral debt is owed to Germany and virtually the same proportion of commercial bank debt is owed to German banks. This, however, does not pose a major threat to such banks, because they have reportedly provisioned more than 90 per cent of their exposure.

The severity of Russian indebtedness can be gauged from a number of indicators. Although the Russian Federation has been so far classified by the World Bank as a moderately-indebted country, for 1993 the ratio of debt to convertible-currency exports is expected to

climb to 224 per cent, just above the 220 per cent threshold for the severely-indebted countries.[213] Before the Paris Club rescheduling, the maturity structure was so short, and arrears so large, that about 60 per cent of the debt stock was due in 1993-1995. For 1993, contractual debt service obligations, including the clearance of arrears, would have amounted to some $32 billion, absorbing about 80 per cent of exports. If non-Paris Club creditors grant debt relief on terms comparable to Paris Club creditors, debt service payments in 1993 are expected to be only $3.5 billion, or less than 9 per cent of exports. As an indication of how private markets perceive the gravity of the country's external financial situation, in April 1993 secondary market prices for Russian commercial bank debt stood at 16 cents on the dollar.

C. Debt servicing capacity

The Russian Federation's debt servicing capacity will depend on: (1) its export potential; (2) its trade with the former republics of the USSR; (3) its import requirements; and (4) the magnitude and terms of official and private capital which it will be able to attract.

The long-term export potential is good, but it will take some time for the country to rehabilitate its export sector, which - among other things - suffers from an obsolete capital stock, with a technological lag of many years behind international standards (see box 20). Over the past two years, oil production has fallen by 25 per cent and the volume of oil exports to countries outside the former Soviet Union by as much as 57 per cent. Although the downward trend in total exports to these countries is expected to be reversed this year, their 1990 level is unlikely to be reached by the end of the decade. The success and pace of the restructuring of the export sector will depend closely on the overall structural transformation of the economy and the maintenance of a competitive exchange rate. Although export expansion is largely a problem of supply, improved access to OECD markets would greatly help exports of manufactures.

Trade and financial relations conducted in roubles between Russia and the other former republics of the USSR have an impact on its trade with the rest of the world, and thus on its earnings of convertible currency. At present, the country is heavily subsidizing its oil exports to many republics and extending rouble financing for those exports. To the extent that Russia increases oil export prices, demands payment in convertible currency, or reduces export credits, there would be either a drop in oil exports to those countries or a rise in their external financing requirements in convertible currencies, which presumably would have to be covered by donor countries. In both cases, Russia could reduce its own financing requirements in convertible currencies, either by switching oil exports to third countries or by receiving convertible currency payments from the other republics. Thus, the financing gaps of Russia and of the other republics concerned should be assessed together and Russia should be given proper recognition of its transfers to them in the form of subsidies and credits.

Resumption of growth and structural change can be sustained only with a strong increase in imports, following the collapse registered in the past two years. A sharp expansion of imports of capital goods will be essential for a fast recovery in oil production and for replacing obsolete equipment. The scope for import substitution is greatest in agriculture and depends on the pace of agricultural reforms, namely improvements in land tenure arrangements, farmgate prices, and distribution channels.

Because of its debt servicing difficulties, Russia is unable to attract a significant volume of commercial bank lending and lacks access to international capital markets. Foreign direct investment (FDI) is expected to play a major role in the transformation of the Russian economy, especially in the energy sector, but current domestic economic and political uncertainties discourage foreign investors. There are other obstacles to FDI, including issues relating to the legal and regulatory framework, the slow pace of privatization and restrictions on the ownership and use of land. Despite a major

[213] While World Bank indicators cover exports of goods and services, figures for Russian exports do not include services, which are, however, marginal.

Box 20

EXPORT CAPACITY OF THE RUSSIAN FEDERATION

Given its huge reserves of natural resources and its industrial base, Russia has a large export potential. In the past two years, however, its exports fell sharply - by a cumulative 50 per cent - reflecting the chaotic state of the economy and the ensuing drop in economic activity as well as the disruption in trading relations with the former CMEA countries. [1] Lack of intermediate inputs and insufficient investment, which severely constrained production capacity in key export sectors, also affect short- and medium-term prospects.

Exports have also been hindered by impediments such as export quotas, licensing schemes and export taxes, which have been maintained for a large number of goods. In addition, a centralized exports scheme was introduced in January 1993. It affects some 25 per cent of total exports and involves the collection of export taxes in foreign currency. This scheme is deemed to be unfavourable to export expansion.

Energy exports (oil and natural gas) account for approximately half of total exports. While the country is endowed with huge reserves of oil and gas and is the world's largest exporter of energy, its economy is also one of the world's most energy-intensive. Reducing domestic energy consumption, which absorbs some 60 per cent of output, is as vital as increasing output to generate larger exportable surpluses. Oil production has slipped precipitously for more than three years and now stands at some 40 per cent below the level reached in the late 1980s. The factors responsible for this decline include shortages of specialized equipment (previously obtained from the other republics); the decline in productivity of the old fields, due partly to poor maintenance and inferior technology; lack of development of new fields, which would require large investment outlays and sophisticated equipment; and a tax system which discourages production.

Another factor adversely affecting prospects in the energy sector is the conflict between the central authority and regions. Many of the energy-producing regions, especially in western Siberia, are pushing the central Government towards revenue-sharing agreements, claiming in some cases full authority over underground resources located in their territory. This additional uncertainty discourages foreign investment.

Reforms are expected to halt the decline in oil production by the mid-1990s, but no major rise in output is likely to take place before the end of the decade because of the time lag between investment in exploration and production. A fall in domestic consumption is predicated on a higher relative price of oil and the introduction of energy-saving technologies. These diverging trends in production and consumption could lead to sharply increased earnings by the end of the decade.

The gas sector seems to be faring better, as both production and exports have stabilized since 1990. Here, too, however, endemic problems exist, such as constraints in pipeline capacity. Nevertheless, exports could rise steadily over the next few years, in view of the growing European markets, provided that pipeline capacity is increased.

Exports of machinery and equipment (roughly 10 per cent of total exports) declined by 50 per cent over the past two years. Output was constrained by supply problems in the capital goods sector and by the obsolescence of equipment. Moreover, the majority of Russian machinery and equipment cannot compete with exports from OECD countries and newly industrialized countries on technical standards, quality, and other non-price characteristics. Export promotion is hampered by the lack of marketing skills and channels, the difficulty in acquiring spare parts, and inappropriate after-sales services. There is little hope that the changes required in Russian manufacturing to overcome these problems will take place in the next few years.

Medium-term prospects for gold exports are not encouraging. Russia is the world's third largest gold producer, behind South Africa and the United States. Production problems have led to a decline in output - about 50 per cent since 1990 - forcing the country to run down reserves further. In 1992, gold exports, estimated at $1.1 billion, accounted for only 3 per cent of total exports. In addition to difficulties resulting from under-investment and inferior technology, the industry is experiencing a rapid process of decentralization, which might set the path for the rest of the mining industry. Local gold mine enterprises, enrichment centres and miners' cooperatives tend to break away from the federal and regional associations to form independent joint-stock

Box 20 (concluded)

companies. This renders even more complicated the conflict between the regions and the centre. It might also slow down prospective FDI, which at present is virtually absent but is deemed to be crucial to the development of the sector.

On the demand side, the country is faced with the collapse of its traditional export markets in Central and Eastern Europe which cannot be easily replaced by other outlets. Expansion of exports to OECD countries is hindered by trade restrictions affecting non-energy products, such as textiles, steel, uranium, and high technology items.

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1 "Exports" in this box exclude exports to the former republics of the USSR.

increase in the number of joint ventures, the net flow of FDI is still very small - less than $1 billion in 1992. With a small stock of FDI (around $2.5 billion), the scope for increased flows through reinvested earnings is minimal. FDI is expected not to exceed $5 billion by 1995.[214]

Over the next few years, official external assistance will be crucial for the restoration of Russian creditworthiness. In April 1992, the G-7 announced a $24 billion package in support of the country's reform effort, including $21.5 billion from multilateral and bilateral sources and $2.5 billion rescheduling of interest on Paris Club debt. In 1992 commitments from multilateral and bilateral creditors amounted to $16.8 billion, resulting in a shortfall of $4.7 billion. Furthermore, greater-than-expected reliance on bilateral credits (with an average maturity of three years), rather than on longer-term multilateral resources, has aggravated the debt burden. However, in April 1993, the Paris Club rescheduling of interest was larger than envisaged, thus partly offsetting the shortfall in new money.

In April 1993, the G-7 pledged a new $43 billion package, including the $15 billion debt relief granted by the Paris Club. The remaining $28 billion would be provided by bilateral creditors ($10 billion) and IFIs ($18 billion). This compares with an external financing requirement of $40 billion in 1993 - as large as exports - and a residual financing gap of $11 billion, after taking into account debt relief, both already obtained and expected, amounting to $29 billion. The pledges need to be turned swiftly into commitments, so that they can generate enough disbursements in 1993 to fill the financing gap, which is consistent with an 18 per cent surge in imports. The international financial community has shown increased flexibility in the design of the package, which includes $3 billion disbursements under IMF's new Systemic Transformation Facility (STF).[215] Similar flexibility and progress toward the formulation of an economic programme by the Government would be needed for the prompt disbursement of the other components in order to avoid further import cuts or accumulation of arrears.

Future external financing requirements might not be as large as in 1993, as the country is expected to generate a trade surplus by 1995. But their size will also depend on the terms of new borrowings. If new borrowings were to continue to carry relatively short maturities and market interest rates, the financing requirements, though declining, would remain disturbingly high. Debt service obligations would continue to rise in absolute terms, and most probably also as a proportion of exports, until the mid-1990s, since the debt service on new borrowings would be larger than the fall in the servicing of the old debt.

