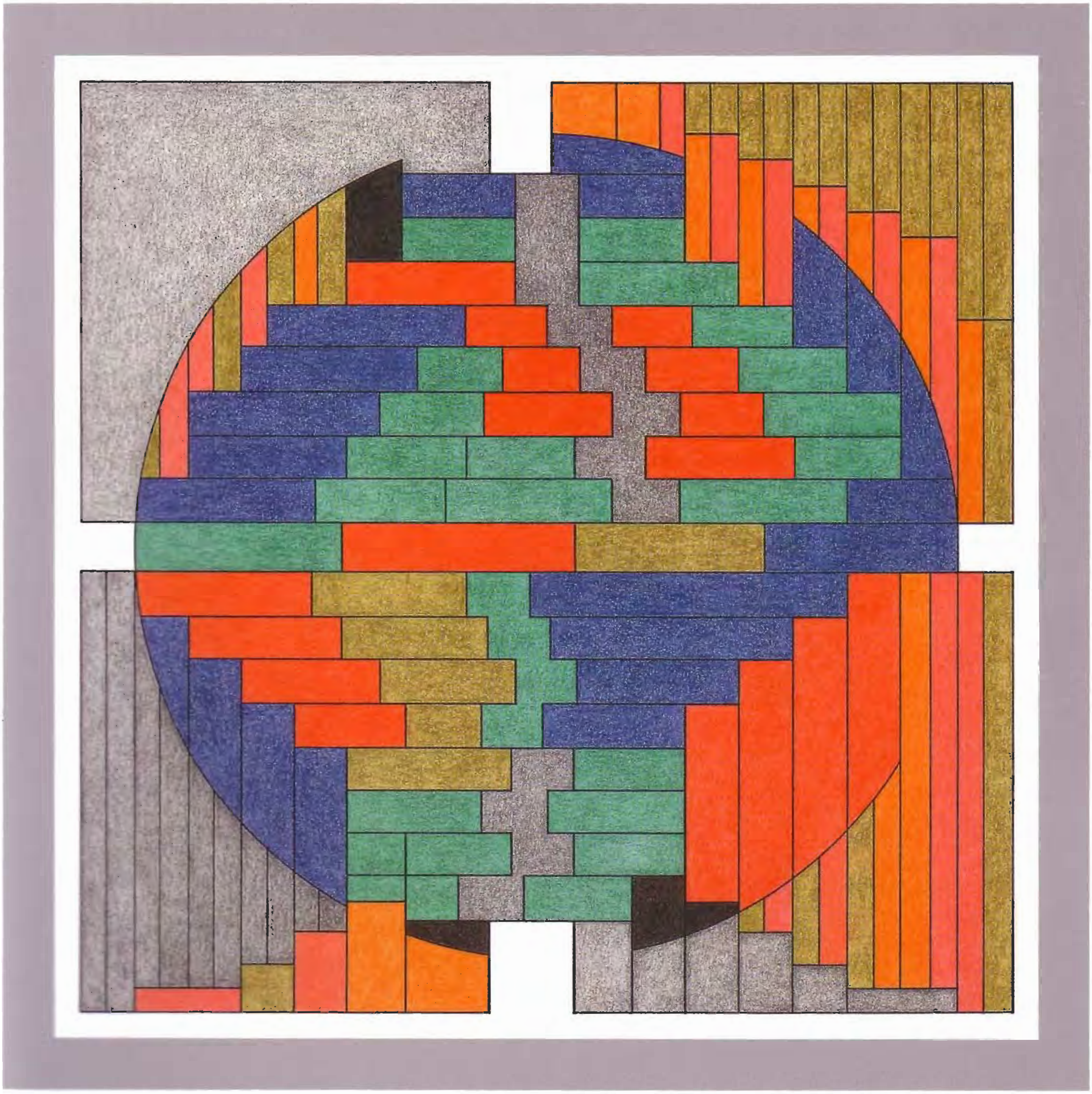
UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1994

UNITED NATIONS



UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 1994

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

UNITED NATIONS
New York and Geneva, 1994

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UNCTAD/TDR/14

UNITED NATIONS PUBLICATION

Sales No.: E.94.II.D.26

ISBN 92-1-112360-7
ISSN 0255-4607

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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 1993.*[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 1993.* 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 and the Commonwealth of Independent States (CIS)).

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 1993.*

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 1993* refers to *Trade and Development Report, 1993* (United Nations publication, Sales No. E.93.II.D.10).

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.

1 United Nations publication, Sales No. E/F.94.II.D.24.

Abbreviations

ACP	African, Caribbean and Pacific
AMS	Aggregate Measurement of Support
ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
bp	basis points
CD	certificate of deposit
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)
DC	developing country
DMEC	developed market-economy country
DRF	Debt Reduction Facility (of IDA)
DSB	Dispute Settlement Body (of WTO)
EC	European Community (or Communities)
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECB	European Central Bank
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
EEA	European Economic Area
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
EU	European Union
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
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product

GSP	generalized system of preferences
ICAO	International Civil Aviation Organization
IDA	International Development Association
IFC	International Finance Corporation
ILO	International Labour Organisation
IMF	International Monetary Fund
IPR	intellectual property right
ITC	International Trade Centre UNCTAD/GATT
LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
MFA	Multi-Fibre Arrangement
MFN	most favoured nation
MTA	multilateral trade agreement
MYRA	multi-year rescheduling agreement
NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NIEs	newly industrializing countries
NIESR	National Institute of Economic and Social Research
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacture
PPP	purchasing power parity
PSI	preshipment inspection
R&D	research and development
RAP	Rights Accumulation Programme
RBP	restrictive business practice
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDR	special drawing right
SITC	Standard International Trade Classification
STF	Systemic Transformation Facility (of IMF)
TNC	Trade Negotiations Committee
TNCs	transnational corporations
TRIMs	trade-related investment measures
TRIPs	trade-related intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
VER	voluntary export restraint
WIDER	World Institute for Development Economics Research
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

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OVERVIEW
by the
Secretary-General of UNCTAD

Global trends and the continuing deflationary gap

Slowly, the world economy is picking up. After several very lean years, output is expected to grow in 1994 by 2.5 per cent. This is much lower than is normal for a cyclical recovery, and even below the sustainable long-term growth rate.

For the developing countries, the picture remains much the same as last year. Their combined output is once again growing modestly (probably by 4 per cent in 1994), with the same marked disparities among different regions. Thus, economies in East and South-East Asia that performed well in the past continue to advance rapidly, Africa's stagnation persists, and the resumption of growth in Latin America remains at a slack pace. As regards external funding, developing countries continue to be bifurcated, with one group enjoying relatively easy access to international financing and another experiencing stringency.

Growth performance in *Africa* remains highly unsatisfactory. With output continuing to lag behind population growth, per capita incomes are heading downward, as they have done for a decade and a half. In the past few years, the economies pursuing "strong adjustment policies" have grown somewhat faster than others, but they have also received substantially more external funding. Moreover, as was discussed in last year's *TDR*, Structural Adjustment Programmes have failed to bring about the turnaround they promised; so far only one African country has managed to graduate from them.

In several African countries, the main factor behind poor economic performance has been political unrest or armed conflicts of various kinds; and some have been struck by drought or other natural disasters. But over the years a problem common to these commodity-dependent economies - and to other such economies in other continents, including other least developed countries - has been the weakness of primary commodities, including oil. Falling export prices have depressed the export earnings of African countries notwithstanding increased export volumes, making it necessary to make huge cuts in imports.

Commodity prices began to recover in the autumn of 1993 and by the following April had on average risen by one third above their level a year previously. However, for the most part, these gains have proved short-lived, and prices of many commodities have in recent weeks been falling back. Coffee is an exception, and one of considerable importance to Africa, but the current price boom is not likely to last long.

African economies have not shared in the recent revival of capital flows to developing countries, and remain under intense financial pressure. Net flows of medium- and long-term export credits to Africa declined sharply to a negative figure in 1992, and total net flows of export credits were also negative in the first half of 1993. Very few countries have access to international bond markets and to bank credits, and no significant increases in foreign direct investment (FDI) have occurred, notwithstanding the liberalization of foreign investment laws.

Meanwhile, payments and financing arrangements for imports (which reflect countries' creditworthiness) are costly and carry unfavourable terms. In spite of concessional restructurings at the Paris Club, the servicing of external debt remains extremely difficult. A welcome initiative was taken at the Naples summit of the Group of Seven, aimed at deepening official bilateral debt reduction for low-income countries (most of which are African). It is to be hoped that this new political consensus will impart a strong impetus for early adoption by the Paris Club of the Trinidad terms, accompanied by country-specific measures when needed. Eligibility for the new terms should be widened to include, at a minimum, all severely indebted countries that borrow from both IBRD and IDA. Moreover, in order to expedite the conclusion of "exit" rescheduling agreements for countries carrying out adjustment programmes, debt stocks should be reduced as soon as possible, and in one go.

Recent growth performance in *Latin America and the Caribbean* has varied considerably, with some countries moving out of and others into recession, and with some registering acceleration and others deceleration. As a whole, growth continues to be much better than during the debt crisis, though weak when viewed in an historical perspective. The rise in output since the "lost decade" has stemmed more from the increased capacity utilization made possible by higher imports than from additional investment and improved productivity. With few exceptions, investment rates are modest, in some cases even lower than during the debt crisis, and higher domestic spending has tended to be driven by consumption. Private savings have declined in most countries, alongside major improvements in budget balances.

Exports have in general risen over the past year. The main impetus has come from the recovery in the United States, which has raised demand for the region's exports, and the increase in the imports of the Latin American countries themselves. The latter has spilled over to produce a substantial increase in intraregional trade. While the countries have been taking a larger share of each others' exports, imports from the region have not been more dynamic than imports from elsewhere. Export diversification has progressed, largely through increased shipments of non-traditional primary or semi-processed products; diversification into manufactures is still slow, especially in comparison to some Asian economies.

The most striking feature of Latin American performance has been the huge inflow of funds from abroad, including repatriated capital. The $55 billion figure of capital inflows reported in 1993 is impressive, even though lower than the $62 billion for the previous year. The question is how long large-scale capital inflows will be sustained. Three quarters of the funds flowing in, other than FDI, have been fixed-interest securitized loans consisting of high-risk non-investment grade bonds (commonly referred to in the United States as "junk bonds") and high-cost commercial paper. Moreover, much of the FDI inflow, which has been copious in some countries, has stemmed from privatization, which is a one-off process; some of the purchases have been motivated by the prospect of early capital gains. The negligible amounts of syndicated bank credits, the onerous terms of international bond issues, ratings from the major credit-rating agencies and the evidence from trade finance all suggest that Latin America's creditworthiness has not yet been fully restored.

The flow is being driven in part by speculative behaviour in financial markets abroad. It is not a coincidence that capital flows to Latin America shot up soon after the end of a period of intense financial activity in the United States involving a surge of mergers and acquisitions financed by issuing high-risk, high-yield instruments (including "junk bonds"). It would seem that as debt deflation put an end to this speculative boom and the attendant opportunities for quick capital gains, hot money turned to "emerging markets" in Latin America and East Asia. Prospects of improved returns in the industrial countries or other parts of the world, perhaps in the form of a speculative bandwagon in financial or currency markets, might prompt a reversal of such capital flows.

The flood of money has helped raise output and reduce inflation in the recipient countries. None the less, it has posed serious problems, by putting upward pressure on the real exchange rate, thus eroding the competitiveness and profits of manufacturing industry. This has occurred just as economic policy as a whole was being reoriented in order, among other things, to emulate the export and investment performance of East Asia. Some countries, such as Chile, have taken steps to discourage inflows motivated by short-term gains.[1] This approach appears to be useful, for there are dangers in too much financial openness. Capital account convertibility must not be turned into

1 The potentially destabilizing influence of these flows and the measures to discourage them were reviewed in last year's *TDR* and that of 1992.

an objective of policy in its own right; it is a policy tool, and one among many, to be used when it serves development objectives, and avoided when it does not. Under the current global regime for international capital movements developing countries retain considerable flexibility in their policies (unlike developed countries, which are subject to commitments under agreements reached in OECD and EEC/EU). Recent experience serves to emphasize the importance of maintaining this flexibility.

There are, of course, also other, more fundamental issues in Latin America. Investment rates need to be stepped up considerably; but, poverty too, remains a serious problem. The dilemma is that to raise the share of investment in income generally requires increasing the share of profits, whereas alleviating poverty normally suggests a need to reduce income inequalities. Could the East Asian experience provide a way out? There, the pattern of landownership has been less skewed, and corporate profits have been mostly saved and re-invested, rather than used for upper-class consumption.

In most of *developing Asia*, growth has continued to be strong. China continues to bound ahead despite inflationary pressures and social dislocations, while a number of countries in South Asia are beginning to join the growth pole of East and South-East Asia. The picture in West Asia has been very different because of the depressed price of oil and, in some countries, political impediments to normalizing external financial and trading relationships.

The dynamism of East and South-East Asia comes from a virtuous circle of growing investment and trade, rapid structural change and deepening industrialization. Imports have risen rapidly, from both within and outside the region. So, too have exports. Their main impetus has been the high rate of investment, but an important contributing factor has been the appreciation of the yen. Besides making current output more competitive, this has induced further relocations of more labour-intensive industries from Japan to developing countries in the region. A similar process, also involving investment flows, has been taking place in the Republic of Korea and Taiwan province of China. As a result, both the providers and recipients of regional FDI have moved up the industrial ladder. Thus, as noted in last year's *TDR*, the "flying geese" pattern has continued and exports to Japan have expanded, notwithstanding the recession in that country. External financing has been ample, and a handful of economies in the region account for the bulk of total syndicated bank credits to developing countries. Most of the FDI into the region has involved new investments rather than purchases of existing companies. In many countries, growth is being limited by the strain on infrastructure, rather than by unwillingness to take risks and innovate or by external financial pressure.

In *Central and Eastern Europe* as a whole, output continues to contract. The fact that the rate of contraction slowed considerably from 16 per cent in 1992 to 10 per cent in 1993 provides little comfort. A number of countries have bucked the general trend to register some upturn, and it is as yet uncertain whether this trend will be sustained. The situation in the former Soviet Republics is a particular cause of concern, especially since few of these new States are able to make up for their shrinking sales to each other by expanding exports to the rest of the world. Central European countries managed to switch their export markets at the beginning of the reform process, but appear to have largely exhausted their possibilities of doing so. The terms of official insurance cover remain restrictive for most countries in transition, and other costs of payments arrangements for imports also remain high.

The key question is how to accomplish the massive enterprise restructuring needed to create efficient units capable of responding to market signals. The machinery of government inherited from the past is too otiose for such an intricate operation. On the other hand, an entrepreneurial class and the institutional infrastructure required to sustain capitalist activity are highly underdeveloped, while a system to finance restructuring and investment is still present only in embryo. The future of the transition to a market economy is thus unsure. It is hardly surprising to find growing popular disaffection, both in countries where the Government is pursuing market-oriented reforms in earnest and in those where it is not. Governments, in turn, are becoming more pragmatic, and changing the reform agenda from simply dismantling the old system towards more subtle management of the transition process.

Growth in the *developed market economies* decelerated in 1993, falling to 1.4 per cent from the meagre 1.8 per cent of 1992. This reflected a contraction of output in the European Union (especially France and Germany) and no growth in Japan. By contrast, in the United States and other English-speaking countries, where the recession started earlier, the pace of recovery quickened. Within Western Europe, those countries that cut their interest rates and let their currencies depreciate after the crisis of 1992 of the European Monetary System have fared better than Germany and countries choosing to maintain their parity with the Deutsche mark. Thanks to its (until recently) relaxed monetary policy, the recovery of the United States has been gathering momentum, and 3.4 per cent growth is expected for 1994. By contrast, the Japanese economy, still suffering from the bursting of the bubble in financial markets and in investment, is expected to register growth of merely 0.5 per cent. A stronger rebound is likely in Western Europe, but, as in Japan, the pace of expansion in 1994 will be very modest. Unemployment is therefore likely to continue to mount in Japan and Western Europe. In the United States, it has been declining, but whether this will continue depends critically on the pace of economic activity.

The short-term outlook is clouded by uncertainties relating to the policy stances of Governments and the behaviour of currency markets. In the United States, monetary policy has been tightened somewhat with the aim of preventing overheating. That objective is not in question; but the monetary brakes may be applied too hard and too soon if the inflationary danger is exaggerated. It will be unless it is borne in mind that the strong pace of investment in recent years has enlarged the supply capabilities of the United States economy, and that there is considerable slack in the world economy as a whole. In Japan, monetary policy has been extremely cautious for fear of a recurrence of the speculative bubbles that inflicted so much harm in the past. Again, the objective is valid; but the more potent danger today is continued deflation and currency appreciation. In Western Europe, monetary policy continues to be too tight. Prospects of recovery hinge on a revival in exports, which is premised in part on a strengthening of the dollar vis-à-vis the Deutsche mark. However, the tendency has been in the opposite direction.

Pressure in currency markets has in recent months been in line with the need for trade-balance adjustment, with the yen (and, to a lesser extent, the Deutsche mark and the currencies closely connected with it) coming under strong upward pressure, and the dollar under downward pressure. But the more the dollar weakens relative to the yen (and the Deutsche mark), the more will world demand shift away from Japan (and Western Europe) towards the United States, increasing the already wide disparities in growth. The exchange market pressures will help or hinder recovery, depending on how monetary authorities choose to react. If the Federal Reserve Board opts for monetary tightening to counteract the impact of dollar weakening on the domestic price level, recovery in North America, as well as overall, will be slowed; moreover, trade conflicts between the United States and some of its trading partners might well intensify. Alternatively, if fears of losing competitiveness induce the Deutsche Bundesbank and the Bank of Japan to ease up, the global upturn will be strengthened.