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214 See World Bank, *Russian Economic Reform: Crossing the Threshold of Structural Change* (Washington, D.C., 1992), p. 51.

215 STF conditionality is tailored to the special situation of the economies in transition, which are unable to formulate a programme that IMF could support under its existing policies. Disbursements of STF resources carry standard interest charges, but the repayment period (10 years) is longer than for normal stand-by arrangements.

D. Options for the treatment of Russian debt

Under these circumstances, further rescheduling of Russian debt will be inevitable. Another Paris Club rescheduling is already expected for 1994, in view of scheduled debt service which may exceed 50 per cent of exports. As box 19 illustrates, the Paris Club has already shown a high degree of flexibility in rescheduling the Russian debt, though the traditional short-leash approach has been maintained. The lessons of the international debt crisis can be useful in this respect. If the Paris Club agreements continue to deal only with debt falling due each year, rather than with the entire stock of debt, there is a high risk of repeated reschedulings which will exacerbate the debt problem. Arrears would continue to emerge, with a negative impact on new flows. The short-leash approach creates uncertainty, thus providing further fuel to capital flight. Another lesson of the debt crisis is that coordination of action by the various groups of creditors is essential to avoid delays in providing adequate debt relief, and to ensure a fair sharing of the burden between official and private creditors. Russia needs a comprehensive medium-term debt relief programme, to be designed under official leadership, with the aim of accelerating the restoration of its external financial viability.

An appropriate response to the country's debt servicing difficulties is delayed by the problems being encountered in formulating and implementing a reform programme. The policy issue is whether a track record of policy reforms should be established before a comprehensive debt restructuring is considered. It has been argued that, although a comprehensive treatment of the Russian debt can provide the country with a badly needed breathing space, at the same time it can delay the implementation of adjustment measures. However, this argument assumes that adjustment is feasible in the absence of debt relief. On balance, debt relief will continue to be needed, although it alone will not be sufficient for the correction of Russian macroeconomic imbalances. No country should be denied debt relief because of poor performance, when good performance is unattainable without it.

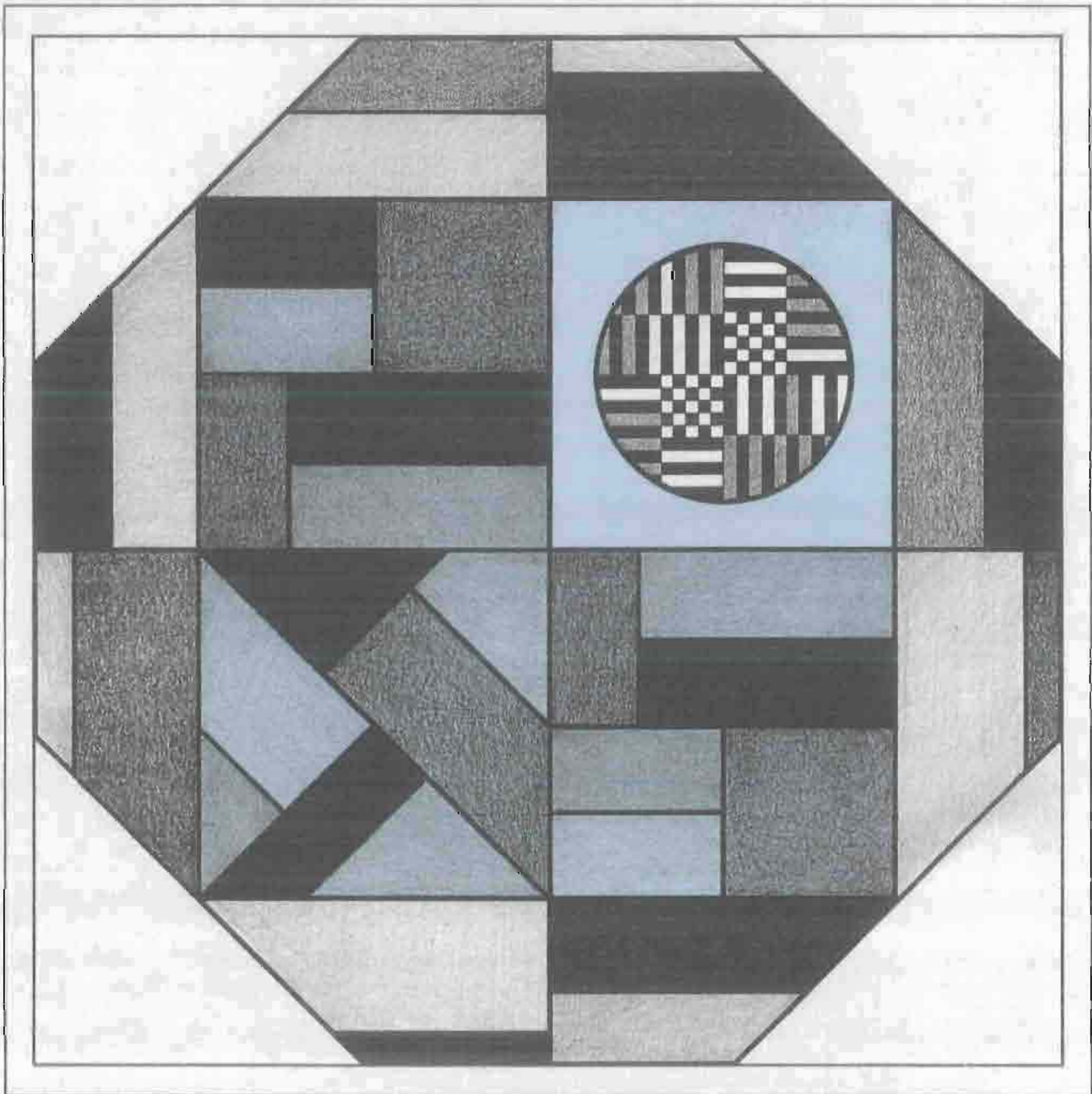
There are many uncertainties which make it difficult to say whether the current liquidity crisis is being handled in ways that will jeopardize the country's solvency. If a solvency crisis threatens, debt and debt service reduction will be warranted, perhaps accompanied by provisions to allow creditors a share of any unexpected increases in oil revenues.[216]

In dealing with Russian debt, the international community should also take into account the financial relations between Russia and other debtor countries, including the other former Soviet republics. With the country's growing integration into the international financial community, its participation in the Paris Club as a creditor could take place in the near future. If it were itself to grant in that forum any debt reduction with regard to its claims on debtor countries, this could be acknowledged by its creditors in terms either of increased financial assistance or of equivalent relief on Russian debt.

To conclude, Russia is well endowed with natural resources, human capital and technology. Restoring its creditworthiness and sustained growth will depend essentially on the successful implementation of structural reforms. But the transition period is likely to be difficult. The country has inherited a large stock of relatively short-term debt, and reforms need external financing. Along with the provision of adequate new money, debt restructuring should ease the transition, rather than make it ultimately harder and longer.■

216 See chap. II, sect. B.1(c) above.

ANNEXES



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Annex 1

RECENT DEVELOPMENTS RELATING TO INTERNATIONAL COMMODITY AGREEMENTS AND ARRANGEMENTS

A. Cocoa

International cooperation on cocoa dates back to the mid-1950s. However, the first International Cocoa Agreement was concluded in 1972 and was followed by three others, in 1975, 1980 and 1986.

One of the principal objectives of the four agreements concluded to date has been the prevention of excessive price fluctuations. The main economic mechanism for achieving this objective has in all cases been a buffer stock. The Agreements of 1972 and 1975, however, also included an export quota scheme, whereas, the 1980 Agreement relied exclusively on a buffer stock. For the first time, the 1986 Agreement also prescribed a supplementary price-defence mechanism in the form of a cocoa withholding scheme. Since the filling of the buffer stock soon after the Agreement entered into force, there has been no international intervention in the world cocoa market, mainly as a result of divergences between producers and consumers; and when the 1986 Agreement was extended in 1990, until 30 September 1993, the price support mechanisms were in effect discontinued.

Producers and consumers are currently negotiating a successor to the 1986 Agreement within the framework of the United Nations Cocoa Conference, 1992. At its fourth part, held in March 1993, the Conference reaffirmed its intention to negotiate an agreement with economic mechanisms. Following a special session of the International Cocoa Council, in which a decision containing elements for the conclusion of the negotiations on the new Agreement was adopted, the President of the Conference recommended the reconvening of the fifth part of the Conference from 5 to 16 July 1993. In June 1993, the Council decided to provide for a new agreement concerning production policy, consumption, financing, participation, information and studies, R&D, sponsoring of Common Fund projects and the International Cocoa Organization as a forum for discussion of all matters concerning cocoa.

B. Coffee

The International Coffee Agreement, 1983, with its economic provisions suspended since July 1989, has been extended to 30 September 1993. In April 1992 the International Coffee Council established a Negotiating Group for the negotiation of a new, market-oriented International Coffee Agreement on the basis of a universal quota supported by an effective system of controls. The Negotiating Group has not been able to bridge the gap be-

tween the different views on the question of the continuous operation of the selective adjustment of quotas under a universal quota system. This was an obstacle for further discussions on other important issues, such as the number of groups of coffee for a selective system, the distribution of quotas, votes, the duration of a new Agreement, and imports from non-members.

At its meeting of 29 April 1993, the Executive Board of the International Coffee Organization recommended that the issue of a possible one-year extension of the current Agreement till 30 September 1994 be put to a postal vote in order to maintain international cooperation on coffee and allow more time for renegotiation of a new Agreement. Following the postal vote, the International Coffee Council agreed, on 4 June 1993, to the further extension of the International Coffee Agreement, 1983, for one additional year (i.e. until 30 September 1994), in the belief that this would allow time for negotiation of a new Agreement.