* * *

However, adjustments in monetary policy alone will not be sufficient to tackle the main cause of current slow growth in the developed market economies, namely persistent inadequacies in the pace and pattern of demand creation. These stem from the radical change of approach towards economic policy-making that took place in the 1980s, which was hostile to demand management, especially as a means of boosting economic activity. The new consensus on macroeconomics espouses a number of doctrines contrary to those held earlier: that inflation is invariably a more serious threat than unemployment; that output growth depends primarily on supply-side factors and relatively little on effective demand; that attempts to stabilize the level of activity usually serve to destabilize it; that monetary policies affect prices not production; that fiscal deficits crowd out private investment, and raise interest rates rather than the level of activity; that a relatively high degree of unemployment is "natural"; and that rising unemployment is much more a reflection of artificial rigidities in labour markets than of weak demand for final output.

Policy, too, has moved a long way towards monetarism and fiscal orthodoxy, though the latter movement has in practice been slowed by political constraints, and was for a time derailed in the United States by a belief that lower taxation would evoke a vigorous supply-side expansion. Governments have been reducing their efforts to manage demand, but they have simultaneously been increasing the need for it by deregulating the financial sector. They have consequently increased the capacity of the private sector to push up (or pull down) the pace of credit creation, and thus generate fluctuations in aggregate spending and in economic activity.

The change of policy regime has kept inflation down. But it has also had a number of undesirable consequences:

- A deflationary gap has normally been present, since upturns have tended to be quickly smothered whereas downturns have been left to work themselves out;
- The real economy has been disturbed by waves of private debt and credit-creation and contraction, in the course of which speculation has naturally thrived; and
- There have been large imbalances in current account positions and consequent strains in foreign exchange markets and the trading system.

These phenomena not only have been responsible for problems that are apparently obviously cyclical in origin, but also have substantially contributed to problems that are apparently structural, such as mounting unemployment and trade imbalances.

In the 1980s, domestic demand in the United States leaked abroad on a large scale and international imbalances widened as many industrialized countries pursued tight monetary and fiscal policies, while the United States adopted a combination of monetary restrictiveness and "supply-side" fiscal relaxation. The Plaza agreement sought to tackle the problem by lowering the value of the dollar through changes in monetary policies. However, Japanese firms adjusted in an unexpected manner, by investing heavily in cost-reducing techniques in order to retain their market share in the United States; financing investment was made especially cheap by the inflation of asset prices. Meanwhile, the weakening of the dollar eased the pressure on United States firms to recover their market shares by investing and restructuring.

Eventually, expansion in the developed market economies was brought to a halt by the debt-inflation process.[2] The combination of this process with the imbalances built up earlier has shaped the course of events in the 1990s. In the United States, firms have finally been pushed into downsizing and restructuring their capital stock. For that reason, the recovery was initially much weaker than in previous cycles, and output grew without (until recently) a corresponding increase in jobs. But, on the other hand, productivity has increased at rates not seen since the 1960s. The United States has thus been able to regain competitiveness because of the decline both of the dollar and of production costs.

Japan has found adjustment to this situation extremely difficult. The fact that it is still in recession, despite three packages to stimulate the economy, suggests that the mismatch between capacity and demand is deep-rooted.

Western Europe responded to the depreciation of the dollar following the Plaza agreement by increasing private investment, stimulated by the establishment of the single European market. This, together with the increase in German government expenditure for unification, helped to forestall recession. However, the path to monetary union set out in the Maastricht Treaty required substantial reductions to be made in net government expenditures, just as the downturn was occurring in other industrialized countries. The Bundesbank's decision to slow German growth through tighter monetary policy put additional deflationary pressure on EU members. Those countries that have remained in the Exchange Rate Mechanism (ERM), and continued to impose fiscal restriction to satisfy the Maastricht convergence criteria, now face the same problem as Japan, i.e. inadequate home demand and heightened foreign competition.

As already noted, hopes for expansion in Western Europe hinge once again on exports. But the United States and Japan, too, are counting on rapid export growth. They cannot all simultaneously increase their exports by reducing labour costs. They can do so only if global demand is increased.

One telling symptom of global demand deficiency is the fact that surpluses are again being valued not only as a means of financing long-term lending, but as a prop to economic activity. Similarly, deficits are again deplored not only because they add to debt but, even more, because they reduce jobs and profits. The idea that countries should seek growth by improving their overall competitiveness vis-à-vis others is fast becoming accepted as an axiom. Nevertheless, this mercantilist idea is very largely mistaken. Competitiveness is a relative concept: while one country can improve its international competitiveness (and thus, perhaps, its growth performance), it is not possible for all countries to do so at the same time.

2 This process was reviewed extensively in previous *TDRs* (1991 and 1992).

What each and every country can do is improve productivity. Here, too, there is a simple truth that warrants repetition. Improvements in productivity do not raise output unless they are matched by an enlarged volume of monetary expenditures. Otherwise, technical advance will reduce the overall use of labour and raw materials, not only their use per unit of output; and this will in turn put pressure on individual countries to increase their market share at the expense of others. In short, global demand deficiency is a recipe for waste, unemployment, depressed commodity prices, and conflicts among nations.

The level of global demand is not an accident of fortune. While no individual country on its own is large enough to regulate the level of demand, Governments acting collectively have it in their power to do so, in order to ensure that it is compatible with worldwide growth and equilibrium. It is to this task that the international community should now turn:

- Western Europe needs to bring down interest rates substantially for a prolonged period, and to postpone its fiscal adjustment until recovery is well under way;
- Japan needs to loosen its monetary policy and undertake fiscal expansion, while taking steps to increase the share of consumption in national income;
- The United States needs to be cautious in applying monetary brakes, so as not to stifle the recovery of investment and employment and the improvement in productivity;
- The flow of capital resources to developing countries and countries in transition should be increased, in forms that are sustainable and predictable.

The Visible Hand and development experience in East Asia

The changed approach to economic policy in the 1980s has affected not only macroeconomics but also development strategy. Here, too, thinking has turned in favour of a minimal role for the State. Unlike in the "development economics" of the 1950s and 1960s, the emphasis is now on "government failure"; on the capacities of the private sector; on the benefits of openness; on the gains from letting the price mechanism determine resource allocation; and on the costs of selectively promoting industries.

However, the pendulum has swung too far. The experiences of some of the most successful economies in the world - Japan, Republic of Korea and Taiwan province of China - have shown that government intervention can be extremely effective in advancing development.

The success of government policy in these economies reflected the fact that accelerating capital accumulation, industrialization, technological transformation, and growth and diversification of exports were the goals of economic policy not only in words but also in deeds. Unlike many other countries where the State intervened extensively, the Governments were not populist, seeking to advance the interests of other classes at the expense of Business. Still less were they ideologically hostile to private ownership or initiative. Nor, again, was their prime purpose to grant special favours to certain private interests. Rather, they sought to support and advance the growth of the private sector. Not, it must be emphasized, by depressing the living standards of workers and farmers, but by accumulating new wealth. Governments found that to serve Business to the full, they had also to act as its master. They did so by shaping and manipulating market forces in order to ensure that individual firms acted not only in their own immediate self-interest, but also in harmony with the long-term interests of Business as a whole.

Broadly speaking, Government intervention in Japan, Republic of Korea and Taiwan province of China was designed to counteract a number of factors that typically limit the capacity and willingness of individual firms in developing countries to undertake long-term investments and modernize their methods of production and organization. It was directed at accelerating the pace of both growth and structural transformation, by changing the composition of industry through rapid capital accumulation, and by increasing the dynamism and efficiency of the industrialization process as a whole. It sought to make profitable sectors and activities which would not have been attractive to investors in a regime of laissez-faire, but which could be expected in due course to be able to withstand international competition. And it sought to stimulate the "animal spirits" of investors, strengthen their confidence, lengthen their time horizons, coordinate their expansion plans, and enlarge their command over resources.

Policy was formulated in partnership with business. In Japan, for instance, the key Ministries closely coordinated their policies with the private sector within the framework of an overall indicative plan. Deliberative councils and industry associations played significant roles in harmonizing the views of the public and private sectors and those of members of a particular industry. Cooperation between Government and business was facilitated by an oligopolistic structure whereby firms were organized into large, diversified business groupings (*keiretsu*) with cross shareholdings and subcontracting relationships with a large number of small and medium-sized enterprises. The situation was similar in the Republic of Korea, where family-based business conglomerates, the *chaebols*, were predominant, having been deliberately encouraged by the Government to correct the dearth of entrepreneurship. This, and the fact that the banks were publicly owned, facilitated an industrial policy similar to Japan's. In Taiwan province of China public enterprises were more important because private firms, though numerous, were too small to establish the key industries which required large-scale investments and business organization.

"State-created rents" were the centrepiece of government intervention. As pointed out long ago by Schumpeter, entrepreneurial innovation requires the lure of high profits. But the market mechanism is often unable alone to provide sufficient rewards for pioneering by firms in a developing country, since these face experienced foreign competitors. In such circumstances, if private business is to increase production capacity and productivity, compete aggressively for increased market share, and establish new industries, it needs additional incentives and subsidies.

The most important subsidies came from repressing interest rates, and from divorcing domestic prices from international ones. As has been demonstrated in the World Bank's recent study, *The East Asian Miracle*, Japan, the Republic of Korea and Taiwan province of China had greater levels of price "distortion" than, for example, Brazil, India, Mexico, Pakistan, and Venezuela. The most lucrative rents of the State, namely profits from import licences, were linked to strong export performance. As a general rule, subsidies carried conditions designed to improve overall economic growth.

Rapid industrialization reflected the swift pace of capital accumulation, without which these countries would have been unable to attain the productivity growth that they did. Their investment ratios were among the highest in the world. The initial boost came from abroad; but consumption was made to lag behind income growth to yield rising rates of domestic savings.

The extraordinary savings performance of these countries has not received a satisfactory explanation. Rapid income growth was certainly a factor, but this does not translate automatically into high savings rates. Since it was in corporate rather than household savings that the East Asian economies greatly outperformed Latin America, it would seem that part of the explanation lies in the way the policy regime affected corporate profits. By lifting profitability through rent generation and other means, government intervention served simultaneously to enhance the incentive of firms to invest and their capacity to finance new investment; investment was channelled into activities that maximized overall growth; this in turn increased profits, by allowing capacity to be more fully utilized and by quickening the pace of productivity improvement, which increased the overall rate of investment. A "virtuous circle" was thus set in motion, with strong propensities to save, invest and innovate feeding and being fed by profits growth. The importance of the investment-profits nexus in these economies is indicated by the high share of profits in value added.

Nevertheless, the income distribution was relatively egalitarian, largely because reforms in the system of land tenure had removed big landowners. The more even distribution of income appears also to have helped the development process by limiting demand for imported consumer goods and increasing the market for the products of traditional artisans and modern small- and medium-sized industries. This made it easier for Governments to sequence domestic machinery production before costly consumer durables such as motor cars, as well as avoid the extreme technological dualism typical in Latin America.

Growth went hand-in-hand with long-term transformations in the balance of payments, which lifted the foreign exchange constraint. Investment growth laid the foundations for future export growth by expanding and modernizing production facilities, while current export growth made it possible to step up investment. Industrial policy kept up the momentum by encouraging private sector investment and innovation, and directing it to those sectors where international trade was likely to expand most or the potential for productivity gains was greatest. This required giving priority to heavy and chemical industries, rather than allocating resources according to static comparative advantage.

The three economies displayed differences in the degree of trade dependence, reflecting differences in their size. Japan's internal market was large enough to allow the achievement of both economies of scale and (oligopolistic) competition in heavy and chemical industries without dependence on export markets; while these industries were being built up, the labour-intensive industries provided the main source of foreign exchange. In the Republic of Korea and Taiwan province of China, the rapid expansion of labour-intensive exports in the 1960s created a market for imported intermediates and capital goods, while industrial policy encouraged secondary import substitution, including heavy and chemical industries. These industries had to be pushed into exporting more quickly than in Japan because the domestic market was too small to permit scale economies without monopolistic conditions.

In all three economies, Governments engaged in a variety of selective interventions:

- In their *trade policy*, all supported industrial deepening and the development of national firms, with selective incentives to promote exports (including tariff rebates, tax exemptions on export earnings, short-term export credits), and selective protection, using foreign exchange controls and import quotas and tariffs. They liberalized specific industries step-by-step only as they became internationally competitive;
- They restricted *foreign direct investment* to carefully selected sectors. FDI never exceeded 4 per cent and 2 per cent of gross fixed capital formation in the Republic of Korea and Taiwan province of China, respectively;
- The Republic of Korea, like Japan, put great effort into *research and development* to adapt and improve imported technology. Its spending on R&D reached 2.3 per cent of GDP, the highest among the developing countries. The Government provided significant fiscal subsidies and tax incentives;
- All three economies provided *fiscal support* of various kinds to facilitate equipment investment and capital accumulation. Measures to reduce the effective tax rate on corporate earnings and to allow new firms to retain higher percentages of profits, as well as tax exemptions, investment tax credits and industry-specific depreciation allowances, encouraged enterprises to retain and reinvest earnings. They also stabilized corporate earnings in the face of cyclical fluctuations and reduced investment risks;
- *Financial* incentives were also given selectively to promote the development of particular industries, and varied over time as industries evolved. Interest rates were kept generally low and stable in order to reduce the cost of investment and encourage long-term lending for investment in plant and equipment. Especially low rates were given to particular sectors early in their development, for example through preferential "policy loans" and "policy-based" lending. Designated industries received priority in allocating of bank credit, state investment funds and foreign exchange;
- *Competition* policy was oriented towards both productivity and capital accumulation. Some circumstances required restricting competition, and others required promoting it. In order to implement industrial policy, Governments granted exemptions to firms, particularly in export sectors, from laws governing monopolistic practices. They also sought to control capacity expansion and to coordinate market-sharing arrangements in order to achieve efficient-scale plants and manage excess competition. Mergers and cartels were encouraged to attain optimum production scale, particularly in export sectors. Early entrants won monopolistic positions, but firms were encouraged to compete for the prize; and as the industry matured, other firms were allowed in, so as to generate the required degree of competition. Technology screening was also used to sharpen competition, as well as to upgrade technology.

Industrial deepening progressed rapidly and far. The evolution of the structure of industry did not merely conform to changes in comparative advantage brought about by the exhaustion of the supply of surplus labour. It also owed a great deal to the visible hand of government. As economies of scale were achieved, capacity utilization rates increased, and technological capabilities developed, the new industries became competitive on world markets. But typically, before that happened they received substantial government assistance. For instance, the Taiwanese Government led the market, and sought to attract resources into particular sectors, establishing public enterprises where necessary. In the Republic of Korea, without government support, no private agent would have been willing to bear the risks of investing in the heavy and chemical industries.

In short, the "economic miracle" in these economies was not entirely a "miracle of the market". There can be no doubt that the profit motive was the force driving business, and that capitalist enterprises were primarily responsible for carrying out economic development. Yet, it is very unlikely whether without the guiding hand of government, the "animal spirits" of the entrepreneurial class would have reached such a high intensity, or flowed spontaneously into developmental activities in a sequence capable of ensuring a continuous dynamic momentum. The economic policy regimes in Japan, Republic of Korea and Taiwan province of China should not be seen as deviations from laissez-faire capitalism. They correspond to another paradigm altogether, consisting of a forced-pace advance of industrial capitalism under the auspices of a State that was simultaneously the servant and master of business enterprise.

The fact that the Japanese model of industrialization was successfully adopted (and adapted) by two other economies in the region suggests that it can be applied in other places too. That is not to say it can be transplanted everywhere, any time. Each country confronts at any moment a unique situation which depends on a host of factors, including its own size, level of development, and past history, as well as the state of the world economy, something that is in constant flux.

Besides, it is also true that a number of countries (including some in East Asia that opened their doors wide to foreign direct investment) have been able to develop successfully with policies bearing little or no resemblance to Japan's. Moreover, various countries (for instance in Africa and Latin America) have failed precisely because they treated government intervention as a panacea.

These differing experiences suggest that our state of knowledge is as yet insufficient to provide a sure recipe for development in all circumstances. Scepticism rather than faith may therefore be in order. There may not be one right development strategy but several, depending on time and place.

But, of course, one cannot stop there: the challenge of development is too vast, especially in African and other least developed countries, for the economist to rest content with interpretations of things past. Rethinking development policy must also include finding workable solutions to the problems of the present and future. This is a task of great importance and urgency. It has been started, but it is not yet finished.

The Uruguay Round: An initial assessment

The main achievement of the Uruguay Round has been to effectively address those areas where the absence of international consensus and workable rules and procedures had given rise to ever-increasing trade tensions and disputes. Failure to reach agreement would have greatly exacerbated these tensions, leading to a "trade war" which would have seriously jeopardized the stability of the multilateral trading system and placed beyond reach solutions to other international economic issues.

The Agreements reached on safeguards, subsidies and countervailing measures, anti-dumping, agriculture, and textiles and clothing reassert, interpret and expand GATT rules in considerable detail, addressing issues which had given rise to misunderstandings and disputes in the past. Existing multilateral disciplines are now set out in terms of specific economic criteria rather than of rules and principles defined in normative terms. The increased predictability in the application of the trade measures governed by these Agreements should, in itself, significantly improve conditions for export-oriented investment.

Agreement on an effective and efficient multilateral safeguard system was of paramount importance in improving security of access to markets and reestablishing the credibility of multilateral disciplines. The Agreement on Safeguards has clarified and reinforced the disciplines for the application of safeguard measures, in particular by reaffirming the MFN clause and explicitly prohibits voluntary export restraints and similar measures. The Agreement on Textiles and Clothing provides a framework for the phasing out of the Multi-Fibre Arrangement (MFA), thus reversing the trend of the past three decades toward the continuous extension and expansion of the discriminatory and restrictive regime directed against developing countries' major industrial export.

At the end of a 10-year transition period, the same rules will apply to trade in textiles and clothing as to trade in other goods. This represents a serious setback for protectionist interests not only in the developed importing countries, but also for those in exporting countries that benefited from the economic rents.

A key feature of the Agreement on Subsidies and Countervailing Measures is the agreement reached on the definition of a "subsidy", reflecting an international consensus on the appropriate role for Governments in supporting production and trade. The Agreement identifies which subsidies are to be prohibited (those contingent upon export performance or upon the use of domestic over imported goods), permitted (i.e. "non-actionable" - in not being exposed to the possibility of remedial action), or applied only if they do not adversely affect the trade interests of other countries.

The Agreement on Agriculture constitutes an important first step towards stability and predictability in trade in agricultural products by establishing a binding "standstill and rollback" of protectionist measures in this sector, as a basis for further negotiations aimed at more meaningful liberalization and reform. Through "tariffication", all non-tariff measures affecting imports of agricultural products will be converted into bound customs duties, to be reduced by a fixed percentage. In many sectors, the tariffication process may not, in itself, provide any significant improvement in market access conditions; however, the minimum access commitment obliges countries to open a tariff quota equivalent to 3 per cent of domestic consumption, to be increased to 5 per cent over six years. The new disciplines on agriculture also contain commitments to bind and subsequently reduce overall support to the agricultural sector; Governments are thus free to choose from a variety of options in achieving these results. The Agreement contains commitments for the reduction of export subsidies in terms of value (budget outlays) and volume.

The Agreement on Implementation of Article VI of GATT 1994, which represents the outcome of the third attempt to clarify the GATT rules on anti-dumping measures, provides more detailed rules on the procedures for initiating investigations, calculating dumping margins, determining the existence of injury and reviewing findings and undertakings. Negotiations in this area were characterized by the process of alignment with the practices of either the European Union or the United States, drawing on the experience acquired in the application of the Tokyo Round Code. The consequence was often alignment at a higher degree of discipline, although there are some significant exceptions.

Further trade liberalization

A major outcome of the Uruguay Round is an MFN tariff reduction in developed countries on industrial products by an average of 38 per cent on a trade-weighted basis, bringing tariffs down to 3.9 per cent on average. This significant reduction of tariff levels derived essentially from the "Quad" package negotiated among Canada, the European Union, Japan and the United States. Duty-free access for developing countries to these markets will significantly increase. The tariff reductions could serve to increase profits and stimulate export-oriented investment from retained earnings.

While developing countries stand to benefit from liberalization in all sectors, a significant proportion of their exports incur duties exceeding 10 per cent, in particular for products in sectors of export interest to them, such as non-tropical agricultural products, textiles and clothing, and leather and footwear; these are also the sectors with peak tariffs and tariff escalation. The momentum generated by the Uruguay Round should, however, be preserved since further tariff negotiations are already foreseen for the agricultural sector in 1999, while negotiations on services are to take place in 2000. Pending such multilateral action, improvement of their GSP schemes by preference-giving countries would be one way of mitigating this imbalance of results.

Most developing countries made substantial tariff concessions, consolidating the results of their liberalization programmes undertaken unilaterally, and bound their tariffs to an impressive extent. For several developing countries the average MFN tariff reduction on industrial products was comparable to, or greater than, that of OECD countries.

One of the objectives of the Uruguay Round was to correct the situation emerging from the Tokyo Round in 1979, where the nine Codes on non-tariff measures and certain product sectors had not been subscribed to by many GATT contracting parties, including most of the developing countries. A major result of the Uruguay Round has been the conversion of modified versions of these codes into Multilateral Trade Agreements which are binding on all WTO members. There has consequently been a dramatic increase in the levels of multilateral discipline for developing countries, particularly when the increases in bindings resulting from the tariff negotiations are taken into account.

The remaining four agreements retain their "plurilateral" character and are contained in a separate Annex to the WTO Agreement. Of these, the Government Procurement Code was renegotiated in parallel to the Uruguay Round (but with a smaller number of signatories) and the re-negotiation of the Agreement on Civil Aircraft is under way. The WTO Agreement leaves open the possibility of incorporating additional plurilateral agreements on the basis of consensus (one of which could well be the multilateral steel agreement that is at present under negotiation). These consensus provisions may well be required to prevent the concept of the so-called "conditional MFN" from penetrating WTO.

However, the liberalization and increased disciplines achieved are subject to certain qualifications and provisions which could lend themselves to abuse. The Agreement on Safeguards, for example, provides for the possibility of negotiating quotas with supplying countries, as well as for countries' deviation from strict MFN treatment where there has been a "disproportionate increase" of imports from certain supplying countries (the so-called "quota modulation" provisions). The Agreement on Textiles and Clothing provides that, during the transitional period, new restrictions can be negotiated or imposed under a "transitional safeguard mechanism", on a discriminatory basis, when importing countries determine that imports of textile and clothing are causing "serious damage" to their domestic industries. A vague link to other commitments could be viewed by certain importing countries as an excuse to introduce an element of negotiation into the liberalization programme.

The liberalizing impact of the Agreement on Agriculture is mitigated by a special safeguard clause which permits members to impose an "additional duty" on imports of those items subject to tariffication, if the volume of imports of a given product exceeds a "trigger level" in relation to domestic consumption or when import prices fall below a"trigger price". Within the tariff quotas provided, quotas have been allocated to specific suppliers to preserve their "current access opportunities". The preeminence of the Agreement on Agriculture is confirmed by the "peace clause", which ensures that actions taken in "full conformity" with the provisions of the Agreement cannot be challenged under the related provisions in the Agreement on Subsidies and Countervailing Measures, nor even under certain aspects of the Dispute Settlement Understanding.

On anti-dumping measures, the codification and alignment of current practices of the major trading countries has, in certain cases, resulted in lower levels of discipline and the legitimization of practices unfavourable to developing countries. Anti-dumping actions will be subject to a less stringent standard of review in dispute settlement procedures than that applied in other Agreements, obliging panels to accord relatively greater deference to the decisions of the administering authorities and to the provisions of the implementing legislation. In view of the relatively greater stringency introduced in the other Agreements, recourse to anti-dumping action may become even more the preferred "trade remedy" for protectionist interests.

Extension of multilateral disciplines

Initiatives to establish multilateral rules for the protection of property rights have a relatively long history. In the present "globalized" world economy, these initiatives have been broadened to address the whole spectrum of impediments which restrict the global operations of enterprises and concern not only traditional objectives, such as the "right of establishment" and "national treatment", but also access to telecommunications networks, the movement of executives and specialists, and the avoidance of conditions on investment that inhibit the execution of a global production strategy. Intellectual property has become a key element in comparative advantage; differences in levels of protection of intellectual property rights were leading to increased trade tensions, and the universal protection of such rights has become a major priority. The Uruguay Round embraced the negotiation of new multilateral disciplines in the areas of intellectual property and trade in services, linking them to the GATT rights and obligations through the institutional "umbrella" of WTO and its dispute settlement mechanism.

The General Agreement on Trade in Services (GATS) establishes an entirely new contractual framework to govern trade in services, based on its definition of such "trade" and the general obligation to provide unconditional MFN treatment for all measures affecting such "trade" in services. Each country's commitments with respect to national treatment and market access are confined to those relating to the sectors, subsectors and modes of supply specifically included in its individual Schedule of Commitments. The Agreement provides a framework within which developing countries will be able to obtain reciprocity for any further liberalization they undertake with respect to trade in services.

The most impressive feature of GATS is not so much the degree of liberalization that it has achieved, but rather the extension of the scope of multilateral trade rights and obligations to cover measures affecting such diverse aspects as foreign direct investment, professional qualifications, and the movement of persons and electronic data across national frontiers, thus making them legitimate subject-matter for inclusion in the negotiation of future trade commitments under GATS, as well as in other trade agreements. Despite strong lobbying efforts by protectionist interests, its scope covers all service sectors (only air traffic rights being excluded). There is, however, a considerable imbalance as to the extent to which different sectors or "modes of supply" have been made subject to specific commitments in the Schedules.

The Agreement on Trade-Related Investment Measures (TRIMs) does no more than prohibit such measures that contravene the GATT obligations and rules on national treatment and quantitative restrictions; it does not deal with the rights of investors *per se*. Those rights are addressed in GATS (rather than in the TRIMs Agreement), where it is clearly stipulated that neither "establishment" nor "national treatment" are "rights", but can be the subject of qualified concessions exchanged on a reciprocal basis (including concessions in other modes of supply such as the temporary movement of persons) with respect to specific sectors or subsectors. However, GATS implicitly recognizes the right of home countries to defend the interests of foreign affiliates of their enterprises through the dispute settlement provisions. Extension of the GATS approach of sector-by-sector negotiations on commercial presence, in exchange for benefits with respect to other modes of supply or other service or goods sectors, might provide a technique for bringing investment into the WTO orbit in a future round of negotiations.

Through the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), the essential provisions of the international conventions governing intellectual property protection have been made universally applicable on an MFN basis, given a binding character and incorporated as inherent rights enshrined in the multilateral trading system. The Agreement establishes disciplines for copyright, trade marks, geographical indications, industrial designs, patents, layout designs of integrated circuits, and protection of undisclosed information, in certain instances going beyond the provisions of the WIPO conventions. It provides new rules with respect to issues which had not been resolved in WIPO forums, the most important of which was acceptance that all products or processes in all fields of technology will be patentable. Other key aspects in this regard relate to copyright protection for computer software, protection for data banks and phonogram producers, the term of patent protection, the protection of undisclosed information, and civil litigation procedures. With the exception of certain commitments to encourage technology transfer to the least developed countries, there are no special provisions to facilitate the transfer of technology to developing countries.

Developing countries are likely to incur costs in applying this regime: these will relate not only to higher royalty payments to foreigners, and the increase in prices of products manufactured under licence or imported, but also to the administrative burden of implementing the Agreement. At the same time, however, there could be a greater incentive for enterprises to invest in developing countries and to license patented inventions to entrepreneurs in those countries.

Differential and more favourable treatment

The dramatic increase in the level of discipline accepted by developing countries through their acceptance of all the multilateral trade agreements resulting from the Uruguay Round and the binding of their tariff schedules has significantly reduced the flexibility of Governments in the use of trade and domestic policy instruments. Consequently, many WTO members will not be able to emulate the development strategies pursued successfully by many countries in the past and will need to adapt to the constraints and opportunities of the new system.

The provisions in various Agreements for differential and more favourable treatment go some way to remedy this situation. Many take the form of "best-endeavour" clauses, time-bound exceptions from obligations and longer periods for implementing obligations, flexibility in procedures and access to technical assistance and advice. In certain Agreements, differential and more favourable treatment has been given a more precise, contractual character, particularly in the form of numerical thresholds for undertaking certain commitments or of exemption from others. The promotion of development is an inherent objective of GATS as well as a general obligation, and it is not stated in terms of "special" treatment. In several Agreements account has also been taken of special problems faced by the countries in transition to market-based economies by introducing more flexibility in their respective obligations.

Development strategies in future will nevertheless have to be adapted to the post-Uruguay Round trading system. The success of such strategies will depend upon the effectiveness of WTO in ensuring secure access to markets and in preserving the momentum to further multilateral trade liberalization.

The least developed countries

The Punta del Este Ministerial Declaration recognized the need for "positive measures to facilitate the expansion of trading opportunities" for the least developed countries (LDCs). The Marrakesh Ministerial Decision on this subject exhorts members to implement expeditiously the provisions contained in the various Agreements in favour of those countries. In those Agreements which provide for differential and more favourable treatment for developing countries in general, more generous treatment is extended to LDCs, usually in the form of longer periods for compliance with and implementation of obligations. A Ministerial Decision was adopted as a political message to mobilize the support of Governments, through technical and financial assistance for food aid, as well as that of the multilateral financial institutions, to take action to mitigate the impact on the LDCs and net food-importing countries of the higher food prices that were expected to result from the new multilateral disciplines on agricultural export subsidies.

None the less, the poorer developing countries, including the LDCs and other developing countries in Africa, have emerged confronted by special difficulties on account of the erosion of the preferential margins they enjoyed (particularly under the Lomé Convention), the expected increase in the cost of imported technology and in the price of imported foodstuffs, and the much higher level of both legal and procedural obligations that they have assumed. The African countries, in particular, are not in a position to cope with additional challenges of this nature. There exists, therefore, a pressing need to devise measures to translate the recognition of the special problems of these countries in this respect into concrete action, as well as to assist them in taking maximum advantage of their new opportunities.

The revival of multilateralism

The Understanding on Rules and Procedures Governing the Settlement of Disputes substantially strengthens the dispute settlement mechanism and hence also the multilateral trading system. It ensures a complainant the right to the establishment of a panel, which must proceed through pre-determined successive stages in accordance with a clearly specified timetable. No member will be able to delay, postpone or block a decision. Panel reports are to be approved by the Dispute Settlement Body unless there is a consensus to reject them. Members are committed not to make a determination to the effect that a violation of obligations or other nullification or impairment of benefits has occurred except through recourse to this multilateral mechanism. The final recourse in a dispute remains that of the "suspension of concessions" (i.e. retaliation), which must be authorized and, in certain yet undefined instances, can be "cross-sectoral" (i.e. as between rights and obligations relating to trade in goods, trade in services and intellectual property rights). How this will affect developing countries (which initially opposed "cross-sectoral" retaliation) remains to be seen.

Another pre-Uruguay Round concern was that the multilateral trading system would degenerate into competing and mutually antagonistic "regional blocs" and a return to the policies of "spheres of influence" of the major powers, particularly if the Round failed. However, the outcome of the Round has served to dilute many of the discriminatory aspects of regional agreements, by reducing tariff preferences for regional partners through multilateral tariff reductions, and by establishing disciplines of equal or greater stringency than those in the regional agreements, thus "multilateralizing" large elements of such agreements. While the preeminence of the multilateral system has thus been reestablished, the momentum must be continued to ensure that regional trading arrangements remain a secondary and constructive option.

The Uruguay Round has also resulted in the extension of multilateral trade disciplines to cover a much larger number of countries, due to the recent accession to GATT of many developing countries. All WTO members will be subject to roughly the same level of multilateral obligation; any exceptions, including differential and more favourable treatment, are defined in precise terms. China, which participated in the Uruguay Round while negotiating its resumption of contracting party status, is still carrying out negotiations with a view to becoming an original member of WTO. If China, given the dynamism of its economy and its rapidly increasing importance in international trade, were to remain beyond the reach of multilateral rules and disciplines, the effectiveness of WTO in achieving its objectives would be diminished. The Uruguay Round furthermore attempted to adapt to the new situation arising from the dissolution of the USSR and the transition to a market-oriented economy by the newly independent States; in the later stages of the negotiations additions were made to several Agreements which took into account the specific problems faced by these countries in the transition process. Most of the countries concerned which are not contracting parties have initiated procedures for accession to GATT.

The WTO and future negotiations

Specific provision is made in some agreements for further negotiations, while in others comprehensive reviews of the operation of the Agreements are envisaged, usually within five years. Assuming that the WTO Agreement enters into force in 1995, multilateral negotiations will thus begin on a wide range of issues around 1999-2000, without any specific decision to this effect being required.

Meanwhile, countries face the challenging task of implementing the Agreements. These provide a mechanism for countries to effectively defend and pursue their interests if they have the requisite resources. The detailed elaboration and tightening of multilateral disciplines, the introduction of new concepts and detailed criteria for their application and the improvement of the dispute settlement mechanism provide new scope for action against trade-restrictive measures; countries, particularly the major trading nations, may accordingly be encouraged to initiate litigation to assert and clarify their rights and obligations.

Many developing countries, as well as the countries in transition, will be faced with serious challenges with respect to institutional capacity, human resource development and information management. Effective utilization of the Agreements requires coordinated governmental machinery on trade matters, in order to monitor compliance with the new rules by their trading partners, as well as to bring national legislation into conformity with the new rules and establish the institutional mechanisms for the purpose. Technical assistance programmes designed to assist these countries to respond to these challenges will undoubtedly be necessary.

The WTO Agreement (which some have described as a "mini-charter") is strictly institutional and procedural in character, and has no substantive rules or principles other than those which are included in the annexed Agreements. Its primary function is to link all the Multilateral Trade Agreements together, subject them to a common dispute settlement mechanism, and provide the framework for the implementation of the results of negotiations, on either a multilateral or a plurilateral basis. It commits its members to ensure conformity of their laws, regulations and administrative procedures with the obligations in the Agreements and also abolishes the "grandfather rights" (with one exception) which enabled countries to maintain mandatory legislation otherwise inconsistent with their GATT obligations. At the initial stage of its activities, the main objectives of WTO would consist of ensuring full and faithful implementation of the Uruguay Round Agreements.

As the negotiations concluded, the question of the future work programme was linked to the acceptance of the final package: acceptance by some countries was made conditional upon decisions to include certain new issues in the work programme of the WTO Preparatory Committee. In this connection certain developed countries laid particular stress on (a) links between trade rights and environmental measures, (b) multilateral rules on competition policy and (c) links between trade and labour rights. A series of additional proposals were submitted in Marrakesh which included the relationship between immigration policies and international trade; trade and investment; regionalism; the interaction of trade policies and policies relating to financial and monetary matters, including debt, and commodity markets, international trade and company law; compensation for the erosion of preferences; the link between trade, development, political stability and the alleviation of poverty; and unilateral or extraterritorial trade measures.

The Uruguay Round resulted in an extension of the scope of multilateral trade disciplines to cover those aspects of technology, investment, immigration policy and communications where Governments were willing to accept contractual obligations linked to their market access concessions. It did not attempt to address these issues in a comprehensive fashion. The extent to which the scope of WTO will be enlarged to encompass additional "trade-related" areas will be determined by the willingness (or reluctance) of countries to submit their policy measures in additional fields to contractual obligations that could expose them to the threat of possible trade sanctions.

The tendency to emphasize, or even exaggerate, the importance of the institutional result of the Uruguay Round, as opposed to the substantive results embodied in the constituent Agreements, may have had the unfortunate effect of setting up WTO as a target against which protectionist forces can rally. Political interest groups, driven by essentially parochial sectoral protectionist interests, are uniting to oppose ratification of the WTO Agreement on the basis of supposed threats to "national sovereignty". Similarly, the conversion of GATT into WTO appears to be used by others to claim that the institutional outcome of the Uruguay Round is a reason for downgrading the involvement of the United Nations proper in trade and development issues.

The relationship of WTO with the United Nations system and other international organizations remains to be defined. At its forthcoming forty-ninth session the General Assembly will be considering the strengthening of international organizations in the area of multilateral trade and in this context will have an opportunity to make proposals for ensuring the effective cooperation and complementary roles of these organizations.