The fluctuations of coffee prices in 1992 were very much influenced by this negotiating process. After the largely sterile meeting of the Council in July prices fell to their lowest levels.

C. Sugar

The United Nations Sugar Conference, 1992, established the text of the International Sugar Agreement, 1992, to succeed the 1987 Agreement which expired on 31 December 1992. The 1992 Agreement entered into force on 20 January 1993 for a period of three years, with a possibility of extension for successive periods of two years each.

The objectives of the new Agreement are to ensure enhanced international cooperation in all matters relating to world trade in sugar, including establishment of a forum for intergovernmental consultations on sugar and on ways to improve the world sugar economy, facilitation of trade by collecting and providing information on the world sugar market and that of other sweeteners, and the encouragement of increased demand for sugar, particularly for non-traditional uses. New provisions include an article whereby due consideration shall be given to environmental aspects in all stages of sugar production. The two major differences from the 1987 Agreement are: (a) the introduction of a single list of members rather than the previous separate lists of exporters and importers; and (b) the possibility of taking full advantage of the Common Fund for Commodities.

D. Wheat

International cooperation in wheat can be traced back to 1933, when the first International Wheat Agreement was established. The present International Wheat Agreement, 1986, consists of two separate legal instruments: the Wheat Trade Convention, 1986 and the Food Aid Convention, 1986, which are linked by a common preamble.

The main objectives of the Wheat Trade Convention are to further international cooperation in all aspects of trade in wheat, and other grains, to promote the expansion of international trade in grains, to contribute to the stability of international grain markets, to enhance world food security, to provide a forum for exchange of information, and to provide an appropriate framework for the possible negotiation of a new international agreement or convention with economic provisions. In December 1992 this Convention was extended by decision of the International Wheat Council until 30 June 1995.

The objective of the Food Aid Convention is to secure, through joint efforts by the international community, the achievement of the target of at least 10 million tons of food aid annually to developing countries in the form of grain suitable for human consumption. The duration of this Convention was extended until 30 June 1995.

E. Olive oil

The International Agreement on Olive Oil and Table Olives is one of the earliest worldwide commodity agreements. The first version was signed in 1956 and entered into force in 1959. The United Nations Conference on Olive Oil and Table Olives, 1993, which took place in Geneva from 8 to 10 March, adopted the Protocol extending the 1986 Agreement, with amendments, until 31 December 1998, with the possibility of two further extensions not exceeding two years each.

Though the Agreement does not contain economic clauses, it has an impact on the olive oil and table olives economy by providing, in particular, the framework for developing multilateral technical cooperation among its members. The International Olive Oil Council (IOOC) devises, promotes and prepares relevant programmes of technical cooperation.

In June 1992 the Governing Council of the Common Fund approved a grant of SDR 365,000 for a project on Research and Development for the Genetic Improvement of the Olive.

F. Natural rubber

A decision is to be taken soon on renegotiation of the International Natural Rubber Agreement, 1987, which has successfully kept prices within a price range that gives producers at least some support. Producers in the Association of Natural Rubber Producing Countries have a number of ideas under consideration for improvements, including ways in which long-term production capacity could be brought into line with the ever-changing forecasts of long-term global consumption. The International Rubber Study Group continues to serve as a forum for discussion of a wide range of matters concerning natural and synthetic rubber and has members representing both of these two types.

Some problems arose recently in the functioning of the 1987 Agreement. A revision of the reference price should have taken place as a routine matter at a session of the International Rubber Council in January 1993. Article 31, paragraph 1(b), provides that, if the daily market indicator price (DMIP) over the six-month period prior to review is below the lower intervention price (LIP), the reference price shall be automatically revised downwards by 5 per cent. The actual six-month average of DMIP was 175.95 Malaysian/Singapore cents per kg, a mere 0.05 cents below LIP. Producers rejected the 5 per cent price reduction while consumers insisted that the terms of the Agreement must be followed. Put to a ballot, renegotiation of the Agreement was supported by exporting countries but rejected by importing countries in view of the controversy over the revision of the reference price. The dispute has stalled further consideration of a decision on renegotiation of the Agreement, which expires on 28 December 1993.

G. Tropical timber

In recent years, many organizations at the international, national and non-governmental levels have had discussions and taken decisions on tropical forests and trade in tropical timber. The United Nations Conference on Environment and Development (UNCED), which took place in Rio de Janeiro in June 1992, is of particular importance. It met at the level of Heads of State and Government and was the culmination of a long process of reflection and dialogue on issues that included sustainable management of all forests, involving Governments, the United Nations system and other international organizations, academic institutions, non-governmental organizations and the business community. The

subject of forests was extensively discussed in the preparatory process and at the Conference. The Conference adopted a "Non-legally binding authoritative statement of principles for a global consensus on the management, conservation and sustainable development of all types of forests" (known less formally as the "Statement of Forest Principles"). Agenda 21 adopted by the Conference contains a number of chapters relevant to tropical timber, in particular chapter 11 on "Combating deforestation".[a]

Since its inception in 1985 the International Tropical Timber Organization (ITTO) has approved 179 projects, with a total budget of $150 million. The International Tropical Timber Council has agreed that "through international collaboration and national policies and programmes, ITTO members will progress towards achieving sustainable management of tropical forests and trade in tropical timber from sustainably managed resources by the year 2000".[b] To that end, it adopted sets of Guidelines for sustainable management and protection of biological diversity in tropical forests and recommended them as international reference standards to members and the international community in general. Tropical timber producing countries have expressed the view that temperate timber production should be subject to equally stringent guidelines.

The first part of the United Nations Conference for the Negotiation of a Successor Agreement to the International Tropical Timber Agreement, 1983, was held from 12 to 16 April 1993 and a second part from 21 to 25 June 1993. Main issues for the Conference (to be reconvened from 4 to 8 October 1993) are expansion of the scope of a new agreement to cover timber from all sources and mandatory finance for activities, proposals favoured by producers, and proposals by consumers for inclusion of ITTO's target of the year 2000 as the date by which all tropical timber in international trade should come from sustainably managed resources as well as for a greater policy role for the Organization.

H. Iron ore

The Intergovernmental Group of Experts on Iron Ore (IGEIO), which operates under the auspices of UNCTAD, has been in existence since 1986 with the aim of strengthening international cooperation on iron ore issues, notably through improving market transparency and providing a forum for regular dialogue between iron ore producers and consumers. As the only study-group type of forum exclusively devoted to iron ore, the Group attracts at its annual sessions policy-makers in government and industry from about 40 countries, representing all those involved to any significant extent in world trade in iron ore, with the exceptions of China and Mauritania. Over these years, the Group has been active in improving statistics and market transparency, reviewing and monitoring the market situation and outlook for iron ore, and facilitating closer cooperation through regular exchanges of views and information on issues of concern to the iron ore industry worldwide. UNCTAD also publishes, on a regular basis, statistics and market reports on iron.

I. Bauxite

A dialogue between bauxite producing and consuming countries, covering not only bauxite but also alumina and aluminium, was initiated in UNCTAD in 1991, when an *Ad hoc* Review Meeting on Bauxite was held. At a second Meeting, in April 1993, attention was given in particular to the difficult market situation and the need for adjusting output to demand. The Meeting also discussed the need for increased transparency of the market, in

[a] Recent developments of relevance to the negotiation of a successor agreement to the International Tropical Timber Agreement, 1983, including the relevant proceedings of UNCED, are reviewed in a note by the UNCTAD secretariat of 26 February 1993 (TD/TIMBER.2/3). For the text of Agenda 21 and the Statement of Forest Principles see United Nations Department of Public Information, *Earth Summit. Agenda 21. The United Nations Programme of Action from Rio* (United Nations publication, Sales No. E.93.I.11).

[b] Decision 3(X) of the Council, 6 June 1993.

particular as regards improved information on production, consumption and trade of bauxite, alumina and aluminium of the republics of the former USSR.

J. Copper

International cooperation in copper has recently taken the institutional form of the International Copper Study Group, which was formally established in January 1992 and started effective operations in the course of 1993. It is composed of 22 members, including producing and consuming countries which represent approximately 78 per cent of world copper trade. Its main objectives are: consultations and exchange of information among the main actors of the copper market; improvement of statistics; regular assessments of the market situation and outlook (including long-term trends); and consideration of special problems or difficulties which exist or may arise in the international copper economy.

K. Tin

At the end of June 1989, the sixth International Tin Agreement effectively expired, thus putting an end to the longest-standing regulated commodity market. However, all operations under the Agreement had already ceased by June 1988 and the final settlement of all debts was completed at the end of March 1990.

Following an initiative from the Association of Tin Producing Countries (ATPC), the terms of reference for the establishment of an International Tin Study Group (ITSG) were negotiated under the auspices of UNCTAD and adopted at a United Nations Conference in April 1989. So far, only 11 countries (Belgium, France, Greece, Indonesia, Italy, Luxembourg, Malaysia, Netherlands, Nigeria, Portugal, Thailand) and EEC (accounting together for some 37 per cent of world trade in tin) have notified their provisional or definitive acceptance of the Terms of Reference. The Study Group can be formally established only if countries representing at least 70 per cent of world trade in tin ratify the Terms of Reference. The UNCTAD secretariat has been requested to continue the statistical work previously undertaken by the International Tin Council and the UNCTAD Trust Fund on Tin Statistics until the Study Group is established. The statistical activities are now being undertaken by UNCTAD as part of its regular work, and six issues of the *Bulletin of International Tin Statistics* have already appeared.