The subjects referred to above for possible inclusion in the WTO work programme include wider economic, social and political issues that may both influence, and be influenced by, trade flows. But should the main thrust of further multilateral trade negotiations be to seek to establish disciplines in all areas where differing national standards and practices can affect competitiveness in international trade, thus extending the scope of trade disciplines even further into the areas of domestic policy measures and private sector practices? Would this not give rise to concern that there would be a significant strengthening of the arsenal of protectionist "trade remedies"? There is also the issue of how to address the problems - social, economic and other - that arise from changes in the size and direction of trade flows, and to devise mechanisms to assist those countries which may be disadvantaged, at least temporarily, by the inevitable adjustment process, as well as to provide a "safety net" for those which will simply be unable to compete effectively in the foreseeable future. The extent to which these various issues can be dealt with through the extension of multilateral trade disciplines depends on the factors mentioned above. Many "trade-related" issues could also be considered as problems of "governance" in the United Nations context.

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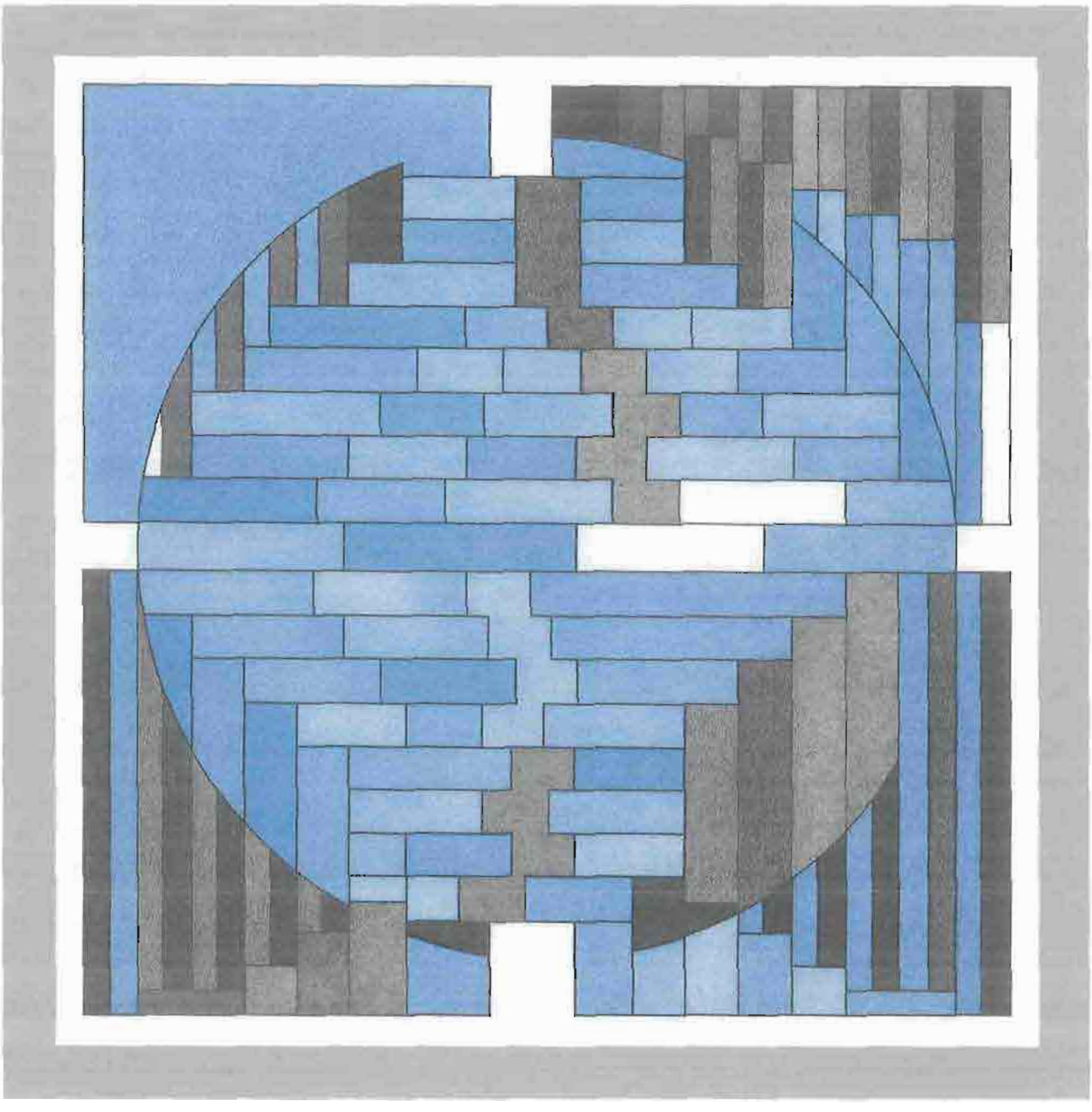
GLOBAL TRENDS



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Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

The world economy continued to perform poorly in 1993, making it the fourth consecutive year of relatively slow growth. The maintenance of high interest rates in a number of Western European countries and continuing debt deflation and currency appreciation in Japan have largely offset the moderate economic recovery in North America. By contrast, growth in most developing regions continued to accelerate in 1993 and is expected to maintain its pace in 1994. For the economies in transition, there were definite signs of a turnaround in a few cases but most continued to be plagued by high inflation and declining output. Prospects for a strong global performance depend critically on whether and how far the developed world takes measures to remedy the persistent weakness of demand.

A. Recent performance

There continues to be a distinct divergence of trends among three major groups of countries, though there is much variation within each of the groups:

- slow or no growth in OECD countries;
- contracting output in transition economies;
- rapid and sustained growth in developing countries.

World output rose by 1.7 per cent in 1993, against 1.3 per cent in the previous year. World trade continued to grow more rapidly than world production, but the 2.5 per cent increase in volume in 1993 stands in sharp contrast to the 5.4 per cent achieved in 1992 (see table 1).[1] It is no coincidence that the regions where trade expanded more than the world average (North America, Latin America and Asia) were also those with rapid output growth.

1. Developed market-economy countries

The rise in output in developed market-economy countries in 1993 was 1.4 per cent, somewhat below the 1.8 per cent of 1992. As explained in detail in Part Two of this report

1 Trade in 1993 may be significantly understated because of incomplete coverage resulting from the abolition of customs controls on trade among members of the European Union and the consequent institution of the new system for collecting trade data (Intrastat). Exports of EU countries in 1992 amounted to some 40 per cent of the world total and trade among EU countries alone accounted for 24 per cent. For further details, see GATT press release 1625 of 30 March 1994.

Table 1

WORLD OUTPUT, 1980-1994

(Percentage change)

Country groups	1980-1990 (Annual average)	1991	1992	1993 [a]	1994 [b]
World	2 9	0.3	1.3	1.7	2 5
Developed market-economy countries	2.8	0.3	1.8	1.4	2.4
of which:					
United States	2.7	-1.1	2.6	3.0	3.4
Japan	4 1	4 0	1.3	0.1	0.5
European Union	2.4	0.7	1.1	-0.4	1.6
of which:					
Germany [c]	2 3	1 8	2.5	-1.3	1.0
France	2.3	0.7	1.4	-0.9	1.2
Italy	2.2	1.3	0.9	-0 7	1.2
United Kingdom	2.7	-2.3	-0.5	1.9	2.5
Central and Eastern Europe	2.1	-11.9	-15.5	-9.9	-6.8
Developing countries	3.0	3 8	3.3	3.8	3.8
of which:					
America	1.3	3.5	2.7	2.9	2.5
Africa	1.9	1.6	0.8	1.2	1.8
Asia	4.6	4.7	4 8	5.0	5.2
Least developed countries	2.3	0 5	0.4	2.1	2.8
China	8.8	7.1	11 4	13.4	10.0
Memo item:					
World exports (volume)	3.7	2 0	5.4	2.5	5.0

Source: UNCTAD secretariat calculations, based on national and international sources.
a Estimate.
b Forecast.
c Including the eastern *Länder* after 1990.

(chapter II), with the major exception of the United States, most of these countries continued to encounter serious economic difficulties in 1993, with high and rising unemployment.

Recovery in the United States began in the third quarter of 1991. Growth was sluggish in the first half of 1993, but in the latter part of the year resumed momentum; the resulting increase in output of 3.0 per cent for the year as whole was somewhat higher than the 2.6 per cent of the previous year. The unemployment rate was reduced from 7.4 per cent in 1992 to 6.8 per cent, a rate which is still high by past standards. In contrast to foreign demand, which had a negative effect on GDP due to continued stagnation in other developed market-economy countries, private domestic demand, particularly household consumption and housing investment, grew thanks largely to a highly supportive monetary policy. This constituted the main underlying factor allowing productivity increases to be translated into output growth.

There was no significant recovery in other OECD countries, except for Australia, New Zealand and the United Kingdom. Indeed, in 1993 the EU economies as a whole moved into outright recession, with output declining by 0.4 per cent, and in Japan growth virtually came to a halt. The Japanese economy was adversely affected by the strong yen and the balance sheet adjustment following the steep declines in equity and real estate prices, and failed to respond significantly to the three policy packages designed to stimulate the economy between August 1992 and September 1993. The persistent appreciation of the yen against the dollar caused the trade surplus to mushroom in dollar terms, in spite of both a sharp volume decline in exports and increase in imports.[2]

In Western Europe, contrary to expectations, economic conditions deteriorated significantly in 1993, presenting most Governments with an acute dilemma between stimulating the economy and reducing unemployment, on the one hand, and reducing the budget deficit, on the other. Following a downturn in Germany, stagnation set in in most EU economies after modest growth in the second and third quarters of the year, with the notable exception of the United Kingdom, where there was a rise of 1.9 per cent. Output in Germany, France, and Italy declined respectively by 1.3 per cent, 0.9 per cent and 0.7 per cent, resulting in an overall decline of 0.4 per cent for the EU as a whole.[3] The unemployment rate continued to rise in the major countries in 1993, to 8.3 per cent in Germany (excluding the eastern *Länder*), from 6.7 per cent in 1992, and to 11.7 per cent in France (from 10.4 per cent). It even increased (from 9.8 per cent to 10.3 per cent) in the United Kingdom, in spite of the economic recovery.

Policy in the various EU countries diverged significantly following the turbulence of the foreign exchange markets in 1992. In some, notably the United Kingdom and Italy, participation in ERM was suspended and the currency allowed to depreciate, while in others, such as France, maintenance of the currency at the central parity against the Deutsche mark was preferred to exercise of the wide band option. In consequence, export performance improved in the United Kingdom and Italy at the expense of other EU countries, notably France and Germany.

2. *Developing countries and China*

World economic growth is presently concentrated in developing countries. Output continued to expand in 1993 in these countries, and growth even accelerated to 3.8 per cent (from 3.3 per cent in the previous year),[4] in spite of generally weak export demand in the developed world. However, there were wide differences among countries and regions, in particular with respect to Asia and Latin America, on the one hand, and Africa, on the other.

During 1993, heavily indebted developing countries continued to benefit from low interest rates which reduced their debt service payments. However, the continuing recession in the industrial countries adversely affected most developing countries by depressing further the prices of most commodities.[5]

Economic performance continued to be least satisfactory in the African region, where output rose by 1.2 per cent in 1993, a rate which exceeded the 0.8 per cent achieved in 1992 but which was below the rate of population growth, with the result that per capita income continued to decline. Economic performance in sub-Saharan African economies has remained weak since the bottom fell out of the markets for commodities in the mid-1980s. It has also been hampered by natural disasters such as the drought in North Africa and Eastern and Southern Africa, as well as by political unrest and civil conflicts in countries such as Liberia, Angola, Mozambique, Zaire, Sudan,

2 The volume of exports from Japan fell by 1.5 per cent in 1993, having risen by 1.5 per cent in 1992. The volume of imports, on the other hand, increased by 3 per cent, having declined by 0.5 per cent the previous year. For a more detailed discussion, see Nomura Research Institute, *Quarterly Economic Review*, February 1994 (Vol. 24, No. 1), pp. 12-13.

3 For the four prospective new members of the Union, output in both Finland and Sweden had been declining in the three years up to 1993 and Austria moved into recession in 1993. In Norway, on the other hand, growth was again positive in 1993 but slower than in 1992 (2.2 per cent, against 3.3 per cent).

4 The weighting system used for aggregating individual country data in dollar terms reflects more than the relative importance of individual countries in world output; it directly affects the estimated aggregate dollar value of world output and its rate of change over time. A change in the base year is only one reason that may lead to different regional growth rates. The measurement of regional shares in world output is also affected by the exchange rates used for conversion into dollars. If the purchasing power parity (PPP) of a domestic currency is used, rather than the official exchange rate, the share of developing countries in world ouput can be expected to come out higher, since studies show that official rates tend to understate the purchasing power of the currencies of those countries to a greater extent than in developed economies. The share of developing countries in world ouput is thus 17.4 per cent on the basis of official exchange rates but 34.5 per cent on the basis of PPP. The corresponding figures for developed market-economy countries are 73.7 per cent and 54.5 per cent. For further details, see Asian Development Bank, *Asian Development Outlook 1994* (Hong Kong: Oxford University Press, 1994), pp. 229-230.

5 The effect on the terms of trade was softened for oil importers by the declining and low price of oil, but by the same token the export earnings of oil-exporting countries were sharply reduced.

Somalia, Burundi and Rwanda. African oil-exporters have been hit by the weak oil market.

In Latin America there was a continuation in 1993 of the moderate recovery which began in 1991. GDP grew by 2.9 per cent, marginally above the 2.7 per cent of 1992, in a climate of relative price stability (with the principal exception of Brazil). Though below the record level of 1992, there was a continued massive net inflow of capital, far in excess of the current account deficit, which widened as import volumes expanded rapidly.[6] There was also a sharp rise in the volume of exports, by almost 9 per cent, thanks to the vigorous growth of intra-Latin American trade, itself largely due to the expansion of imports and to recovery in the United States, as well as to success in export diversification. The terms of trade, however, continued to decline.

Within Latin America it is possible to classify countries into four groups with respect to their performance during 1992-1993: (1) those which had turned around from recession to recovery; (2) those with accelerating rates of growth; (3) those with declining rates of growth; and (4) those which moved into recession. Prominent in the first group are Peru and Brazil.[7] After three years of poor performance, Brazil contributed positively to the expansion of regional output in 1993. Countries in the second group include Bolivia, Colombia and Paraguay. Included in the third group are countries such as Argentina, Chile and Costa Rica, where although growth in 1993 was slower than in 1992 it was still as much as around 6 per cent; but the group also includes countries where there was a sharp decline in growth in 1993, such as the Dominican Republic, Guyana, Honduras and Uruguay.[8] Of particular importance is the steady decline in the growth of the Mexican economy, from 4.4 per cent in 1990 to 0.4 per cent in 1993. Finally, countries which moved into outright recession (the fourth group) include Nicaragua and, more significantly, Venezuela.[9] Trinidad and Tobago, in particular, moved into deeper recession (output declining by 0.6 per cent in 1992 and 1.0 per cent in 1993).

Developing countries in Asia continued to show resilience and robust growth. This was once again the fastest growing region, sustaining a rate of increase of 5 per cent in 1993. A major factor was the vigorous growth of intra-regional trade and foreign direct investment, both of which benefited greatly from the appreciation of the yen. For these fast-growing economies, labour shortages and bottlenecks in infrastructure continued, by and large, to be the main constraints on growth. Both the newly industrializing economies (NIEs) and the ASEAN-4 performed better than in the previous year, with rates of growth of 6.0 per cent and 6.5 per cent, respectively, compared to 5.3 per cent and 6.1 per cent in 1992.[10] Particularly noteworthy was the dramatic reversal in Singapore, where growth had been slowing down for several years; there was also the beginning of a recovery in the Philippines. Growth remained high in Viet Nam (at 8 per cent, which was only slightly below the previous year), and was respectively 4 per cent and 6 per cent in Cambodia and Lao People's Democratic Republic.

In South Asia and West Asia, output continued to increase in 1993, at rates only slightly below the previous year. In West Asia the slight deceleration (from 4.6 per cent in 1992 to 4.3 per cent) was mainly due to the slowdown in growth in the Islamic Republic of Iran (from 4.6 per cent to 3.4 per cent). Kuwait continued its drive to restore pre-Gulf war levels of oil production and Iraq pursued the rebuilding of non-oil infrastructure. Growth in most South Asian countries continued to be constrained by fiscal and balance of payments considerations and inadequate infrastructure as well as by political problems. In recent years wide-ranging measures of reform have been undertaken, covering all sectors of the economy and involving the dismantling of rigid controls and the removal or relaxation of restrictive policies with a view to improving internal and external balance, productivity and exports. While the full impact of these reforms will not be felt for some time, their effects have already been noticeable in India, Sri Lanka and

6 The net capital inflow in 1993 is estimated to have been $54.6 billion, but as much as $62.0 billion in 1992. The current account deficit in 1993 was $42.6 billion. See Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Economy of Latin America and the Caribbean 1993*, Santiago, Chile, December 1993, tables 1 and 16.

7 Output in Peru and Brazil declined by 2.8 per cent and 0.9 per cent, respectively, in 1992 but grew by 6.5 per cent and 5.0 per cent in 1993.

8 GDP growth fell from 7.8 per cent in 1992 to 2.0 per cent in 1993 in the Dominican Republic, from 7.8 per cent to 4.0 per cent in Guyana, from 5.6 per cent to 3.5 per cent in Honduras, and from 7.4 per cent to 2.0 per cent in Uruguay.

9 GDP in Nicaragua grew by 0.8 per cent in 1992, but contracted by 1.0 per cent in 1993. Similarly, in Venezuela it expanded by 6.8 per cent in 1992 but declined by 1.0 per cent in 1994.

10 NIEs are defined as Hong Kong, Republic of Korea, Singapore and Taiwan province of China; ASEAN-4 refers to Indonesia, Malaysia, Philippines and Thailand (see *TDR 1993*, Part Two, chap. IV).