L. Tungsten

The Intergovernmental Group of Experts on Tungsten (IGET) was established in October 1992, with the same membership and terms of reference as the Committee on Tungsten, to succeed the latter body which had been suspended following UNCTAD VIII. The establishment of IGET thus allows continuity of the forum started in 1964 when UNCTAD, at its inception, established the Committee on Tungsten. Like that Committee, it is designed to provide opportunities for undertaking international consultations concerning trade in tungsten, promoting the improvement of statistics on tungsten and following developments in the tungsten market. The Group currently has 29 members, consisting of producing and consuming countries representing around 95 per cent of both world production and world consumption. It held its first session from 7 to 11 December 1992 with, as the main substantive items on its agenda, the examination of statistics and review of the current market situation and outlook, and the consideration of project proposals which could be submitted for possible financing under the Second Account of the Common Fund for Commodities. A major challenge facing the Group is attracting a larger participation by industry experts in its meetings.■

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Annex 2

SUMMARY OF SALIENT TRADE POLICY MEASURES AND ACTIONS TAKEN SINCE 1990[a]

A. Developing countries and China

Algeria: All import licensing procedures were abolished as of 1 April 1991. Import monopolies were also abolished. Imports of leather and textile articles, including yarn, fabrics, clothing, footwear, carpets and floor coverings, were temporarily suspended.

Argentina: A new tariff structure was introduced at the beginning of 1991, establishing three levels of tariffs: zero, 11 and 22 per cent *ad valorem*. The tariff average, which was 38.2 per cent in 1988, fell to 18.3 per cent. On 30 October 1991 new tariff levels were set for capital goods (duty-free), raw materials (5 per cent), intermediate goods (13 per cent) and finished products (22 per cent) and the tariff average dropped further to 12.2 per cent. In April 1991 licensing and other non-tariff restrictions were abolished except for 22 items (vehicles and parts, which remained subject to restrictions). Except for these products, GATT article XVIII is no longer invoked. The remaining import controls were removed on 30 October 1991.

Bangladesh: A significant move towards greater transparency and simplicity in the tariff structure was made in 1991. The development surcharge, regulatory duty and sales tax were abolished in July 1991. The programme to rationalize the import system involves lowering the maximum tariff on all items to 100 per cent (with the exception of a few specified luxury items) in the near future; thereafter maximum rates will be reduced to 75 per cent selectively. Restructuring import duties in the textiles, steel and light engineering sectors is also contemplated. After the liberalization undertaken in July 1989 and July 1990, which reduced the number of four-digit headings subject to restrictions from 26 per cent to 20 per cent of the total, a further 59 items were removed from the controlled list in August 1991 under the 1991-1993 Import Policy Order. In addition, "right to refusal" provisions were withdrawn from 47 import items, leaving only 4 items now subject to such provisions. (Under "right of refusal" provisions, imports can be limited at the request of public enterprises that produce substitutable products). All remaining restrictions are to be removed by 1994, except for about 80 items which will remain restricted for health, social, religious or security reasons, and about 7 items considered sensitive.

Brazil: Following the programme of tariff reductions introduced in 1990 the average tariff rate of 37 per cent was brought down to 25 per cent in 1991 and to 20.1 per cent in 1992. Tariffs will be further reduced, to an average of 14 per cent, by 1994. GATT article XVIII is no longer invoked. The Informatics Law, which limited market access to products in the informatics sector, was abolished in October 1992.

Chile: As from 12 June 1991 a uniform reduced import duty rate of 11 per cent is applied, instead of the previous 15 per cent in force since January 1988. Chile has bound its entire tariff schedule at a maximum rate of 35 per cent.

China: Import duties on 225 tariff lines were reduced as from 1 January 1992, in addition to

[a] The list of countries and actions taken is not exhaustive. This summary does not cover actions regarding anti-dumping and countervailing duties or voluntary export restraints.

another 83 items for which tariffs have been reduced since 1986. In October 1992 China undertook to eliminate within two years nearly 75 per cent of all import licence requirements, quotas, controls and restrictions.

Colombia: Several amendments were made to the rates of the Customs tariff, bringing down the average rate to 11 per cent in March 1992. A new tariff structure with five levels of tariffs (zero, 5, 10, 15 and 20 per cent *ad valorem*) was introduced at the end of January 1992. The import surtax (surcharge) was reduced in September 1991 from 10 per cent to 8 per cent (5 per cent for some specific items). In February 1992 the surtax was eliminated and replaced by tariffs. A system of variable levies was introduced in June 1991. It operates in conjunction with the dismantling of the prior licensing regime in force for agricultural and agro-industrial products. GATT article XVIII is no longer invoked.

Costa Rica: Tariffs on 8,000 items were reduced in February and March 1992. The entire tariff schedule is to be bound at 55 per cent by November 1993.

Ecuador: The tariff schedule, with duties ranging from 5 per cent to 35 per cent, was superseded by a new tariff in 1992, with duties of 5, 10, 15 and 20 per cent. Some items enter duty-free, while imports in the automotive sector are subject to duties of 40 per cent. Import restrictions, including certain para-tariff measures and licensing, were removed as part of the trade liberalization programme, except for those imposed on imports of certain primary products for the pharmaceutical industry or for national health and security reasons.

Egypt: As from May 1991, procedures regarding prior approval to import for certain products were eliminated. In August 1992, measures affecting imports of some 30 items and most export restrictions were removed.

El Salvador: Tariffs have been gradually reduced following the adoption of a wide economic reform programme in June 1989. The entire tariff schedule was bound at the maximum rate of 50 per cent *ad valorem* at the time of accession to GATT in 1991. Tariffs will be bound at a ceiling level of 40 per cent as from December 1993. Import prohibitions have substantially been abolished and discriminatory tax exemptions, as well as the protective effect of internal taxes, have been suppressed following the economic reform programme adopted in 1989. Controls, monopolies, subsidies and other trade-restraining measures were eliminated in order to deregulate markets. Quantitative restrictions, including prohibitions and restrictive licensing, are scheduled to be removed in 1993.

Ghana: Various amendments to the tariff schedule made since 1988 resulted in a tariff rate averaging 17 per cent in 1991.

Guatemala: In accordance with the terms of its accession to GATT, various categories of non-tariff measures, affecting 134 products, are being removed. Quantitative restrictions are to be phased out by 1994.

Honduras: The gap between minimum and maximum tariff rates (respectively 4 per cent and 35 per cent until 31 December 1991) has been further narrowed, with substantial reduction of the maximum rate after 1 January 1992.

India: Far-reaching changes have been made following the Trade Policy Reforms announced on 4 July 1991 with the main objective of reducing significantly discretionary import licensing. A new instrument called "Exim Scrips", superseding the previous Import Replenishment Licensing Scheme, was adopted so as to allow exporters to obtain access to international markets for raw materials, components and spares. Exim Scrips are issued against exports at a basic rate of 30 per cent of f.o.b. value. For certain value added agricultural products, electronics, some pharmaceutical products, marine products and advanced engineering goods the rate is 40 per cent. Exim Scrips are freely tradeable and can be used to import products specified in six categories of goods. Moreover, the procedure for import of capital goods has been simplified. Licensing requirements have been liberalized or simplified for several product categories. Administrative controls on imports of capital goods, intermediate goods and most raw materials were removed in April 1992.

Indonesia: Import duties on 559 HS tariff items and surcharges on 301 HS items were reduced or eliminated in June 1991. The rate of 40 per cent on most finished products was reduced to 30 per cent; raw materials and semi-finished products are mostly subject to a rate of 15 per cent. Imports were liberalized for a total of 322 items previously prohibited or restricted, including beverages, glassplate, paper, tyres, household equipment, paints, cosmetics and iron and steel products.

Malawi: All imports were liberalized at the end of 1991, except for some 30 strategic items still subject to licencing.

Mexico: Tariffs were reduced to an average of 13.1 per cent in 1992, from averages of 22.6 per cent in 1986 and 27 per cent in 1982. Import

licensing requirements covered less than 10 per cent of total imports in 1991, reflecting a major liberalization in comparison with the situation 10 years earlier, when virtually 100 per cent of imports were subject to restrictive licensing. Requirements for the remaining 24 items in the pharmaceutical sector are scheduled to be eliminated by the end of 1993. A gradual liberalization programme in the automotive sector is also being implemented.

Morocco: Import authorization requirements were removed for 425 items in 1991 and for 460 items in 1992. 416 items were liberalized by transferring them to the list of articles for which licences are granted automatically.

Nigeria: Tariffs on a wide range of products in the health, education, transport, agriculture and industry sectors were reduced in early 1992.

Pakistan: Reforms that were initiated in mid-1988 continued within the budgets and trade policy orders announced in 1989, 1990 and 1991. These orders had the objective of replacing most non-tariff restrictions by tariffs; reducing the maximum levels of duty rates and rationalizing the tariff structure; and increasing the ceilings for certain types of imports. A large number of specific duties were converted to *ad valorem* rates. In June 1990 the rate on 270 items was reduced from 125 per cent to 100 per cent; the maximum rate was reduced to 95 per cent in January 1991 and, with some exceptions, to 90 per cent in June 1991. The number of items in the "negative list" (items prohibited for import, unless specifically authorized) was significantly reduced to 93 in 1991, compared with 285 prior to July 1989. The coverage of the restricted list was also reduced, to some 60 items. The ceilings on the value of certain categories of imports were raised.

Peru: Trade was further liberalized in March 1991 through a Presidential Decree which, with exceptions for reasons of public health, security, etc., repealed all restrictions of a para-tariff nature - licences, decisions, prior authorizations and consular authorizations, import registration, registers of importers or exporters, administrative requirements, permits, prior approval and prior conditions of any type affecting the import or export of goods in Peru. GATT article XVIII is no longer invoked.