Bangladesh. India has become one of the largest emerging markets, attracting substantial inflows of equity investment in recent years. In Pakistan, on the other hand, output growth fell from 7.8 per cent in 1992 to 2.6 per cent, largely because of political uncertainty and damage to both the cotton crop (from a virus) and the wheat crop (drought). Consequently, for South Asian developing countries as a whole there was a slight decline in growth in 1993, as noted above.

Following a year of negligible growth, output in the least developed countries as a whole rose significantly in 1993, with an estimated GDP growth of 2.1 per cent, due primarily to the acceleration of growth in Asian LDCs. In African LDCs, however, there was hardly any growth, and in the island LDCs there was actually a decline.[11] The LDCs continued to be adversely affected by depressed commodity prices and recession in Western Europe. Some of those in Africa, as well as some other African developing countries, also suffered from bad weather, affecting agricultural output and political instability. Indeed, civil strife often not only severely disrupted the domestic economy but also had an impact on neighbouring countries.

In China, an investment boom was responsible for a 20 per cent increase in industrial output in 1993, resulting in an increase in GDP even greater than that achieved already in the previous year (13.4 per cent, against 11.4 per cent). The consequence was, however, a rise in the rate of inflation from 8.6 per cent to 14.5 per cent, which led to the adoption of a 16-point austerity programme to provide more effective and stricter macroeconomic controls. Massive inflows of foreign direct investment, which have in the past been concentrated in coastal areas, are now directed to inland regions too, and are expected to give a further impetus to growth. There has also been a rapid expansion of Chinese investment in Hong Kong, as well as in other countries in developing Asia. Because of China's close ties with other countries of the region, especially the NIEs, in terms of trade and investment, the dynamism of the Chinese economy has been a major factor underlying the rapid growth of the region's trade and output which has contributed to maintaining stability in the world economy.[12]

3. Central and Eastern Europe

The prolonged contraction of production in Central and Eastern Europe continued in 1993.[13] Output declined by 10 per cent, on top of the 16 per cent in the previous year. There was much variation, however, among countries. In a few there were clear signs of an upturn, while output continued to decline in others. Exports and production in most countries were affected by the recession in western Europe and large current account deficits, and shortages of foreign exchange continued to pose major problems. Nevertheless, the sharp deterioration in the current account balances of all countries of the region (with the exception of the Czech Republic), as a result of growing imports but declining exports, was unexpected.

There were signs of improving macroeconomic performance in a number of countries, but also of emerging new problems and constraints. Indeed, the process of transformation which began in 1989 has led to growing differences among countries in the region - some are now fairly advanced in their transition to a market economy and have stopped and even reversed the declining trend in output, while others are still in the midst of recession with uncertain prospects for the immediate future.

For the region as a whole (but excluding the former USSR), GDP continued to decline in 1993, but at 3 per cent the decline was much smaller than in previous years. Only in Yugoslavia (Serbia and Montenegro) and to a lesser extent the former Yugoslav Republic of Macedonia, did output fall more than in 1992.[14] Elsewhere, the decline in output slowed significantly. Indeed, in Poland the recovery which began in 1992 strengthened in 1993, with growth reaching some 4 per cent, and in Albania the recovery of agricultural production was largely responsible for an increase of GDP

11 For a fuller review of the performance of the LDCs, see UNCTAD, *The Least Developed Countries, 1993-1994 Report* (TD/B/402/11), United Nations publication, Sales No. E.94.II.D.4, Part One, chap. I, sect. B.

12 For a fuller discussion of this subject, see *TDR 1993*, Part Two, chap. IV.

13 The UNCTAD secretariat's former classification "Socialist countries of Eastern Europe" included the USSR. In the present Report these former socialist countries as a group are referred to as "Central and Eastern Europe". See the Explanatory Notes at the beginning of this Report.

14 8 per cent in 1990, 12 per cent in 1991 and 7 per cent in 1992. See Economic Commission for Europe, *Economic Survey of Europe in 1993-1994* (United Nations publication, Sales No. E.94.II.E.1), table 3.1.1. It should be noted that in that table, in accordance with ECE practice, the economies of the successor states of the Socialist Federal Republic of Yugoslavia are also included in the transition economies of Central and Eastern Europe.

of 11 per cent, in contrast to a decline of 6 per cent in the previous year. Following four successive years of decline in Romania, GDP rose by about 1 per cent in 1993 due mainly to agriculture and certain industrial sectors. It would appear also that the recession has come to an end in Slovenia, the Czech Republic and Hungary, with prospects of resumed expansion. In spite of the progress which has been achieved, recovery in these countries is still fragile and subject to the risk of setbacks as the authorities continue to struggle with problems in the areas of macroeconomic stabilization, privatization of state-owned enterprises and reforms in banking.

In the area constituted by the former USSR (CIS and the Baltic States), the economic situation in 1993 continued to be depressed. Both external and domestic factors have led to continuing economic and political instability in most of these countries, and they were particularly affected by the collapse of the high level of trade that they previously conducted among themselves. Most members of CIS suffered not only from a severe decline in their terms of trade with the Russian Federation and other suppliers of energy, on account of having to pay for these supplies at world prices, but also from interruptions in deliveries because of non-payment of debts and the disruption of the inter-state distribution systems. The economies of the Baltic States, which have been severely affected by the loss of markets in the rest of the former Soviet Union, and by higher energy prices, have on the whole suffered more than those of the other transition economies.

In 1993, output in the CIS area declined by 13 per cent and in the Baltic States by 15 per cent. While in Russia the decline was 12 per cent, in most other CIS members it was much greater. The one notable exception is Turkmenistan, a net energy exporter, which reported an increase of about 8 per cent in GDP. The declines in output were generally smaller than in 1992, but that alone is not a sufficient cause for optimism. All the former republics of the USSR, in particular Russia and Ukraine, are still beset by serious economic difficulties; and there is also a risk of future political instability in some cases. Their conditions and prospects for recovery in the near future remain not only unclear but also highly uncertain.

B. Short-term outlook

The world economy is expected to strengthen moderately in 1994 as the recovery in Europe gradually gathers momentum and stimulates further growth in North America. The rise in world output is projected at 2.5 per cent (table 1) and in the volume of world trade at 5.0 per cent. Developing countries should continue to grow at much the same rate as in 1993 (which was almost 4 per cent), though with continued variation among regions. The fastest-growing region will be Asia (5.2 per cent), due to the same factors as operated in 1993. While growth is projected to accelerate to 6.4 per cent in the NIEs, China is expected to maintain a more subdued (but still high) rate of growth of 10 per cent. The ASEAN-4 countries are expected to grow by 7.1 per cent, thanks to improvements in social and physical infrastructure resulting from increased investment in past years. With the recovery of Pakistan, growth in South Asia is forecast to rise to 4.9 per cent.

In Latin America, output should continue to expand, with relatively stable inflation rates in most countries, but the implementation of stabilization programmes will lead to a slowdown in Brazil and a further contraction in Venezuela. Growth for the region as a whole is expected to be 2.5 per cent, somewhat lower than in the previous year. Prospects for growth and stability in the region, however, remain hostage to the volatility of capital.

Prospects for Africa remain bleak, with at best only a marginal increase in output and a consequent further decline per capita. While the export earnings of African countries dependent on agricultural products and minerals are likely to increase because of recent improvements in commodity prices and a modest recovery in Western Europe (which accounts for some 60 per cent of developing Africa's exports), depressed world oil prices will continue to constrain the oil-exporting economies such as Nigeria, Gabon and Algeria. In addition, there are uncertainties associated with the 50 per cent devaluation of the CFA franc and with the weather, especially in those countries which have suffered from drought, as well as with risk of further unrest and conflict.

As regards the LDCs, some should benefit from the recent improvement in commodity prices and from recovery in Western Europe, but much will continue to depend on weather conditions and the flow of ODA and external support. For most African LDCs, however, there will be little prospect for economic recovery if political stability is not restored.

Although there is much uncertainty over the evolution of the economies of Central and Eastern Europe, output is expected to grow in a few cases, but for the region as a whole further contraction seems likely, notably in the countries comprising the CIS.

The modest revival forecast for the industrial countries - an increase in the growth rate from 1.4 per cent in 1993 to 2.4 per cent - reflects the drag on expansion represented by the persistence of demand deficiency in Western Europe and Japan. Low interest rates have played a major role in the recovery of the United States economy, but in February 1994, in view of the unexpectedly rapid acceleration of growth in the second half of 1993, the Federal Reserve Board put an end to its five-year-old policy of easy money by raising the federal funds rate. GDP is expected to rise by 3.4 per cent for 1994, which will provide only a modest stimulus to other industrial countries.[15]

In Western Europe, growth patterns have become increasingly divergent, the outcome of varying competitive positions and differences in fiscal stance, and although the recession has come to an end, growth continues to be constrained by both fiscal and monetary policies. Interest rates have fallen only modestly, and in real terms remain exceptionally high. German monetary policy is still heavily dominated by domestic considerations and remains relatively tight. The German economy began to stabilize somewhat toward the end of 1993 and economic performance should gradually strengthen to yield a growth rate of 1.0 per cent in 1994, in contrast to a decline of 1.3 per cent in 1993. Consequently, growth in EU as a whole should be resumed, reaching an average of possibly 1.6 per cent in 1994, as compared to a decline of 0.4 per cent in the previous year.

In Japan recovery is not yet strongly in evidence, in spite of numerous policy packages to stimulate the economy, which continues to be plagued by a combination of debt deflation and currency appreciation. With a cut in income taxes and further increases in public works planned for the second half of 1994, some rebound of the economy is expected, but without any significant increase in domestic demand the rise in output is unlikely to be more than about 0.5 per cent.

C. Uncertainty in short-term forecasting

The growing integration of the global economy in terms of trade and financial markets has increased the complexity of the task of forecasting based on econometric models. It is difficult to identify and specify the nature and extent of the relevant international linkages in trade and financial flows, their changes over time, and the relevant national policy responses to them. The hazards involved in short-term forecasting can be seen from table 2, which compares forecasts for 1993 made by various international organizations and research institutions for selected OECD countries with the actual outcome.[16] What is most noteworthy is that the rapid deterioration of the Japanese economy was altogether unforeseen. The upsurge in the United States in the latter half of the year also came as a surprise to many forecasters. The same individual forecasts that proved to be unduly pessimistic for the United States also proved to be unduly optimistic for Japan.

Alternative forecasts for 1994 for selected OECD countries by the same international organizations and research institutions, are presented in table 3. While there are discrepancies in the forecast for the United States, there is general agreement that recovery in that country is well under way, the main uncertainty being,

15 For a more detailed discussion of the outlook for the major industrial countries, see Part Two, chap. II, below.

16 For a fuller discussion of the recent record of economic forecasting, see *TDR 1993*, box 1.

Table 2

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1993: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS

(Percentage)

Country	LINK	ECE	OECD	EC/EU	IMF	NIESR	Nomura	UNCTAD	Actual
United States	3.2	3.0	2.6	2.5	3.2	3.3	2.5	2.0	**3.0**
Japan	1.4	1.5	1.0	1.5	1.3	2.1 [a]	1.4	1.0	**0.1**
Germany	-0.7	-1.0	-1.9	0.0	-1.3	-0.3 [a]	-1.4	-1.7	**-1.3**
France	0.3	-0.5	-0.7	1.0	0.0	0.9	-0.1	-0.8	**-0.9**
Italy	0.5	-0.5	-0.2	0.8	0.3	1.1	-1.2	-0.2	**-0.7**
United Kingdom	1.4	1.0	1.8	1.5	1.4	2.0	0.3	1.3	**1.9**

Source: Reproduced from *Trade and Development Report, 1993*, tables 1 and 2 (which latter indicates the sources of the various forecasts)

a GNP.

Table 3

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1994 FOR SELECTED OECD COUNTRIES

(Percentage)

Country	LINK	ECE	OECD	EC/EU	IMF	NIESR	Nomura	UNCTAD [a]
United States	3.5	3.5	4.0	2.6	3.9	3.4	3.9	3.4
Japan	1.0	0.5	0.8	1.3	0.7	0.4	-0.5	0.5
Germany	1.3	0.5	1.8	0.5	0.9	1.0	-0.2	1.0
France	1.4	1.0	1.8	1.0	1.2	1.7	0.6	1.2
Italy	1.9	1.0	1.5	1.6	1.1	1.7	0.6	1.2
United Kingdom	2.6	2.5	2.8	2.5	2.5	2.9	2.4	2.5
Memo item:								
Total OECD	2.3 [b]	2.0 [c]	2.6	1.3 [d]	2.4 [e]	2.2	1.9	2.3

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook" (mimeo), Post-meeting forecast (April 1994); ECE, *Economic Survey of Europe in 1993-1994* (United Nations publication, Sales No. E.94.II.E.1); OECD, *OECD Economic Outlook* (June 1994); Commission of the European Communities, *European Economy, Supplement A* (November/December 1993); IMF, *World Economic Outlook* (April 1994); National Institute of Economic and Social Research (London), *National Institute Economic Review* (May 1994); Nomura Research Institute (Tokyo), *Quarterly Economic Review* (May 1994).

a See table 1.

b Including also Israel and South Africa.

c Excluding Australia, Iceland, Luxembourg and New Zealand.

d European Community only.

e Excluding Turkey.

as already noted, how monetary policy will evolve. There are many more uncertainties as regards Japan, currently suffering from its worst recession since the war. The economy has failed to respond to numerous stimulative fiscal packages, its large trade surplus is a source of tension with the United States, and there is uncertainty regarding the political situation. These factors are reflected in the substantial discrepancies among the various forecasts, ranging from a decline in GDP of 0.5 per cent to an expansion of 1.3 per cent.

With respect to Western Europe, it is generally agreed that in most countries the recession has come to an end and that there should now be some upward momentum. However, because of their high degree of interdependence, recovery in one country is not likely to be sustained indefinitely without support from recovery in other countries. At the same time, only Germany is in a position to provide, on its own, sufficient stimulus to the growth of other countries, the reason being not so much its share of overall GDP as the role of the Deutsche mark in the EMS. Now that German inflation has been brought under control, the key issue is how far and how fast the Bundesbank will be prepared to further ease its monetary stance. Uncertainty on this score largely explains the wide range of forecasts, ranging from a decline of 0.2 per cent in GDP to a rise of as much as 1.8 per cent.

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Chapter II

RECENT DEVELOPMENTS IN INTERNATIONAL TRADE

In 1993 world trade rose in real terms by only an estimated 2.5 per cent, which was less than half the rate achieved in the previous year (see table 4). Nevertheless, the increase continued to be greater than that of world output, reflecting the continuing internationalization of manufacturing production. The slowdown in world trade owed much to the depressed level of activity in the developed world (reviewed in the previous chapter). On the whole, where exporters have performed well it has been either because of specific regional factors, in particular the dynamism of East Asia and the large capital flow to Latin America, and/or because of currency realignments. For most countries, export revenues have suffered from the low level of world demand and associated low prices of most primary commodities.

A. Developed market-economy countries

Growth was unusually sluggish in the industrial countries in 1993. The combined real GDP of those countries is estimated to have risen by a mere 1.4 per cent, and in several major OECD countries (including Japan, Germany, France, and Italy), economic activity and associated import demand either stagnated or declined. Declines in import volumes were pronounced in Western Europe, averaging about 4 per cent. Weak demand in Western Europe (GDP declined on average in 1993) is reflected in the rhythm of exports of the region's major trading partners. For example, the value of United States exports to Western Europe fell by over 5 per cent and that of Japan's by over 10 per cent (see tables 5 and 6). Trade among Western European countries accounts for the bulk of their total trade; Western Europe's total exports actually declined in volume, and its net stimulus to the rest of the world economy was consequently negative, to the extent of more than 1 per cent of its combined GDP.

It was only because of the recovery in the United States (where the increase in net imports accounted for slightly less than 1 per cent of the country's GDP) that the OECD economies as a whole were able to contribute in a small, albeit very modest, way to an increase in world output in 1993. Total imports into the United States rose by more than 9 per cent in value in 1993, an increase slightly exceeding that of 1992. A number of developing countries were among the main beneficiaries of this increase in United States demand, notably South Asia (a 17 per cent rise in exports to that market), Latin America (9 per cent), and East Asia (8 per cent). Exports from China rose by as much as 22 per cent. In sharp contrast, United States imports from Africa were unchanged and from West Asia even declined, reflecting continued low prices of primary commodities, including oil.

The stimulus to the rest of the world from the United States recovery has nevertheless been somewhat smaller than that provided during the upswing of the early 1980s, when (in 1984) it amounted to as much as 1.8 per cent of GDP.[17] Part of the explanation lies in the weakness of the dollar (relative to this earlier period), and part to the greatly enhanced productivity of United States producers (see below, Part Two, chapter II). Unit labour costs in manufacturing have fallen over 40 per cent in the United States, relative to those of its trading partners, and relative export prices of man-

[17] See *OECD Economic Outlook*, June 1985.

Table 4

MAIN INDICATORS OF WORLD TRADE

(Percentage change)

	1991	*1992*	*1993*
World exports			
Volume	2.0	5.4	2 5
Unit value	-3 4	0.7	-3 5
Primary commodity prices (excluding fuels)	-7.1	-2.5	-3.5
***Memo item*:**			
World output	0 3	1.3	1 7

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

ufactures by over one third, since the mid-1980s.[18] Manufacturers have consequently been able to increase their market share both abroad and at home: the share of the United States in world exports rose from 11 per cent in 1986 to 12.5 per cent in 1993, while that of world imports declined from 17.9 per cent to 16.4 per cent.

In contrast to Western Europe, imports into Japan have grown steadily, after a decline in 1992, despite depressed domestic conditions largely caused by the appreciation of the yen. Sales of imported consumer durables rose by 19.2 per cent in real terms in 1993, whereas for domestically produced ones there was a fall of over 8 per cent.[19] Thus, the adjustment of Japanese external trade, which started towards the middle of 1993, was large as regards both exports and the imports, and exports declined steadily in volume despite the strong demand growth in the country's major markets, namely the United States and East Asia. Yen appreciation also gave strong encouragement to Japanese manufacturers to relocate their production facilities abroad. The fall in export earnings in terms of the yen had a highly adverse impact on domestic output; typically, in Japan a drop of 10 per cent in export volume causes a decline of as much as 1.4 per cent in domestic production,[20] apart from the impact on investment. However, Japanese capital goods and component parts continued to be shipped to production sites overseas, and exports of goods produced at those sites, especially in Asia, continued to increase rapidly. On the other hand, imports into Japan, often originating from Japanese production facilities in neighbouring countries, rose significantly. This tendency may well become more pronounced in future years (as discussed in Part Two, chapter I, below). If confirmed, it would have widespread consequences for Japan's trading partners, especially those in East Asia, and reinforce the trends (noted in last year's *Report*[21] and discussed further below) in the regional trade and production patterns which started to take shape towards the second half of the 1980s.

While the impact of exchange rate changes was strongest in Japan, it was also significant in a number of Western European countries; currency depreciation in Italy, Finland, Greece, Ireland, Portugal, Spain, Sweden, and the United Kingdom provided a stimulus to domestic manufacturing activity, whereas activity in other sectors remained generally sluggish. By the same token, currency appreciation hampered exports, as in Germany.

As a result of the movements in trade described above, international payments imbalances widened. In particular, the United States recovery, in combination with weak demand growth in most of its OECD trading partners,

18 See *OECD Economic Outlook*, December 1993, tables A39 and A40.

19 See Nomura Research Institute, *Quarterly Economic Review*, May 1994, Vol. 24, No. 2, p. 1.

20 *Ibid.*, February 1994, Vol. 24, No. 1, p. 12.

21 See *TDR 1993*, Part Two, chap. IV.

Table 5

UNITED STATES: TRADE BY MAJOR REGIONS OF ORIGIN AND DESTINATION IN 1992 AND 1993

(Percentage)

Origin/ destination	Exports				Imports			
	Increase over previous year		Share in total increase		Increase over previous year		Share in total increase	
	1992	1993	1992	1993	1992	1993	1992	1993
World	6.1	3.4	100 0	100.0	8.8	9.3	100.0	100.0
European Community	-0.4	-5.7	-1.4	-33.9	8.8	4.2	17.5	8.1
Japan	-0.8	0.4	-1.5	1.1	5.3	11.2	11.3	22.0
Developing countries in:								
Africa	11.1	-4.8	2.9	-2.1	1.1	2.7	0.3	0.7
Latin America	21.1	3.2	48.5	13.0	9.8	8.9	13.5	11.9
West Asia	11 9	-2 8	5.3	-2.1	-3 8	-7.9	-1 1	-1 9
South Asia	-5.3	27.9	-0.6	4.5	20.6	17.3	1 8	1.6
East Asia	9.2	10.1	20.7	36.8	11.6	8.3	21.5	15.0
China	18.9	17.3	4.6	7.5	35.4	22.8	15.5	11.9

Source: OECD, *Monthly Statistics of Foreign Trade*, various issues

induced a rise in the trade deficit of around $35 billion (to more than $130 billion) in 1993. On the other hand, the trade surplus of Japan rose by about $40 billion, to reach $145 billion. However, the dollar value of Japanese exports has been inflated by the appreciation of the yen, and the surplus in dollar terms might come down in the near future once the valuation effects of the appreciation (the so-called J-curve effect) wear off.

B. Developing countries

1. *Trade volumes and terms of trade*

The growth of world trade would have been much weaker in 1993 without the continued expansion of activity in the developing countries, in particular the sustained growth rates in Latin America and the accelerated growth in developing Asia. Exports from developing countries rose by about 10 per cent in volume and imports by about 8 per cent.

Imports into the fast-growing East Asian developing countries were particularly buoyant. In Latin America a continued high level of capital inflow, albeit more modest than in 1992, together continued output expansion, induced a further increase in imports (see table 7), the bulk of which was accounted for by Brazil and Colombia (facilitated by trade liberalization in the latter case and a certain degree of currency appreciation in the former). Exports from Latin America rose in volume by an estimated 11 per cent and from developing Asia by over 10 per cent, aided not only by steady growth within each region, but also by the recovery in the United States. While intra-regional trade had been particularly buoyant in East Asia, it

Table 6

JAPAN: TRADE BY MAJOR REGIONS OF ORIGIN AND DESTINATION IN 1992 AND 1993

(Percentage)

Origin/ destination	Exports: Increase over previous year 1992	Exports: Increase over previous year 1993 [a]	Exports: Share in total increase 1992	Exports: Share in total increase 1993 [a]	Imports: Increase over previous year 1992	Imports: Increase over previous year 1993 [a]	Imports: Share in total increase 1992	Imports: Share in total increase 1993 [a]
World	8.0	7.2	100.0	100.0	-1.6	3.4	100.0	100.0
European Community	5.5	-10.2	13.1	-27.4	-1.7	-4.1	14.5	-16.3
United States	4.9	10.9	17.8	42.5	-2.1	5.9	29.7	39.6
Developing countries in:								
Africa	16.5	9.5	2.6	0.3	-14.6	29.9	7.4	6.0
Latin America	24.5	7.5	10.9	4.2	-11.7	-6.5	29.0	-6.8
West Asia	25.4	-12.1	10.5	-6.6	-0.1	-3.7	1.0	-12.8
South Asia	-3.3	9.2	-0.4	1.0	-9.7	2.8	7.4	1.0
East Asia	8.6	14.2	32.1	58.4	-1.8	5.3	27.7	36.6
China	39.1	56.2	13.4	25.7	19.2	18.1	-73.5	37.6

Source: As for table 5.
a Derived from data for the first three quarters of each year.

has also become important for some countries in Latin America, especially Brazil; in spite of lower exports to Western Europe, its largest market, Brazil's total exports are estimated to have risen by over 11 per cent in real terms.

Many developing countries suffered from weak commodity prices during much of 1993, when the price index of commodities (including fuel), fell by 3.5 per cent (see table 8), marking the fifth consecutive year of decline. The terms of trade of most primary exporters, therefore, continued to be very unfavourable, and their trade balances also worsened markedly during 1993. However, many commodity prices began to recover in the autumn of 1993 and by the following April had on average risen by about one third above their level a year previously, albeit from a very low base. As is typical of commodity markets, however, these gains were short-lived, and prices of many commodities have in recent weeks been falling back.

Volatility is a characteristic of commodity markets. Prices of agricultural commodities have been most strongly influenced by supply-side factors. Favourable weather conditions drove prices of tropical beverages to historical lows in mid-1993, from which they recovered sharply when weather conditions deteriorated and crop diseases broke out. Coffee, for example, reached in June 1994 its highest price since 1986 and cotton prices also climbed to three-year highs. Although crude oil prices were on a rising trend, they were nevertheless, at mid-1994, still almost 4 per cent lower than a year earlier.

Metal prices collapsed by 15 per cent in 1993, amid protracted recession in OECD countries which affected prices for copper, tin, lead, zinc and iron ore in particular. Large exports from Russia depressed aluminium and nickel prices as well. However, the revival of the world economy and reduced export availabilities of aluminium from Russia have helped strengthen prices of metals since early 1994. Stocks are nevertheless abundant, and much of the recent rise in prices can be attributed to the activities of investors, including investment funds, whose extremely short-term profit horizons can lead to overshooting in either direction, contributing still further to price volatility. Many market commentators believe that such

Table 7

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1991-1993

(Percentage change in volume over previous year)

	Exports			Imports		
Grouping/region	*1991*	*1992*	*1993*	*1991*	*1992*	*1993*
World	2.0	5.4	2.5	1.9	5.8	1.2
Developed market-economy countries	2.6	4.4	-1.2	0.6	5.6	-2.9
Developing countries	9.8	6.8	10.0	15.2	11.3	7.9
of which:						
Latin America	1.4	5.0	11.0	13.3	17.0	7.3
Africa	3.9	-8.5	5.2	-	4.6	3.3
West Asia	2.7	3.9	11.4	16.3	15.0	-1.6
Other Asia	15.9	12.5	10.3	18.1	10.0	11.4

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

investors fled the bond markets in late 1993 and early 1994 in anticipation of interest rate increases and placed their funds in the commodity markets instead. Certainly, the fundamentals of the commodity markets do not appear to warrant price rises of the magnitude observed in recent months.

External imbalances became more acute in those countries where GDP growth was higher than the average of their trading partners' growth rates. Thus, even the continued modest expansion of output in Africa, combined as it was with poor export earnings (in spite of an increase in volume), led to a worsening of the trade balance. Because of the decline in their terms of trade, the purchasing power of Africa's exports fell by about 3 per cent in 1993.

Continued strong domestic activity, combined with weak export demand, also led to a widening of the external deficit of a number of fast-growing developing countries. The trade imbalance of Latin America with the rest of the world also widened, on account of continued real currency appreciation, domestic demand expansion and depressed prices for primary commodities. The effects were most pronounced in respect of the deficits of Chile and Colombia and of the reduced surplus of Brazil. On the other hand, for countries in recession, especially Venezuela, the trade balance improved. Weak commodity prices led to further declines in the terms of trade for the region, which were about one third lower than in 1988. The export purchasing power of the region, however, recorded a modest increase thanks to the strong expansion of non-traditional exports, particularly from Bolivia, Colombia, and Mexico.

2. *Recent developments in trade among developing countries*

Of the various developing regions, intra-trade has been rising most rapidly in Asia, so that intra-regional exports have been a rising share of total exports.[22] While intra-regional trade has recovered in Latin America during recent years, it is still very modest in Africa: intra-African exports amounted to only about 6 per cent of total African exports in 1990, or scarcely above the share in 1970.

The acceleration in intra-trade, especially in East Asia, coincided with the very fast expansion of world trade following the end of the recession of the early 1980s. Since then, world trade has consistently grown faster than world

22 For details, see *TDR 1993*, Part Two, chap. IV.

Table 8

WORLD PRIMARY COMMODITY PRICES, 1991-1994

(Percentage change over previous year)

Commodity group	*1991*	*1992*	*1993*	*May 1994* [a]
All commodities	-7.1	-2.5	-3.5	10.3
All food and beverages	-6.0	-2.7	1.9	10.1
of which:				
Tropical beverages	-8.1	-14.0	6.1	33.9
Coffee	-6.6	-20.1	15.5	51.6
Cocoa	-6.0	-8.2	1.9	1.7
Tea	-9.1	8.1	-4.9	-2.5
Food	-6.6	-2.1	0.7	7.3
Sugar	-28.6	1.1	10.6	10.1
Beef	4.7	-7.8	6.6	-3.0
Maize	16.8	-2.4	3.7	-17.7
Wheat	-6.0	20.5	1.2	7.4
Rice	9.4	-8.5	-6.8	9.7
Bananas	8.9	-15.6	-7.4	78.0
Vegetable oilseeds and oils	8.1	7.5	-1.2	3.0
Agricultural raw materials	-5.9	-2.4	-3.2	9.2
Hides and skins	-39.4	-3.2	28.8	23.7
Cotton	-7.0	-24.6	-	40.7
Tobacco	5.5	0.1	-1.5	-2.7
Rubber	-5.1	5.3	-2.2	14.6
Tropical logs	-8.0	4.7	-5.0	1.6
Minerals, ores and metals	-9.5	-3.7	-14.7	13.5
Aluminium	-20.6	-3.7	-9.2	20.9
Phosphate rock	4.9	-	-10.6	n.a
Iron ore	8.1	-5.1	-11.1	-9.3
Tin	-10.3	9.0	-15.4	15.2
Copper	-12.1	-2.4	-16.2	24.7
Nickel	-8.0	-14.2	-24.4	18.9
Tungsten ore	22.0	0.4	-37.0	18.2
Crude petroleum	-16.8	-0.5	-11.4	34.6

Source: UNCTAD, *Monthly Commodity Price Bulletin*, various issues.
a Change from December 1993.

output and has changed significantly in structure; there have also been large shifts in the distribution of world output. This period was one of a pronounced deterioration in the terms of trade for primary exports which encouraged many developing countries to diversify their export structure in favour of manufactures. Over the past decade many developing countries have emerged as major producers and exporters of manufactures, especially in mature industries, and the market shares gained by a few East Asian countries, not least in other developing countries, have been particularly impressive. As was documented in detail in last year's *Report*,[23] the increase in intra-East Asian trade, in combination with intra-regional

23 *Ibid.*

investment, has helped to accelerate the economic integration of the entire Asian region.

Large appreciations of the Japanese yen in 1985-1986 led to widely different responses by the established exporters of manufactures in the region (the newly industrializing countries and the ASEAN-4).[24] With production and export structures very similar to those of Japan, the NIEs gained much in terms of competitiveness from the Plaza Agreement of 1985. They also benefited from large inflows of FDI from Japan, as firms in that country resited production abroad. The ASEAN-4, by contrast, suffered from both higher import prices and a higher burden of debt, and since they did not compete directly with Japan they did not stand to gain from the rise in Japanese export prices. As a consequence, whereas the NIEs recorded double-digit growth during 1986-1987, the economies of the ASEAN-4 remained on the whole sluggish. However, the appreciation of the yen during recent months appears to have had the opposite outcome for these two groups of countries. Thanks to their fast pace of development since the late 1980s, the ASEAN-4 - as well as China - have become strong competitors for their neighbours, while the NIEs, which are now less reliant on exports of labour-intensive products than a decade ago, have benefited much less than before, and their gain in market share is now limited largely to capital and technology-intensive products. Thus, exports, and consequently domestic activity, in the ASEAN countries and China were on the whole highly buoyant during much of 1993. By contrast, in the Republic of Korea, while exports of automobiles and computers appear to have risen rapidly, those of textiles and footwear stagnated or even declined.

Regional integration in East Asia had also been much facilitated by Japan's role as investor and importer. Almost three quarters of the increase in Japan's imports in 1993 was accounted for by the developing countries in East Asia and by China (see table 6), whereas only about 12 per cent of the increase in United States imports in that year originated in Latin America countries (see table 5). It is clear that the expansion of intra-regional trade has been faster and more firmly grounded in East Asia than in the Americas.

Latin America's trade has nevertheless undergone transformation during recent years. In particular, the export structure has become more diversified, with a greater variety of products being sold on international markets, though most countries still rely heavily on primary exports and so have continued to suffer from terms of trade losses. Among the larger trading countries, export diversification has been important in Argentina, Mexico, and Venezuela, and also, though to a lesser extent, in Colombia (see table 9). Agricultural exports from the region have benefited greatly from diversification, and non-traditional exports such as tropical and sub-tropical fruits and their derivatives, as well as out-of-season horticultural products, have become important foreign exchange earners. However, the array of manufactured products offered by the major exporters in the region still remains modest, and the importance of manufactures in total exports is still small by Asian standards. For example, among the major exporters, there were only three manufactured products (mostly in the leather and iron industries) that in 1989-1990 accounted for more than 1 per cent of total exports. Likewise, Mexico exported only six such products in 1989-1990, Colombia five and Venezuela only one. In Brazil, however, there were eight such products (mainly from the iron and steel, leather, paper, and transport equipment industries). By contrast, in the same period, the major products of export interest to the East Asian countries were more numerous and their shares in total exports were also in general much larger. For example, Hong Kong, the Republic of Korea and Taiwan province of China each had 16 such major manufactured exports, and Singapore 13.[25]

The growth of Latin America's total exports of manufactures has also lagged behind that of Asia. They rose by an annual average of 16.8 per cent from 1970 to 1990, increasing their share in total exports from 10.6 per cent to over 30 per cent (see table 10), whereas in South and South-East Asia the export increase was almost twice as fast and by 1990 the share of manufactures was almost 78 per cent.

The rapid growth of East Asian exports owed much to the dynamism of intra-regional trade. As was discussed in last year's *Report*, the economies in that region exported more to each other than to third countries, but they also increasingly imported more from each other. The increased intra-trade in manufactures has been particularly pronounced. As regards such trade in Latin America, the rise has on the whole been less important (in terms of the

24 For the countries comprising these two groups see footnote 10 above.

25 Data drawn from UNCTAD, *Handbook of International Trade and Development Statistics 1992* (United Nations publication, Sales No. E/F.93.II.D.9), table 4.3 (which distinguishes products at the three-digit level of SITC Revision 2).

Table 9

EXPORT CONCENTRATION AND DIVERSIFICATION INDICES FOR SELECTED LATIN AMERICAN COUNTRIES, 1980 AND 1990

	1980			1990		
Country	Number of commodities exported [a]	Diversification index [b]	Concentration index [c]	Number of commodities exported [a]	Diversification index [b]	Concentration index [c]
Argentina	198	0.706	0.153	214	0.650	0.142
Brazil	225	0.556	0.148	210	0.529	0.101
Colombia	162	0.779	0.579	172	0.710	0.296
Mexico	201	0.542	0.475	215	0.497	0.311
Venezuela	153	0.730	0.674	196	0.796	0.784

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1992*, table 4.5

a Defined at the three-digit SITC level. The number excludes products with an export value of under $50,000 in 1980 or $100,000 in 1990 or under 0.3 per cent of the country's total exports.

b Absolute deviation of the country commodity shares from world structure (see source for the formula used).

c Hirschmann index normalized to make values ranging from 0 to 1 (maximum concentration). See source for the formula used.

increase in the share of total intra-trade) and less rapid; moreover, exports are still predominantly to the United States. Thus, although intra-Latin American trade accounted for about 27 per cent of the region's total exports of manufactures in 1990, it was responsible for only about 10 per cent of the region's imports of such products, more than 40 per cent of which came from the United States (see table 11).

Like its total trade, Latin America's intra-regional trade has been showing greater dynamism in the last two years, as total import demand in the region increased. For example, while Western Europe remained Brazil's largest export outlet, its most dynamic markets in recent months have been within Latin America. While lack of up-to-date information precludes a detailed assessment of the consequence of this upsurge in demand for the region's exports, available evidence suggests that trade has been buoyant in both traditional manufactures (such as leather products) and newer products (such as chemicals, machinery and transport equipment).