Philippines: A Tariff Reform Programme has been in effect since August 1991, aimed principally at rationalizing the protection structure through the reduction of the overall level of tariffs and their dispersion within and across industries. A simplified tariff structure, with four levels of duty rates (3, 10, 20 and 30 per cent), was established, to be phased in from August 1991 to July 1995. The average tariff rate was reduced from over 40 per cent in 1980 to 25.6 per cent in 1992. The 9 per cent import levy was reduced in August 1991 and, with a few exceptions, removed in May 1992. Nearly 300 items were liberalized in 1991 and 1992, leaving a further 66 to be liberalized by 1994. After the completion of the Programme, 69 items will remain restricted for health, safety and national security reasons.

Republic of Korea: Quantitative restrictions on some 100 items were eliminated in January 1991 in addition to more than 1,000 items which were liberalized between 1986 and 1990. Under a three-year import liberalization programme for 1992-1994, restrictions affecting 133 products, mostly agricultural, are scheduled to be phased out (43 in 1992, 45 in 1993 and 45 in 1994). Remaining restrictions taken for balance of payments purposes under GATT article XVIII will be eliminated, and others will be brought into conformity with GATT, by 1 July 1997.

Sri Lanka: The tariff structure has been further simplified considerably, by the adoption in November 1991 of a tariff with four levels of duties, to replace the 13-band structure established in 1990. The present duty levels are: 10 per cent for basic raw materials, machinery, equipment and similar capital goods; 20 per cent for components, semiprocessed and intermediate goods; 35 per cent for certain finished goods; and 50 per cent for other finished products. Simultaneously, tariffs had been eliminated for 2713 HS items and reduced for 2937 HS items.

Thailand: Tariffs on various categories of products were reduced in 1991 and 1992, including products in the automotive sector, computers, chemicals, iron and steel and several other products. Non-automatic licence requirements for imports of most passenger motor vehicles and 10 other product categories were lifted and replaced by automatic licences in May 1991.

Trinidad and Tobago: Under a reform programme introduced in 1990, the negative list of imports was abolished in July 1992, except for a few categories of imports. Imports can be made under specific licences and subject to a temporary surcharge that is to be phased out by 1995. The import procedures were considerably simplified.

Tunisia: Upon accession to GATT in August 1990, tariff rates on about 1,000 items were bound at levels ranging from 17 per cent to 52 per cent. Licences and quantitative restrictions on imports of a great number of products were abolished. As from May 1992, 85 per cent of all imports were liberalized.

Uruguay: In September 1991, tariff rates were reduced and a minimum rate of 10 per cent and a maximum rate of 30 per cent established. In April 1992, tariffs were further reduced and a new tariff structure with four rates (zero, 10, 17 and 24 per cent) was established.

Venezuela: The weighted tariff average, which amounted to 35 per cent in 1988, has been steadily reduced - to 17.4 per cent in 1989, 13.5 per cent in 1990 and 10 per cent in 1991. Whereas in 1988 the proportion of items with a tariff of 20 per cent or less was 44 per cent, it had risen to 85 per cent by 1991. Tariffs in the automotive sector have been substantially lowered: the ceiling binding level was lowered to 40 per cent in 1992 and the maximum applied rate was reduced to 20 per cent. The number of tariff items subject to quantitative restrictions has been substantially reduced, from 2,204 in 1988 to 200 in 1991. Import prohibitions and most restrictive import licensing requirements were eliminated as of 1 October 1991. Other quantitative restrictions will be phased out by 1995.

B. Developed market-economy countries

Australia: As part of a wide package of measures to increase international competitiveness, maximum tariffs applied on most products were set at 10 per cent and 15 per cent as from July 1992, and will be further reduced to a general rate of 5 per cent by July 1996. Tariffs on passenger cars are to be reduced in annual steps of 2.5 percentage points from 35 per cent in 1992 to 15 per cent in 2000. Reduction of tariffs on textiles, clothing and footwear is being accelerated so that the maximum rate will drop to 25 per cent by 2000. Quotas limiting the amount of textiles, clothing and footwear imported into Australia were abolished in March 1993.

Austria: Tariff reductions on a large number of tariff lines which were implemented on a provisional basis on January 1990 until 31 December 1991, as an advance contribution to the results of the Uruguay Round, have been extended for another two years until 31 December 1993. Import quotas were imposed for the period March-December 1990 on certain types of prepared fowls. Imports of certain medicaments containing penicilins or other antibiotics were liberalized as from 1 January 1991. The import quota régime applied since 1987 to broken rice was terminated on 31 October 1991. Imports of cement from all sources, excluding EEC and EFTA countries, have been subject to quota restraints since September 1991.

Canada: Tariffs on a number of household products and consumer goods were eliminated in February 1992. As of 1 January 1993, MFN rates of duty on a range of textile products are being reduced progressively by 1.5 percentage points each year, until maximum MFN rates for fibres, yarns and fabrics are 5 per cent, 10 per cent and 16 per cent, respectively. All of the cuts involved are scheduled to be completed by 1 January 1998.

European Communities: On July 1991 EEC and Japan reached an agreement on imports of Japanese automobiles into the Community. The objective of the Community is to fully liberalize imports of automobiles by eliminating quantitative restrictions in five member States by the end of 1992 and gradually increasing the level of imports in these countries during a transitional period until 1999. National import restrictions maintained under Council regulation 288/82 were significantly reduced in October 1991 and September 1992. The number of restrictions was reduced from 71 to 30 in France and from 48 to 19 in Italy. Restrictions on imports from the three Baltic republics and CIS countries were removed in January 1992. The interim association agreements with (former) Czechoslovakia and with Poland and Hungary entered into force in March 1992, and imports from these countries were freed from all quantitative restrictions, except for coal and textile products. Emergency measures taken in January 1986 under GATT article XIX on provisionally preserved raspberries were terminated in September 1991.

France: Quantitative restrictions on imports of umbrellas, certain ceramics, porcelain and pottery, certain toys and certain electronic measuring instruments were removed in February 1991.

Israel: Non-tariff import restrictions on most agricultural products were lifted and replaced by tariffs.

Japan: In pursuance of the market-opening measures, import quotas on fresh and provisionally preserved oranges and tangerines, as well as on beef, were removed in April 1991. Quotas on imports of coal and orange juice were eliminated at the end of March 1992.

New Zealand: Under a five-step programme, initiated in July 1988, all tariffs on goods subject to industry plans were reduced, so that by July 1992 most tariffs were either zero or within the 15-20 per cent range. In March 1991 duty rates were reduced and two levels of tariffs established: a minimum rate of 15 per cent which applied to approximately 80 per cent of items in the tariff schedule and a maximum rate of 25 per cent which applied to the remaining products. The tariff reduction programme continued without interruption after July 1992. With the exception of motor vehicles, textiles, clothing, carpets and footwear, which are subject to separate tariff reduction programmes, tariffs will in general be reduced by one-third between July 1993 and July 1996, to a range of 0-14 per cent. Tariffs of 21 per cent or higher will be reduced to 14 per cent. Import licence controls have gradually been phased out. The last remaining controls, applied only to certain apparel items, were removed in July 1992.

Norway: The gradual liberalization of quantitative restrictions on textiles was continued, reducing to four the number of product categories covered by restrictions on imports from all suppliers (except Hong Kong, for which five categories are restricted).

Sweden: All quantitative restrictions on textile imports were removed on from 1 August 1991, including those under bilateral restraint agreements. All quantitative restrictions on imports of leather shoes from Albania, Bulgaria, (former) Czechoslovakia, Democratic People's Republic of Korea, Hungary, Mongolia, China, Poland, Romania, (former) USSR and Viet Nam were abolished on 1 January 1992.

C. Countries in transition to a market economy

Bulgaria: A 15 per cent import tax was introduced in 1991.

Former Czechoslovakia: The State monopoly of trade was eliminated in January 1991. All import restrictions were removed and replaced by tariffs, except for certain product categories. A surcharge on imports of consumer goods and foodstuffs was introduced in 1991. This surcharge, of 20 per cent originally, was first reduced to 18 per cent and then to 15 per cent, to be further reduced to 10 per cent at the beginning of 1992. This latest cut was concomitant with an increase in tariffs affecting, *inter alia*, agricultural products and textiles.

Hungary: From the date of Hungary's accession to GATT until the end of 1990, foreign trade transactions were subject to licensing. In the framework of trade liberalization measures, convertible currency imports of a number of products were freed from import licensing requirements in 1989 (mainly machinery, consumer durables and some agricultural products). In 1990 the licence-free list was further broadened. Since the beginning of 1991 licensing has been abolished, except for certain specified items.

Lithuania: The programme of economic reform applied since 1991 involves the removal of licensing requirements and the adoption of tariffs as the main instrument for trade regulation, together with the dismantling of the State monopoly on foreign trade.

Poland: Tariffs were increased on imports of motor vehicles (from 15 per cent to 35 per cent) and other products, including computers (from 5 per cent to 20 per cent), some consumer electronics (duties raised to 30 per cent) and cigarettes (from 40 per cent to 90 per cent).

Romania: In pursuance of the reform programme initiated in 1990, the general licensing of imports and exports was abolished. Permanent quantitative restrictions are applied only on a few categories of products.

Russian Federation: The liberalization of foreign economic activities and the opening up of the economy are among the major objectives of the reforms undertaken in recent years. The decree on the Liberalization of Foreign Economic Activities abolished the monopoly on foreign trade that prevailed in the former USSR, allowing all corporate entities registered in the territory of the Russian Federation to engage in external economic transactions. Im-

port policy had been completely liberalized during the first half of 1992, with the temporary suspension of tariffs on imports and the removal of all non-tariff restrictions. A provisional Customs Tariff, with a unified 15 per cent MFN duty for the majority of products, entered into effect on 1 July 1992. Somewhat higher rates apply to a number of products, such as alcoholic beverages, and consumer electronics, while a number of items, including foodstuffs, pharmaceutical raw materials and finished products, medical equipment, children's apparel and printed matter, are free of duty.

Slovenia: The number of items subject to quotas was reduced by nearly one-half in 1992. Non-tariff charges and approval requirements for imports that were not consistent with GATT were abolished.■

Source: UNCTAD Trade Control Measures Information System, SELA, ALADI, GATT, OECD and World Bank.

Annex 3

A REVIEW OF INTRA-ASIAN TRADE

The discussion in this annex is confined to subregional economic groupings (except for China and Japan). It should be kept in mind, however, that there are significant differences in the commodity composition of exports and imports at the country level.

A. The increasing importance of intra-Asian trade

Data on intra-Asian trade from 1970 to 1989 (in constant 1980 dollars) are given in table A of the appendix to this annex for three alternative country groupings:[a] Japan, the NIEs, ASEAN, China and South Asia (INTRA(1) in the table); the same countries excluding South Asia (INTRA(2)); and the same countries excluding both South Asia and China (INTRA(3)). To indicate the relative importance of the groupings, as well as to facilitate comparison, each flow is expressed as a percentage share of total exports and imports by commodity category for the respective country groupings as well as as a proportion of world trade.

A comparison of total trade (SITC 0-9) as a percentage share of world trade for INTRA(1) and INTRA(2) shows that the role of South Asia in the region's trade has been rather marginal. On the other hand, a similar comparison between INTRA(2) and INTRA(3) reveals a rapidly growing significance of China in the region's trade, although there are differences among commodity categories in terms of export and import shares.

During 1985-1989, world trade grew in real terms at an annual rate of 6.7 per cent, whereas total Asian exports and imports (INTRA(1)), grew at 9.6 per cent and 13.8 per cent, respectively. Intra-Asian trade in the same period grew by 15.1 per cent each year. Indeed, if South China and China are excluded (INTRA(3)) the figure reaches as much as 18.3 per cent. The share of intra-Asian trade thus rose from less than 3 per cent in 1970 to nearly 9 per cent in 1989, with most of the growth taking place after 1985.

Due to its relatively faster growth, the share of intra-Asian trade in the region's total exports and imports rose steadily from 1970 to 1989. What is not obvious, however, is that whereas regional exports expanded faster than imports prior to 1985, imports grew much faster than exports thereafter. The divergence in growth rates is even more pronounced for INTRA(3) - i.e. excluding China and South Asia. The implication is that the economies of the region were not only exporting relatively more to each other than to partners outside the region, but were also importing increasingly more from each other, particularly for the grouping constituted by INTRA(3). Thus, by 1989, intra-trade accounted for 43.4 per cent of Asia's total exports and 43.6 per cent of its imports, as well as for 8.8 per cent of world trade. By way of comparison, intra-EEC trade (in constant 1980 prices) amounted in 1989 to 71.2 per cent and 66.5 per cent, respectively, of total EEC exports and imports and 29.9 per cent of world trade. On the other hand, intra-trade among signatories of the North American

[a] The grouping "ASEAN" excludes Brunei Darussalam and Singapore, the latter being treated as among the newly industrializing economies (NIEs). See Part Two, chap. IV, footnote 116.

Free Trade Agreement (NAFTA) was 42.7 per cent and 32.8 per cent of their total exports and imports and 6.1 per cent of world trade in the same year.[b]

For individual commodity groups, there is a larger variation in the share of intraregional trade in exports than in imports around the average for all goods. Primary products (food and raw materials), and particularly fuels, are relatively more important than manufactures in intra-Asian exports. Conversely, the latter predominate in (export) trade with third countries, in particular with North America and Western Europe. Nevertheless, manufactures have become increasingly more important in recent years in intra-Asian trade.

Of the three developing country groups, namely the NIEs, ASEAN-4 and South Asia, intra-group trade is most important for the NIEs, where in 1989 it accounted for 12.0 per cent of total exports of the group, against 4.4 per cent for ASEAN-4 and 2.6 per cent for South Asia. For imports the corresponding shares were, respectively, 10.8 per cent, 7.3 per cent and 1.3 per cent.[c] Indeed, the volume of intra-NIE trade grew at an average annual rate of 24.3 per cent during 1985-1989. One important reason for this is that Hong Kong and Singapore are entrepôt centres, respectively, for China and South-East Asia; since the Republic of Korea and Taiwan province of China cannot trade directly with the Chinese mainland, they conduct this trade through Hong Kong. On the other hand, there is little direct trade between the Republic of Korea and Taiwan province of China since their economies are competitive rather than complementary. The ASEAN preferential trade arrangement remains modest in scope and has failed to create much trade.[d] In the case of South Asia, the lack of strong complementarities and the existence of high trade barriers have inhibited the growth of intra-South Asian trade.

B. Direction and commodity composition of intra-Asian trade

To indicate how important Asian intraregional trade is to each economic grouping in the region, appendix tables B and C show, respectively for exports and imports, the share of such trade in the grouping's total trade.[e] Although there is considerable variation among the groupings, and among commodity groups, intra-Asian trade accounted for an increasing proportion of both the exports and the imports of each commodity group in all country groupings (or individual countries - i.e. China and Japan), especially during 1985-1989.

As a whole, intra-Asian exports are relatively more important to the ASEAN economies and China, the latter especially in recent years, and particularly so for fuels. The differences are less marked on the side of imports, but intra-Asian trade is more important to ASEAN and the NIEs, especially for manufactures, than for the other groupings or countries.

China, through its ties with Hong Kong, appears to be more integrated into the region than South Asia. The relatively low export and import shares for Japan imply that there is still ample room for Japan to expand its role in intra-Asian trade. However, it must be borne in mind that Japan is itself a very large potential market for the other economies of the region, whereas for Japan the Asian market consists of these smaller trading countries. The central role of Japan in the region's trade has already been discussed.

The geographical patterns of intraregional exports and imports by major commodity groups among the various Asian economic groupings are shown in appendix tables D and

b The basic picture remains if exports and imports are valued in current prices in 1989. Intra-trade accounted for 38.1 per cent and 44.0 per cent of total Asian exports and imports, respectively, and for 8.0 per cent of world trade. The corresponding percentages for NAFTA are 42.0, 33.8 and 6.8. Intra-EEC trade amounted to 70.3 per cent of member countries' total exports, 70.1 per cent of imports and 31.7 per cent of world trade.

c For these intra-trade flows in current prices, see Part Two, chap. IV, table 50.

d In view of the movement towards the integration of markets in Europe and in North (and Central) America, and given the uncertainties regarding the conclusion of the Uruguay Round, the ASEAN countries decided, at their Summit held in Singapore in January 1992, to establish an ASEAN Free Trade Area (AFTA) over the next 15 years.

e The tables thus elaborate, by individual grouping, on the composite data for INTRA(1) in table A.

E. The overwhelming importance of Japan in intra-Asian exports, particularly in the 1970s, is clearly evident. Up to 1985, ASEAN accounted for a larger share of intra-Asian exports than did the NIEs, but the latter, however, have been gaining in importance, and had overtaken both ASEAN and Japan by 1989. Also significant, but less evident, is the growing role of China in intra-Asian exports. ASEAN continues to dominate in primary products and fuels, while Japan accounted for the largest share in the region's exports of machinery and transport equipment and the NIEs in other manufactured goods.

In terms of total intraregional imports, on the other hand, the NIEs account for a much larger share than Japan. The latter, however, dominates the trade in primary products and fuels. The NIEs, and to a lesser extent, the ASEAN economies play a major role in the flow of manufactured goods.

The commodity composition of intra-Asian exports and imports by economic groupings is shown in appendix tables F and G. For each commodity category, total exports are identical to total imports for intraregional trade, and thus both have the same commodity composition. As can be seen from the tables, the bulk of intra-Asian trade consists of manufactures, particularly products other than machinery and transport equipment. In 1989, more than 95 per cent of the exports of Japan to the region, and 72 per cent those of the NIEs, consisted of manufactures, compared with 50 per cent or more for China and South Asia. In accordance with their respective comparative advantage, Japanese exports are concentrated on iron and steel and machinery and transport equipment, while those of the NIEs and China are essentially comprised of more labour-intensive products, such as textiles, clothing and electrical machinery.[f] Crude materials are an important part of intra-Asian exports for both ASEAN and South Asia. Fuels, mainly Malaysian and Indonesian oil, are important for ASEAN, and to a lesser extent also for China. Intra-Asian imports, on the other hand, consist overwhelmingly of manufactures for all economic groupings, except for Japan, where the most important import item continues to be mineral fuels.

The changing composition of manufactured exports, attributable largely to the introduction of sophisticated technology, is closely related to the growth process of the Asian developing economies. Export diversification, stemming from wage increases and changes in comparative advantage, is a key factor underlying the rapid expansion of Asian exports. Expansion of market shares, moving upmarket and venturing into new product areas are all different forms of export diversification. With exports growing in skill intensity, intraregional trade has shifted increasingly from interindustry to intra-industry patterns. Nearly half of Japan's imports of steel, for example, come from the Republic of Korea and Taiwan province of China, while Japan exports nearly half of its higher-value iron and steel products to those two markets as well as to Singapore and other Asian countries.

Apart from South Asia, the direction and commodity composition of intra-Asian trade, in terms of both exports and imports, clearly reflects a growing interdependence of the Asian economies as a result of progressive subregional division of labour and specialization; it also reveals a strengthening of linkages among Japan, the NIEs and the ASEAN countries. On the other hand, in spite of their apparent complementarities with Japan and the NIEs, the integration of the South Asian economies has not progressed very far.■

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[f] A more detailed breakdown of intra-Asian exports by commodity, but only for the year 1987, is given in tables 5-7 in James Riedel, *op. cit.*, pp. 129, 131 and 132.