Rising imports into Latin America have also stimulated activity elsewhere. In particular, while the region took less than 14 per cent of United States exports in 1991 it accounted for not far short of 50 per cent of the increase in total exports from the United States in 1992. Though its contribution was much smaller in 1993, it still came to 13 per cent, or second only to the contribution of the East Asian economies (see table 5).

C. Central and Eastern Europe

Preliminary information indicates much diversity in the export performance of the Central and Eastern European countries in 1993. Export earnings (in dollars terms) rose markedly in some instances (Czech Republic, Poland, and Romania), whereas declines were observed for Bulgaria, Hungary and Slovakia. Russia's export earnings appear to have stabilized in 1993, after steep declines in both 1991 and 1992. The movement of imports, by con-

Table 10

COMMODITY AND GEOGRAPHICAL STRUCTURE OF EXPORTS FROM LATIN AMERICA IN 1990

(Percentage distribution)

Region	*Food*	*Agri-cultural raw materials*	*Ores and metals*	*Fuels*	*Manu-factures*	*Totals exports*
World	27.0	3.3	11.4	26.5	30.8	100.0
DMECs	28.1	3.5	14.0	21.0	32.6	100.0
of which:						
Western Europe	41.6	5.0	19.1	10.0	23.3	100.0
United States	20.1	2.1	6.5	29.9	40.9	100.0
Developing countries	25.8	4.6	9.6	12.1	47.6	100.0
of which:						
Latin America	22.1	4.2	7.0	16.3	50.2	100.0

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1992*, table 3.2.

Table 11

LATIN AMERICA: TRADE IN MANUFACTURES BY MAJOR REGIONS OF ORIGIN AND DESTINATION, 1970-1990

(Percentage share)

	Exports			*Imports*		
Origin/destination	*1970*	*1980*	*1990*	*1970*	*1980*	*1990*
World	100.0	100.0	100.0	100.0	100.0	100.0
DMECs	54.2	46.0	66.5	88.0	83.1	79.6
of which:						
Western Europe	18.3	18.5	17.1	37.8	29.8	26.5
United States	31.3	21.9	43.3	38.2	38.6	41.2
Developing countries	44.3	51.6	31.7	7.1	12.6	15.4
of which:						
Latin America	41.7	44.0	22.2	6.0	9.6	9.5

Source: As for table 10.

trast, appears to have been much more uniform, with an increase in most countries, the major exception being Russia, where imports continued to fall sharply and severely constrained domestic output.

The geographical pattern of trade flows was also diverse. Thus, while exports from the region to OECD countries were more or less stable, imports from them rose rapidly. And while intra-regional trade contracted sharply, trade with the developing countries expanded rapidly. However, the share of developing countries in the total trade of Central and Eastern Europe is no more than 15 per cent. ■

Chapter III

INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

A. Recent trends in external financing

During 1993 there was a large increase in external financing from the international financial markets, which (as shown in table 12) affected all its major categories. Especially notable was the rise in external bond issues. But international bank lending also revived after a period of stagnation since 1990. Within the total amount of external financing the share of developing countries was still small. However, external bond issues by entities from developing countries tripled, with the result that their share of the world total rose by more than 130 per cent. Moreover, declines in the rates of return available in the financial markets of major OECD countries contributed to a much increased interest on the part of portfolio investors in the securities originated in certain developing countries.

The rise in international bank lending (which is also evident in the increase in the external assets of BIS-reporting banks shown in table 13) reflected, *inter alia*, a large amount of interbank activity associated with currency turbulence within the Exchange Rate Mechanism of the EU countries and a tapering-off of the contraction of Japanese banks' international interbank lending by banks in Japan. The latter had exercised a strongly depressive effect on international bank lending from 1991 until the first half of 1993 as Japanese banks sought to strengthen capital positions weakened by the proliferation of non-performing assets at home and abroad and by sharp falls in the value of their holdings of equities. The changes of direction of international bank lending shown by tables 12 and 13 need to be interpreted with care. The increase in syndicated credits in 1993 was associated with large refinancing operations which amounted to more than the total increase in such lending during that year, while the expansion of the external assets of BIS-reporting banks was due partly to a substantial increase in their holdings of securities such as bonds rather than traditional lending.[26] International bond issues were boosted by declining interest rates in major OECD financial markets (reflected in the international interbank rates shown in table 14) and by the progressive globalization of the issuance of government debt.

In last year's *Report* attention was drawn to the segmentation of developing countries into two groups, one of which enjoyed easy or recently improved access to external financing from the international capital markets, while the other continued to experience external financial stringency.[27] Restructurings of their debt to commercial banks have recently left a few additional countries with more sustainable external payments positions (as described in section B), and there have been some new

[26] OECD, *Financial Market Trends*, No. 57, February 1994, p. 77, and BIS, *International Banking and Financial Market Developments*, May 1994, p. 2.

[27] See *TDR 1993*, Part One, chap. 3, sect. A.

Table 12

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES THEREIN, 1989-1993

Category	*1989*	*1990*	*1991*	*1992*	*1993*
External bond offerings					
Total ($ billion)	255.7	229.9	308.7	333.7	481.0
Percentage share of:					
Developing countries	0.9	2.0	2.9	3.8	8.9
Central and Eastern Europe	0.7	0.7	0.5	0.4	1.1
Syndicated credits					
Total ($ billion)	121.1	124.5	116.0	117.9	130.1
Percentage share of:					
Developing countries [a]	12.1	14.7	21.0	11.7	11.4
	(12.1)	(12.3)	(20.9)	(11.7)	(11.4)
Central and Eastern Europe	2.0	2.5	0.1	0.2	0.3
Eurocommercial paper programmes					
Total ($ billion)	54.1	48.3	35.9	28.9	36.6
Share of developing countries (per cent)	2.4	1.9	2.8	11.8	7.4
Committed borrowing facilities [b]					
Total ($ billion)	8.4	7.0	7.7	6.7	8.2
Share of developing countries (per cent)	10.7	30.0	58.4	25.4	14.6
Other non-underwritten facilities [c]					
Total ($ billion)	19.1	17.9	44.3	99.0	113.9
Share of developing countries (per cent)	3.7	1.7	1.6	4.5	5.1
International equities [d]					
Total ($ billion)	8.1	7.3	23.4	23.5	40.7
Share of developing countries (per cent)		13.7 [e]	21.4 [e]	27.7	23.3

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.

d Includes new issues and initial public offerings (IPOs) of common and preferred shares, participation certificates and similar instruments, secondary offerings of such instruments, issues of redeemable convertible preference shares, and placements of closed-end funds, in all cases in the markets other than the domestic one of the issuer.

e Including China, for which separate data are not available.

developing-country entrants into the international bond markets. Nevertheless, the characterization in last year's *Report* still holds.

Once again the segmentation can be illustrated by the fact that relatively few countries accounted for the bulk of external financing in major categories for developing countries as a whole. Four Latin American countries (Argentina, Brazil, Mexico and Venezuela), four from South and South-East Asia (India, Indonesia, Republic of Korea and Thailand) and China accounted for more than three quarters of external bond issues by devel-

Table 13

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA [a] VIS-À-VIS DEVELOPING AND CENTRAL AND EASTERN EUROPEAN COUNTRIES, 1986-1993

	1986	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*Stock (end-1993)*
	Percentage rates of increase [b]								*$ billion*
All developing countries [c]	0.6	0.9	-0 6	-2.4	-3.0	0.4	10.5	2.5	578
Of which in:									
America	0.2	-1 8	-1.7	-7.4	-13 2	-0 4	6.9	2.6	231
Africa	1.8	-3.0	-2.0	-6.2	-4.1	-8.3	-3.9	-7.5	43
West Asia	0.4	10.7	5.8	9.8	0.5	-8.2	26.4	-1.5	109
South and South-East Asia [d]	2.3	3.5	-2.0	2.1	15.4	12.2	12.1	8.4	189
Europe [e]	-8.5	-8.4	-5.7	-15.7	-10.2	-17.7	-11.2	-8.9	5
Central and Eastern Europe	6.1	3.2	9.8	10.7	-10.1	-1.6	4.1	-1.5	88
Memo items:									
All borrowers [f]	19.8	18.4	10.4	15.2	11.4	-0.9	3.1	4.4	6465
14 highly indebted countries [g]	0.7	-2.0	-2.8	-8.5	-13.7	-1.4	4.6	1.6	234

Source: Bank for International Settlements, *International Banking Statistics 1977-1991* (Basle, 1993), and *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.
b Based on data for end-December after adjustment for movements of exchange rates.
c Excluding offshore banking centres, i.e. in Latin America: Barbados, Bahamas, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Lebanon; in South and South-East Asia: Hong Kong and Singapore.
d Including Oceania.
e Malta and former Yugoslavia.
f Including multilateral financial institutions.
g Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay and Venezuela.

oping countries and China in 1993.[28] Of the regions specified in table 13 only Latin America and South and South-East Asia experienced an expansion of financing from BIS-reporting banks in 1993 (after adjustment for movements of exchange rates), much the largest increase going to the latter. Moreover six countries from South and South-East Asia (including China) received more than two thirds of the syndicated bank loans to developing countries and China in 1993.[29] Within the group consisting of developing countries of South and South-East Asia and China, six countries (Indonesia, Republic of Korea, Malaysia,

28 Broadly similar degrees of concentration in 1993 are indicated by the data for external bond offerings in *Financial Market Trends*, table 2, and by those for both announced and completed international bond issues in *International Banking and Financial Market Developments*, table 13A. A significant part of the international bond issues not accounted for by the country groups mentioned in the text consisted of those of Turkey (some 8-10 per cent of the total for developing countries and China).

29 The proportion estimated from *Financial Market Trends*, table 13, is a little less than 70 per cent, while that estimated

Table 14

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	1991	1992	1993	1994 (Jan-Mar)
United States dollar	6.08	3.90	3.41	3.78
French franc	9.64	10.16	7.92	6.11
Deutsche mark	9.40	9.41	6.95	5.72
Japanese yen	7.16	4.32	2.96	2.21
Pound sterling	11.40	9.65	5.93	5.29

B. COMMERCIAL INTEREST REFERENCE RATES [a]

Currency		1993		1994 (up to July)	
		High	Low	High	Low
Australian dollar		9.48	7.01	9.14	7.05
Austrian schilling		8.65	7.08	7.59	6.68
Belgian franc		9.02	7.85	8.40	7.42
Canadian dollar	(1) [b]	8.20	6.35	8.81	6.05
	(2) [c]	8.50	7.00	9.08	6.55
	(3) [d]	8.90	7.50	9.30	7.00
Danish krone		11.40	7.60	7.90	6.70
Finnish markkaa		11.95	7.50	9.00	6.90
French franc		9.44	6.73	7.53	6.37
Deutsche mark		8.18	6.29	7.32	6.17
Irish punt		11.75	7.10	8.52	6.95
Italian lira		13.31	8.52	9.03	8.21
Japanese yen		5.50	3.30	4.20	3.30
Netherlands guilder	(1) [b]	8.30	6.25	7.20	6.00
	(2) [c]	8.30	6.50	7.70	6.30
	(3) [d]	8.45	7.15	8.35	7.00
New Zealand dollar		8.57	6.62	8.21	6.20
Norwegian krone		11.26	6.33	8.16	6.03
Spanish peseta		14.02	9.34	10.11	8.80
Swedish krona		11.82	7.93	9.18	7.33
Swiss franc		7.18	5.32	5.82	5.24
Pound sterling		8.30	7.21	9.36	6.71
United States dollar	(1) [b]	6.21	5.17	7.34	5.43
	(2) [c]	7.08	5.71	7.78	6.06
	(3) [d]	7.49	6.05	8.01	6.43
ECU		9.18	6.83	7.57	6.33
SDR [e]		8.10	6.85	5.95	5.95

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 (the OECD Consensus).

b Maturity of less than five years.

c Maturity of from five to eight and a half years.

d Maturity of more than eight and a half years.

e 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. This rate is revised semi-annually (in January and July).

Table 15

RATIO OF DEBT TO EXPORTS OF GOODS AND SERVICES [a] OF SELECTED GROUPS OF DEVELOPING COUNTRIES

	1988	*1989*	*1990*	*1991*	*1992*	*1993* [b]
Latin America	330.6	294.6	281.7	282.5	279.2	269.8
Sub-Saharan Africa	410.7	392.8	345.6	376.7	382.2	400.1
Central and Eastern Europe [c]	..	..	121.9	160.2	179.4	175.6

Source: Figures for Latin America and the highly indebted countries were taken from the World Bank, *World Debt Tables 1993-1994, External Finance for Developing Countries* (Washington, D.C., 1993); figures for Central and Eastern Europe are based on data provided by the ECE secretariat; debt figures for sub-Saharan Africa were taken from World Bank, *op. cit.*, and those for exports are UNCTAD secretariat estimates.

a Expressed as a percentage.

b Preliminary.

c Countries for which relevant data are available.

Taiwan province of China, Thailand and China) accounted for more than 100 per cent of the increase in BIS-reporting banks' exposure to the group.[30] This figure implies that there was a reduced exposure for other countries.

The position was similar as regards other categories of external financing. For example, in the case of Eurocommercial paper programmes[31] Latin American countries (principally Argentina and Mexico) were responsible for more than 90 per cent of issues by developing countries in 1993.[32] Countries from the same region (in this case principally Argentina, Brazil, Mexico and Venezuela) accounted for about 75 per cent of other non-underwritten facilities.[33] Two Latin American countries (Argentina and Mexico), and six Asian ones (China, Hong Kong, Indonesia, Republic of Korea, Singapore and Thailand), accounted for almost 90 per cent of $10.7 billion of international equities issued by developing countries and China.[34]

During 1993 and early 1994 international bonds were issued by entities from a number of developing countries for which funds had not been raised in this form either recently or at all, such as Colombia, Congo, Costa Rica, Guatemala, Philippines, Trinidad and Tobago, and Uruguay. However, such expansion of developing countries' access to international financial markets can be expected to be gradual, so that the concentration of inflows just described is likely to diminish only slowly.

There remain wide divergences between the external financial positions of different groups of developing countries and the transition economies of Central and Eastern Europe. These divergences are evident in the costs and other terms of insurance of the payments and financing arrangements for imports (discussed in section D) and in key debt indicators. Among the latter, for example, as indicated in table 15, the ratio of external debt to exports in countries of Latin America and of sub-Saharan Africa has recently been tending to improve,

from *International Banking and Financial Market Developments*, table 8 (after exclusion of major offshore banking centres among developing countries), is more than three quarters.

30 *International Banking and Financial Market Developments*, table 5A.

31 Eurocommercial paper programmes are a short-term financing instrument generally available at a lower cost than short-term bank credit.

32 *Financial Market Trends*, table 15. Figures in *International Banking and Financial Market Developments*, table 11A, estimated on a different basis, show that these two countries accounted for almost all issues of Eurocommercial paper by entities in developing countries other than offshore banking centres.

33 *Financial Market Trends*, table 16. Other non-underwritten facilities consist of selected categories financing that are longer-term than Eurocommercial paper. The instruments under this heading, unlike bonds, are sold by dealers on an agency basis rather than underwritten by banks. Although there is no breakdown by individual countries in Latin America in the table just cited, data in *International Banking and Financial Market Developments*, table 11B show that the four countries mentioned in the text accounted for 90 per cent of medium-term notes (Euro-MTNs), a major category of financing among other non-underwritten facilities.

34 *Financial Market Trends*, No. 57, February 1994, p. 75.

but it remains high in the latter group. By contrast, for countries of Central and Eastern Europe this ratio remains lower than in Latin America, although it has risen significantly since the beginning of the 1990s.

The limited extent of the recent revival in external financing for developing countries is indicated by the figures for export credits in tables 16 and 17, as well as by those for the increase in the exposure of BIS-reporting banks already discussed. The marked revival in total net flows of export credits to developing countries in 1992 (which involved only those at short term) was apparently not sustained in the first half of 1993. Net flows of medium- and long-term export credits to countries in Africa declined sharply to a negative figure in 1992; total net flows also turned negative in the first half of 1993, a period in which almost two thirds of these countries repaid more than they received in new financing in this form.[35] The generally low levels of external financing in countries outside the developed world accord with the information elsewhere in this chapter on widespread difficulties in servicing official debt (reflected in the tempo of renegotiations of such debts, discussed in section E) and on the high costs and unfavourable terms of payments and financing arrangements for their imports faced by the majority of these countries (the subject of section D).

B. Renegotiation and reduction of bank debt

Since mid-1993 debtor countries have reached a number of agreements with commercial banks on restructuring their debts. The completion of Brazil's agreement in April 1994 marked the finalization of the renegotiations since 1990 for the three largest debtors in Latin America, agreements having been concluded earlier with Mexico and Argentina. Other renegotiations involving developing countries and economies in transition are in progress. The discussion of creditworthiness and payments risk elsewhere in this chapter (section D) does not suggest that an end to the series is in sight.

The final agreement between Brazil and its creditor banks terminated a period of negotiations beginning in October 1990. A preliminary agreement was reached in July 1992, but completion proved a lengthy process.[36] Initial offers by banks would have resulted in the conversion of outstanding debt into discount bonds in an amount which fell short of the target of the Brazilian Government, and discussions on a loan from IMF were difficult. The outcome eventually achieved is estimated to result in a reduction of Brazil's debt and debt service of more than $8 billion.[37] Thanks to a waiver by most creditor banks, the agreement is to be implemented without a loan from IMF, which constitutes a departure from precedent in that the other major agreements on the reduction of bank debt since 1989 have included such loans. In consequence, Brazil is to make use of its foreign exchange reserves and new money lent by its creditor banks to pay for collateral required (about $4 billion) under some of the options of its debt restructuring.

Agreements with creditor banks have also been reached since mid-1993 by the Dominican Republic, Jordan, Ecuador, South Africa, Bulgaria and Poland.[38] An agreement reached between South Africa and its creditor banks in September 1993 covered debt outstanding under its unilateral payments moratorium of September 1994, which was to be repaid in 16 semi-annual instalments starting in February 1994. Exit options are also available to banks in such forms as debt-equity swaps, dollar-denominated bearer notes, and swaps of debt

35 In comparing figures for total net export credits in table 16 and for medium- and long-term lending net in table 17 it should be remembered that only in the former case are the figures adjusted for changes in exchange rates.