Appendix to annex 3

Statistics on intra-Asian trade

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In the tables, ASEAN-4 excludes both Brunei Darussalam and Singapore, the latter being included among the NIEs. For commodity groupings, the specific SITC divisions are as follows:

	SITC
Food and live animals	0
Beverages and tobacco	1
Crude materials, inedible, except fuels	2
Mineral fuels, lubricants and related materials	3
Animal and vegetable oils, fats and waxes	4
Chemicals and related products, n.e.s.	5
Manufactured goods classified chiefly by material	6
Machinery and transport equipment	7
Miscellaneous manufactured articles	8
Commodities and transactions not classified elsewhere	9

Appendix table A

TRENDS IN INTRA-ASIAN TRADE, 1970-1989

SITC division	Year	INTRA(1)				INTRA(2)				INTRA(3)			
			Percentage of:				Percentage of:				Percentage of:		
		Value a	Region's exports	Region's imports	World trade	Value a	Region's exports	Region's imports	World trade	Value a	Region's exports	Region's imports	World trade
0+1	1970	3731	37.3	26.9	3.0	3187	41.1	26.6	2.5	2072	35.8	20.2	1.7
	1975	5152	40.2	27.1	3.5	4511	46.3	28.5	3.1	3132	43.8	21.2	2.1
	1980	8996	45.5	32.2	4.6	8266	50.0	31.2	4.3	5168	44.1	22.1	2.7
	1985	10935	45.6	36.8	4.9	9842	48.3	35.9	4.4	6284	43.0	24.6	2.8
	1989	19568	53.5	38.4	7.1	17998	56.8	37.7	6.6	12969	53.2	28.9	4.7
2+4	1970	7416	46.1	36.1	7.1	6667	46.6	34.1	6.4	5917	45.7	31.8	5.6
	1975	8038	50.0	35.5	7.7	6880	48.0	31.5	6.6	5931	46.6	28.7	5.7
	1980	12481	57.2	36.7	9.4	10591	53.1	33.3	8.0	8951	51.2	31.6	6.7
	1985	13532	55.2	38.1	9.6	10753	48.1	34.0	7.6	8137	44.4	28.9	5.8
	1989	25822	63.5	42.4	13.8	21471	57.2	38.8	11.5	16896	52.6	33.8	9.0
3	1970	9336	69.0	12.4	2.3	9154	69.2	13.0	2.2	7399	56.6	11.1	1.8
	1975	12081	61.5	14.9	3.0	11962	61.1	15.2	3.0	10567	57.7	13.5	2.6
	1980	19686	72.1	19.6	4.3	19060	70.4	20.4	4.1	16313	67.4	17.5	3.5
	1985	29063	79.2	31.9	8.0	28302	79.5	34.0	7.8	22286	76.3	27.1	6.1
	1989	44269	85.0	30.2	9.1	43506	84.9	32.3	8.9	35835	82.5	27.0	7.3
7	1970	4351	20.5	25.0	1.8	4079	19.5	27.5	1.7	3486	16.8	28.6	1.5
	1975	9000	20.0	30.7	2.4	8422	19.0	32.1	2.3	7245	16.4	33.1	1.9
	1980	21528	24.0	39.4	4.2	20206	22.7	41.3	4.0	17500	19.8	41.3	3.4
	1985	34950	23.9	46.0	5.5	31943	21.9	47.9	5.1	23611	16.3	46.4	3.7
	1989	60470	30.0	49.8	7.4	57150	28.5	51.7	7.0	50829	25.6	51.8	6.2
5-9 (less 7)	1970	12038	20.5	41.3	3.3	11091	20.2	42.6	3.1	8258	15.9	38.5	2.3
	1975	19194	25.7	47.0	4.1	17573	25.1	47.7	3.7	13605	20.8	43.4	2.9
	1980	35455	30.1	48.9	5.4	32723	29.2	50.1	5.0	25915	25.2	44.8	4.0
	1985	54125	32.1	49.0	6.5	49678	30.9	50.9	6.0	34195	23.7	42.4	4.1
	1989	100265	40.7	51.7	9.4	93215	40.2	52.6	8.7	68860	34.0	43.0	6.5
0-9	1970	36872	30.9	23.6	3.0	34177	30.7	23.9	2.8	27132	26.0	21.0	2.2
	1975	53465	31.8	27.7	3.6	49348	31.2	27.5	3.3	40480	27.4	24.3	2.7
	1980	98146	35.5	33.9	5.0	90847	34.3	34.1	4.7	73847	30.2	30.1	3.8
	1985	142605	35.6	41.6	6.5	130520	33.9	42.6	6.0	94513	26.9	35.3	4.3
	1989	250395	43.4	43.6	8.8	233340	42.2	44.4	8.2	185388	37.0	38.2	6.5

Source: UNCTAD secretariat calculations, based on data from the United Nations Compressed International Commodity Trade Data Base (COMTRADE), and national and international sources.

Note: INTRA(1) = Japan + NIEs + ASEAN-4 + China + South Asia; INTRA(2) = Japan + NIEs + ASEAN-4 + China; INTRA(3) = Japan + NIEs + ASEAN-4.

a Millions of 1980 dollars.

Appendix table B

EXPORTS OF SELECTED ASIAN COUNTRIES AND COUNTRY GROUPS TO THE ASIAN REGION, 1970-1989, BY COMMODITY GROUPS

(Percentage of exports to world) [a]

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total [b]
0+1	1970	37.1	42.3	40.3	10.8	60.1	37.3
	1975	22.4	48.3	52.2	12.9	56.2	40.2
	1980	37.6	62.8	39.3	16.8	60.9	45.5
	1985	37.2	66.4	41.9	16.9	54.3	45.6
	1989	60.3	73.6	49.0	20.6	59.5	53.5
2+4	1970	43.6	34.7	52.9	39.4	33.4	46.1
	1975	48.4	36.2	54.8	51.5	38.9	50.0
	1980	60.4	45.0	63.3	58.7	40.9	57.2
	1985	64.4	54.2	57.8	53.2	45.4	55.2
	1989	71.0	71.3	63.8	60.8	52.3	63.5
3	1970	72.1	69.6	69.9	27.0	78.9	69.0
	1975	58.3	58.6	59.2	56.0	98.5	61.5
	1980	46.8	75.7	68.9	49.8	93.4	72.1
	1985	47.2	74.4	80.8	19.3	91.8	79.2
	1989	61.5	88.8	84.5	26.8	89.8	85.0
7	1970	20.9	15.4	77.3	19.2	36.7	20.5
	1975	19.5	19.7	52.0	29.8	33.6	20.0
	1980	22.6	27.1	42.1	31.2	43.5	24.0
	1985	22.2	26.5	39.1	34.3	52.9	23.9
	1989	26.7	32.8	43.9	30.0	59.6	30.0
5-9 (less 7)	1970	26.0	11.6	28.5	11.7	32.5	20.5
	1975	29.3	19.0	30.0	12.2	34.9	25.7
	1980	33.3	25.5	35.1	12.6	38.0	30.1
	1985	32.8	26.5	41.5	14.9	50.0	32.1
	1989	40.9	36.8	48.0	19.9	56.4	40.7
0-9	1970	25.4	24.1	54.6	18.1	41.8	30.9
	1975	25.0	26.6	53.4	20.3	48.7	31.8
	1980	27.8	32.5	57.1	23.0	52.0	35.5
	1985	26.9	32.5	58.6	21.7	58.3	35.6
	1989	32.7	41.6	61.1	25.9	61.6	43.4

Source: As for appendix table A.

a Derived from data in 1980 dollars.

b Total of countries or country groups shown.

Appendix table C

IMPORTS OF SELECTED ASIAN COUNTRIES AND COUNTRY GROUPS FROM THE ASIAN REGION, 1970-1989, BY COMMODITY GROUPS

(Percentage of imports from world) [a]

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total [a]
0+1	1970	17.4	56.1	25.8	20.9	5.3	26.9
	1975	25.5	50.2	24.7	11.5	3.3	27.1
	1980	25.0	51.4	44.7	20.6	7.6	32.2
	1985	32.7	48.8	43.3	25.5	26.6	36.8
	1989	36.0	45.8	47.7	24.7	25.6	38.4
2+4	1970	27.7	65.2	28.7	8.1	49.3	36.1
	1975	25.8	59.5	38.3	40.5	38.9	35.5
	1980	30.0	54.1	39.8	38.8	27.1	36.7
	1985	31.8	49.5	48.2	45.0	24.9	38.1
	1989	37.0	47.3	54.6	48.0	35.0	42.4
3	1970	9.3	14.0	18.3	2.2	47.9	12.4
	1975	14.4	18.4	15.5	4.5	31.0	14.9
	1980	20.8	17.4	25.5	9.0	11.6	19.6
	1985	31.8	36.6	49.9	7.3	17.3	31.9
	1989	32.2	27.4	49.3	4.6	31.9	30.2
7	1970	3.0	43.8	34.4	9.5	20.3	25.0
	1975	8.7	41.2	39.4	15.3	25.9	30.7
	1980	11.1	48.5	49.5	21.1	38.2	39.4
	1985	20.1	54.4	54.1	30.3	49.8	46.0
	1989	23.1	59.9	61.7	29.1	41.0	49.8
5-9 (less 7)	1970	18.6	62.1	52.6	17.8	41.1	41.3
	1975	28.4	64.5	54.4	28.4	44.3	47.0
	1980	30.7	63.2	60.8	29.8	46.2	48.9
	1985	33.5	65.6	59.4	26.3	44.9	49.0
	1989	39.3	63.9	60.6	25.5	48.9	51.7
0-9	1970	13.7	42.2	30.5	10.3	34.8	23.6
	1975	18.3	44.7	37.4	17.7	33.5	27.7
	1980	23.6	46.0	47.1	21.9	34.1	33.9
	1985	31.4	54.2	54.0	25.3	43.5	41.6
	1989	34.4	53.5	57.4	23.6	42.0	43.6

Source: As for appendix table A.

a Derived from data in 1980 dollars.

b Total of countries or country groups shown.

Appendix table D

GEOGRAPHICAL DISTRIBUTION OF INTRA-ASIAN EXPORTS BY COMMODITY GROUP, 1970-1989

(Percentages based on data in 1980 dollars)

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total
0+1	1970	16.8	16.7	28.4	6.5	31.7	100.0
	1975	4.9	22.5	36.5	7.7	28.3	100.0
	1980	6.4	27.6	27.2	6.0	32.8	100.0
	1985	4.5	28.3	33.0	5.6	28.6	100.0
	1989	4.3	32.3	36.1	5.2	22.2	100.0
2+4	1970	5.9	12.7	65.9	9.4	6.1	100.0
	1975	7.7	8.9	64.6	11.0	7.8	100.0
	1980	7.3	12.7	63.1	8.8	8.1	100.0
	1985	7.5	14.9	55.6	8.4	13.6	100.0
	1989	5.6	16.4	59.6	7.4	11.0	100.0
3	1970	3.7	37.5	56.8	0.9	1.2	100.0
	1975	2.1	18.5	68.8	0.4	10.1	100.0
	1980	1.2	18.1	66.4	0.6	13.7	100.0
	1985	0.8	18.3	59.9	0.7	20.3	100.0
	1989	1.2	24.4	58.1	0.5	15.9	100.0
7	1970	85.6	10.3	1.6	1.0	1.5	100.0
	1975	83.7	11.1	2.9	1.6	0.7	100.0
	1980	74.3	19.5	4.1	1.0	1.2	100.0
	1985	69.0	23.5	5.3	0.6	1.5	100.0
	1989	54.8	34.1	8.6	0.4	2.1	100.0
5-9 (less 7)	1970	62.1	19.8	5.9	3.7	8.5	100.0
	1975	62.3	20.6	5.8	3.0	8.3	100.0
	1980	51.4	29.4	7.1	2.0	10.1	100.0
	1985	43.5	28.9	10.3	2.3	15.0	100.0
	1989	30.2	36.1	14.6	2.9	16.2	100.0
0-9	1970	34.2	21.4	32.6	4.1	7.7	100.0
	1975	38.6	17.0	31.4	3.8	9.3	100.0
	1980	36.6	22.7	27.3	2.7	10.7	100.0
	1985	34.6	24.0	25.2	2.4	13.7	100.0
	1989	26.4	31.2	27.2	2.5	12.7	100.0

Source: As for appendix table A.

Appendix table E

GEOGRAPHICAL DISTRIBUTION OF INTRA-ASIAN IMPORTS BY COMMODITY GROUP, 1970-1989

(Percentages based on data in 1980 dollars)

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total
0+1	1970	25.0	51.9	10.1	10.6	2.4	100.0
	1975	45.4	39.5	7.4	7.1	0.7	100.0
	1980	35.1	41.9	17.1	3.4	2.6	100.0
	1985	45.7	33.0	11.4	5.3	4.6	100.0
	1989	48.9	30.5	12.8	4.0	3.7	100.0
2+4	1970	50.2	40.3	2.2	1.1	6.2	100.0
	1975	46.3	39.3	4.4	4.3	5.7	100.0
	1980	44.1	36.3	5.2	6.9	7.5	100.0
	1985	39.8	34.2	6.7	12.9	6.4	100.0
	1989	37.2	35.6	9.6	10.1	7.4	100.0
3	1970	45.5	18.5	16.8	1.1	18.1	100.0
	1975	71.4	19.4	6.7	1.0	1.5	100.0
	1980	67.3	19.1	10.2	3.1	0.3	100.0
	1985	59.5	27.3	10.8	1.9	0.6	100.0
	1989	59.7	23.4	14.2	1.2	1.5	100.0
7	1970	2.4	50.5	29.0	5.7	12.4	100.0
	1975	4.4	44.9	33.0	5.2	12.5	100.0
	1980	4.0	47.2	31.6	5.6	11.7	100.0
	1985	5.7	45.3	18.5	8.1	22.5	100.0
	1989	7.2	56.6	22.6	5.2	8.4	100.0
5-9 (less 7)	1970	11.7	48.8	19.2	4.5	15.7	100.0
	1975	16.0	45.4	19.9	5.9	12.8	100.0
	1980	17.1	47.4	19.7	6.0	9.8	100.0
	1985	17.3	48.6	13.7	6.3	14.1	100.0
	1989	22.1	51.4	13.8	4.3	8.4	100.0
0-9	1970	28.3	39.9	15.4	3.7	12.7	100.0
	1975	34.0	38.0	15.6	4.5	7.9	100.0
	1980	29.4	39.7	18.3	5.2	7.4	100.0
	1985	27.4	40.9	13.4	6.4	11.9	100.0
	1989	28.8	44.5	15.5	4.5	6.7	100.0

Source: As for appendix table A.

Appendix table F

COMMODITY COMPOSITION OF INTRA-ASIAN EXPORTS BY COUNTRY AND COUNTRY GROUPS, 1970-1989

(Percentages based on data in 1980 dollars)

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total
0+1	1970	5.0	7.9	8.8	16.0	41.6	10.1
	1975	1.2	12.8	11.2	19.4	29.4	9.6
	1980	1.6	11.2	9.1	20.1	28.1	9.2
	1985	1.0	9.0	10.0	18.0	16.0	7.7
	1989	1.3	8.1	10.4	16.0	13.7	7.8
2+4	1970	3.5	11.9	40.6	46.2	16.0	20.1
	1975	3.0	7.9	30.9	43.4	12.7	15.0
	1980	2.5	7.1	29.4	41.0	9.7	12.7
	1985	2.0	5.9	20.9	33.5	9.4	9.5
	1989	2.2	5.4	22.6	30.4	8.9	10.3
3	1970	2.7	44.3	44.1	5.5	4.0	25.3
	1975	1.2	24.7	49.6	2.1	24.7	22.6
	1980	0.7	16.0	48.8	4.3	25.7	20.1
	1985	0.5	15.5	48.3	6.2	30.2	20.4
	1989	0.8	13.8	37.8	3.5	22.2	17.7
7	1970	29.5	5.7	0.6	2.9	2.3	11.8
	1975	36.5	11.0	1.6	7.2	1.2	16.8
	1980	44.5	18.8	3.3	7.8	2.4	21.9
	1985	48.8	23.9	5.2	6.5	2.8	24.5
	1989	50.0	26.4	7.7	3.8	4.0	24.2
5-9 (less 7)	1970	59.3	30.2	5.9	29.4	36.0	32.6
	1975	58.0	43.7	6.7	27.9	32.0	35.9
	1980	50.7	46.8	9.4	26.8	34.1	36.1
	1985	47.6	45.6	15.6	35.9	41.6	38.0
	1989	45.7	46.3	21.6	46.3	51.2	40.0
0-9	1970	100.0	100.0	100.0	100.0	100.0	100.0
	1975	100.0	100.0	100.0	100.0	100.0	100.0
	1980	100.0	100.0	100.0	100.0	100.0	100.0
	1985	100.0	100.0	100.0	100.0	100.0	100.0
	1989	100.0	100.0	100.0	100.0	100.0	100.0

Source: As for appendix table A.

Appendix table G

COMMODITY COMPOSITION OF INTRA-ASIAN IMPORTS BY COUNTRY AND COUNTRY GROUPS, 1970-1989

(Percentages based on data in 1980 dollars)

SITC	Year	Japan	NIEs	ASEAN-4	South Asia	China	Total
0+1	1970	8.9	13.2	6.6	28.8	1.9	10.1
	1975	12.9	10.0	4.6	15.0	0.8	9.6
	1980	10.9	9.7	8.5	6.0	3.2	9.2
	1985	12.8	6.2	6.5	6.3	3.0	7.7
	1989	13.3	5.4	6.5	6.9	4.3	7.8
2+4	1970	35.7	20.3	2.9	5.9	9.9	20.1
	1975	20.5	15.6	4.3	14.3	10.7	15.0
	1980	19.1	11.6	3.6	16.8	13.0	12.7
	1985	13.8	7.9	4.7	19.2	5.1	9.5
	1989	13.3	8.3	6.4	23.0	11.3	10.3
3	1970	40.8	11.7	27.5	7.5	36.1	25.3
	1975	47.5	11.6	9.7	4.9	4.1	22.6
	1980	45.9	9.6	11.2	12.1	0.8	20.1
	1985	44.3	13.6	16.4	6.2	1.0	20.4
	1989	36.6	9.3	16.2	4.8	4.0	17.7
7	1970	1.0	14.9	22.2	18.1	11.5	11.8
	1975	2.2	19.9	35.6	19.4	26.5	16.8
	1980	3.0	26.0	37.9	23.4	34.8	21.9
	1985	5.1	27.2	33.7	31.1	46.1	24.5
	1989	6.0	30.7	35.2	27.7	30.4	24.2
5-9 (less 7)	1970	13.6	39.9	40.7	39.7	40.5	32.6
	1975	16.9	42.9	45.8	46.5	57.8	35.9
	1980	21.1	43.1	38.8	41.8	48.1	36.1
	1985	24.0	45.1	38.7	37.2	44.9	38.0
	1989	30.8	46.3	35.6	37.6	49.9	40.0
0-9	1970	100.0	100.0	100.0	100.0	100.0	100.0
	1975	100.0	100.0	100.0	100.0	100.0	100.0
	1980	100.0	100.0	100.0	100.0	100.0	100.0
	1985	100.0	100.0	100.0	100.0	100.0	100.0
	1989	100.0	100.0	100.0	100.0	100.0	100.0

Source: As for appendix table A.

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