36 For details of Brazil's restructuring agreement see *TDR 1993*, Part One, chap. III, sect. B.

37 A. Foster, "Brazil completes deal to restructure $49 bn debt", *Financial Times*, 18 April 1994.

38 The preliminary agreement between Bolivia and its creditor banks whose terms were described in *TDR 1993*, Part One, chap. III, sect. B was finalized in April 1993. Under this agreement approximately 50 per cent of the country's debt was bought back at 16 cents on the dollar, the financing being provided by the World Bank and certain OECD countries. CEPAL, *Preliminary Overview of the Economy of Latin America and the Caribbean 1993*, Santiago, Chile, December 1993.

Table 16

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]

	1988		*1989*		*1990*		*1991*		*1992*		*1993*
	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	47	42	43	42	35	42	42	40	41	33	55
Of which in:											
Africa	50	42	38	36	32	42	46	36	42	38	64
America	35	30	41	57	27	41	41	41	51	38	54
West Asia	57	57	57	43	36	43	71	36	57	29	64
South and South-East Asia [c]	48	52	48	34	48	48	24	48	17	21	38
Memo item: [d]											
14 highly indebted countries [e]	4	4	6	7	4	7	7	7	4	6	5
Central and Eastern Europe	3	4	5	4	4	6	-	4	3	1	4

B. NET FLOW AND STOCK IN MID-1993

(Millions of dollars)

	1988	*1989*	*1990*	*1991*	*1992*	*1993 (1st half)*	*Stock (end of June 1993)*
All developing countries	-718	7 000	7 586	5 900	25 463	3 326	213 566
Of which in:							
Africa	451	4 136	-3 800	1 361	4 941	-1 206	60 645
America	3 717	1 259	4 543	3 712	7 773	1 335	62 676
West Asia	-4 115	1 033	5 017	2 472	3 488	735	40 537
South and South-East Asia [c]	-275	485	1 959	-1 244	9 333	2 026	45 596
Memo item:							
14 highly indebted countries [e]	3 376	3 485	5 031	3 392	8 917	1 854	76 696
Central and Eastern Europe	-1 553	-17	-1 021	10 406	8 682	3 053	47 766

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.

Table 17

NET FLOW OF MEDIUM-TERM AND LONG-TERM EXPORT CREDITS TO DEVELOPING COUNTRIES, 1986-1992

(Millions of dollars)

Net flow to:	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
All developing countries							
Total	-3 308	-7 040	-5 163	4 024	-975	1 534	-1 791
Private	-1 985	-4 266	-3 484	4 113	-1 837	-355	-1 809
***By region*:**							
Africa							
Total	-980	-2 939	-2 764	1 768	-1 486	794	-2 350
Private	-281	-2 244	-2 200	1 272	-1 694	-7	-2 579
America							
Total	-758	-891	257	1 295	282	1 232	59
Private	-993	-1 037	256	1 448	26	215	763
West Asia							
Total	-303	183	739	1 324	103	-502	-26
Private	-243	217	1 071	1 560	-191	-699	-162
South and South-East Asia [a]							
Total	-754	-2 909	-2 004	397	105	1 341	802
Private	-102	-821	-1 345	514	-19	720	341

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

for local financial instruments.[39] In December 1993 Jordan completed an agreement restructuring $746 million of principal and $149 million of interest arrears. This followed a preliminary agreement of July 1993 under which the country's debt was to be exchanged for 30-year par bonds with a rate of interest rising in pre-determined stages to 6 per cent in the sixth year, for 30-year discount bonds, and for 12-year interest-arrears bonds (both of the latter at an interest rate of six-month LIBOR plus 13/16). The agreement also contained a buyback option.[40] In February 1994 agreement was finalized on $1.1 billion of principal and interest arrears of the Dominican Republic.[41] In May 1994 a preliminary agreement was reached between Ecuador and its creditor banks, whereby debt is to be exchanged for 30-year discount bonds at a market rate of interest or for 30-year par bonds with an interest rate increasing in a series of steps to 5 per cent in year 11. The agreement covers $4.5 billion of principal and $3 billion of arrears (a large part of which is to be repaid over 20 years).[42]

During 1993 agreement was reached on an extension of the IDA Debt Reduction Facility.[43] Through debt buybacks financed under this facility by mid-1993 five countries (Bolivia, Guyana, Mozambique, Niger and Uganda) had reduced their debt to banks by more than $600 million at prices ranging from 10 to 18 cents on the dollar.

39 The World Bank, *Financial Flows and the Developing Countries*, November 1993.

40 The World Bank, *Financial Flows and the Developing Countries*, July 1993 and February 1994.

41 For the terms of the Dominican Republic's restructuring agreement see *TDR 1993*, Part One, chap. III, sect. B, and *Latin American Economy and Business*, March 1994.

42 *Latin American Weekly Report*, 19 May 1994.

43 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 buybacks at large discounts on face value. Support is contingent on programmes acceptable to IDA for medium-term adjustment and the management of external debt.

Among the economies in transition two (Bulgaria and Poland) reached preliminary agreements with their creditor banks in November 1993 and March 1994, respectively. Under the terms of Bulgaria's agreement,[44] the options available to creditors are the conversion of debt into 30-year discount bonds at a market rate of interest or 18-year par bonds on which the rate of interest will rise in stages from 2 per cent to a market-related level in the eighth year. Interest arrears are to be covered by 17-year bonds at a market rate of interest, and Bulgaria is to buy back a portion of its debt at a little more than 25 cents on the dollar. (Final agreement between Bulgaria and its creditor banks was announced as this *Report* went to press.) Under the terms of Poland's agreement,[45] which restructures $13.2 billion of principal and interest arrears, five options are available to creditor banks: (1) 30-year par bonds on which the rate of interest will rise in a series of steps to 5 per cent in year 21; (2) 30-year discount bonds at a market rate of interest; (3) 20-year past-due-interest bonds on which the rate of interest will rise in a series of steps to 7 per cent in the ninth year; (4) 25-year debt-conversion bonds with an interest rate rising in a series of steps to 7.5 per cent in year 11, which are available only to banks providing new money at a rate of $35 for every $100 tendered for conversion: and (5) 15-year new-money bonds at a market rate of interest which are available only on the same terms as in option (4). An unusual feature of this agreement is the absence of a rolling interest guarantee on either the discount or the par bonds. The resulting reduction of Poland's debt to banks is expected to be 42.5 per cent.

Negotiations between the Russian Federation and its creditor banks began in October 1993 after the latter had accepted a series of three-month postponements of repayments of principal agreed in negotiations starting in December 1991 (as a result of which the country's bank debt had risen to $27.5 billion, including more than $3 billion of interest arrears).[46] However, they are now facing difficulties, one issue being the refusal of the Russian Federation to accept the banks' demand to waive certain sovereign rights regarding state-owned assets. Preliminary discussions designed to establish the Albanian Government's responsibility for external debts incurred by banks under the previous regime have been concluded, and negotiations between the country and its creditor banks on debt restructuring can now begin.[47]

C. Continuing financial flows to Latin America: selected issues

The revival of external financing for a number of Latin American countries since 1991 continued in 1993, but generally at a somewhat slower pace than during the previous year. The destination of these inflows has been a group of countries for the great majority of which access to international capital markets had been either sharply restricted or actually ceased after the outbreak of the debt crisis.[48] Latin America's recent inflows differ from those of most of the countries of South and South-East Asia in that a larger proportion has consisted of portfolio investment. While they have relaxed external financial constraints for the countries affected, they have also posed (often novel) challenges to policy makers. As the stock of financial assets in this region held by non-residents has expanded, the sustainability of the inflows has become a focus of attention not only for the recipient countries themselves but also for significant parts of the community of international portfolio investors.

According to preliminary estimates by the ECLAC secretariat, the net movement of capital to countries of Latin America and the Caribbean (which includes short-term financing and unrequited official transfers) decreased from $62 billion in 1992 to $55 billion in

44 The World Bank, *Financial Flows and the Developing Countries*, February 1994 and May 1994.

45 *Ibid.*, May 1994 and A. Robinson, "Doors open to foreign credit", *Financial Times* (Supplement on Poland), 18 March 1994.

46 ECE, *Economic Bulletin for Europe*, Vol. 45, 1993, pp. 94-95, and *Financial Times*, 4 August 1993.

47 ECE, *op. cit.*

48 Of these countries Columbia has avoided renegotiation of its external debt to commercial banks.

1993.[49] As might be expected from the discussion in section A, this net capital inflow was concentrated on a minority of countries, of which four (Argentina, Brazil, Mexico and Venezuela) accounted for 73 per cent, two Chile and Peru) for 5 per cent each, and Colombia for 3 per cent. Argentina, whose net capital inflow declined from $12.9 billion in 1992 to $10 billion in 1993, received $5.5-6 billion through bond issues, $2.5 billion through issues of Eurocommercial paper and medium-term Euronotes, and $2.7 billion from international equity offerings (much of the last item being the sale to international investors of a minority stake in the oil and gas company, Yacimientos Petroliferos Fiscales (YPF)).[50] For Brazil the net capital inflow fell by 60 per cent, from $8.8 billion in 1992 to $3.4 billion in 1993. New bond issues amounted to $5.5-6 billion and there was also net foreign portfolio investment of about $2.5 billion in the country's equity markets.[51] Mexico's net capital inflow increased slightly, from $24.7 billion in 1992 to $25.1 billion in 1993. The country's international bond issues amounted to $8-9.5 billion, and its issues of Eurocommercial paper and medium-term Euronotes to $4.3 billion. Foreign investment came to more than $15 billion, approximately two thirds of it in the form of portfolio investment and one third in the form of FDI.[52] Venezuela experienced a sharp fall in net capital inflow, from $2.3 billion in 1992 to $1.3 billion in 1993. The country's entities issued $1.3-2.1 billion in the form of bonds and $0.5 billion in the form of medium-term Euronotes. Incomplete data suggest a substantial fall in its inflow of foreign investment in comparison with 1992.[53] Chile's net capital inflow in 1993 came to $2.9 billion, against $3.5 billion during the previous year. Once again much of the country's external financing was in the form of portfolio equity investment and FDI, the total inflow under these headings amounting to $2.7 billion, while $0.8 billion was raised in the form of American Depository Receipts (ADRs).[54] By contrast, international bond issues by Chilean entities came to $0.4 billion. As mentioned earlier, Peru's net capital inflow in 1993 was similar in amount to Chile's. Peru is not yet an important issuer of securities on international financial markets, but this may soon change as part of the large programme of privatization envisaged. The country's equity market (on which prices increased 131 per cent in 1992 and 90 per cent in 1993) has already begun to attract the funds of non-residents on a substantial scale.[55] Colombia's net capital inflow increased sharply, from less than $200 million in 1992 to $1.5 billion in 1993. Its international bond issues amounted to about $0.5 billion and foreign investment in the country rose sharply in the first eight months of the year.[56]

As illustrated in last year's *Report*,[57] the pattern of external financing of the major recipient countries in Latin America during the recent revival has generally diverged from that experienced over a longer period by those in South and South-East Asia. One important difference is the greater recourse by the former to securitized loans in forms such as international bonds, Eurocommercial paper, and various types of notes. These categories of financing accounted for more than 75 per cent of funds raised in the international financial markets by Latin American countries in each of the years 1991-1993, while the share of syndicated bank credits, for example, was less than 10 per cent. For South and South-East Asian countries and China, on the other hand, the share of syndicated credits

49 CEPAL, *Preliminary Overview of the Economy of Latin America and the Caribbean 1993*, Santiago, Chile, December 1993, table 16, which is also the source for the net capital inflows of individual countries in the text which follows.

50 The figures for the issues of international bonds of Argentina and the other Latin American countries mentioned in this paragraph are from OECD, *Financial Market Trends*, and from BIS, *International Banking and Financial Market Developments*, and those for Eurocommercial paper and Euro-MTNs from the latter source (see footnotes 32 and 33 above). The figure for Argentina's international equity issues is taken from the Financial Times Survey, *Latin American Finance*, 11 April 1994, p. VII.

51 This net figure is the difference between an estimated inflow of $12 billion and an outflow of $9.4 billion. *Latin American Economy and Business*, March 1994, p. 3.

52 *Ibid.*, p. 5. Of the equity inflow $2.9 billion was accounted for by new international issues (*Latin American Finance*, p. VII), the rest presumably consisting of purchases on secondary markets.

53 According to *Latin American Economy and Business*, December 1993, p. 7, foreign investment in Venezuela in the first three quarters of 1993 amounted to only a little more than $200 million.

54 *Latin American Finance*, p. II. ADRs are registered negotiable certificates issued in the United States which represent numbers of foreign shares being held by the overseas branches of United State banks or other financial institutions acting as custodians in the country of origin. Transactions in ADRs are carried out in United States equity markets in lieu of transactions in the shares themselves.

55 On the inflow from abroad into Peru's equity market see *Latin American Finance*, p. III. The index of stock prices is that of Baring American Asset Management Company.

56 According to *Latin American Economy and Business*, November 1993, p. 8, foreign investment in Colombia increased 56 per cent during the first eight months of 1993 in comparison with the corresponding period of the previous year.

57 *TDR 1993*, Part One, chap. III, sect. A, especially table 25.

varied from a little less than 40 per cent to 75 per cent, while that of securitized lending instruments varied from 20 per cent to 50 per cent. An important feature of this contrast is the greater reliance of Latin American countries on borrowing on which interest payments are fixed regardless of the borrower's circumstances.[58] Moreover, as a result of their greater reliance on securitized lending the availability and terms of their external financing are likely to be more susceptible to shifts in sentiment in the financial markets. Another difference between the patterns of external financing of major recipient countries in Latin America, on the one hand, and South and South-East Asia, on the other, is that a higher proportion of the flow of FDI to the former has been destined for the purchase of existing assets in the context of privatization, so that the link to increased domestic investment tends to weaker.

As in 1992, one of the driving forces behind securitized international lending to Latin American countries in 1993 was interest-rate arbitrage between United States dollar rates and the much higher ones in the domestic financial markets of some of these countries. The opportunities for such arbitrage are illustrated in table 18 by the excess of domestic monthly short-term interest rates over the rate on United States treasury bills, after adjustment for movements of exchange rates. Moreover, such arbitrage was not limited to short-term borrowing and lending, since another feature of it has been the scale and frequency of international bond issues by banks from Latin American countries (where the arbitrage was between higher rates of interest in both markets). For example, in the case of Eurobonds for Brazilian entities approximately one half of both the amount raised and the number of issues between January 1993 and mid-February 1994 was accounted for by banks, while the corresponding proportions for Mexico were approximately 30 per cent in both cases and those for Argentina about 20 per cent of the amount raised and about 30 per cent of the number of issues.[59] The proceeds of these arbitrage operations have been on-lent to domestic private and government borrowers or used to purchase locally issued securities in secondary markets. Interest-rate arbitrage by borrowers has been accompanied by growing awareness of the high returns on the short-term financial instruments available in the local financial markets of certain Latin American countries among money managers in financial and non-financial enterprises of OECD countries. Holdings of Mexican CETES (Certificados de Tesoreria, short-term government bills), for example, are now in the portfolios of money-market assets of several corporations.[60] Another source of capital flows to Latin American countries has been non-resident equity investors, many of whom are attracted by the quick capital gains which can be realized in the mostly volatile stock markets of certain countries in the region. Thus, for example, in dollar terms equity prices in Argentina rose 53 per cent in 1993 (after falling 24 per cent in 1992), and have declined again in the first half of 1994. The corresponding figures for Brazil were an increase of 111 per cent in 1993 (and a continuing rise in the first half of 1994) following a fall of 4 per cent in 1992; and for Mexico consecutive increases of 22 per cent in 1992 and 48 per cent in 1993 have been followed by a decline of 18 per cent in the first half of 1994.[61]

The scale of external financial inflows since 1991 has caused problems for policy makers in respect of exchange-rate management and the achievement of fiscal balance. These problems, and the measures used to meet them up to early 1993, are described elsewhere in this *Report* (see the annex to chapter II, Part Two). Since that date Brazil has taken additional steps to restrain its inflow; new regulations restrict the types of instrument in which non-residents can invest (in particular placing commodity funds and fixed-income government paper off limits) and a tax of 3 per cent is levied on issues of Eurobonds. In Colombia, which, as mentioned above, received considerably increased capital inflows in 1993, the Government raised from 47 per cent to 93 per cent the proportion of most loans with maturities of less than three years which must be deposited at the central bank.

The sustainability of the external financial flows to Latin American countries reviewed above has been a source of continuing concern. In the longer term the vulnerability of the recipient countries to speculative outflows will be reduced by the strengthening of their export and manufacturing bases. Under this heading, for example, attention is often focused on their recent performance regarding domestic capital formation. Ratios of gross investment or gross fixed investment to GDP were in the range of

58 A large proportion of recent bond issues of Latin American countries consists of straight bonds with a fixed rate of interest.

59 *Euromoney*, March 1994, pp. 106-112.

60 Estimates for early 1994 suggest that typically 40-50 per cent of the outstanding stock of CETES was held by non-residents. *Latin American Economy and Business*, February 1994 (p. 5) and May 1994 (p. 4).

61 Data supplied by Baring American Asset Management Company.

Table 18

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								
Monthly average	-2.21	-2.57	5.57	5.13	0.97	0.52	1.32	0.88
Annualized monthly average	-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
Annualized monthly average	17.80	13.89	189.53	180.73	21.30	17.32	15.53	11.75
1993								
January	0.36	0.27	1.82	1.72	0.10	0.03	1.26	1.17
February	0.93	0.83	2.36	2.26	0.10	0.03	1.27	1.17
March	0.81	0.71	2.06	1.96	-1.16	-1.26	1.27	1.17
April	0.94	0.85	1.75	1.66	0.54	0.45	1.26	1.17
May	0.67	0.57	1.37	1.27	1.22	1.13	1.25	1.16
June	0.86	0.76	1.38	1.28	2.52	2.42	1.25	1.16
July	0.78	0.68	1.56	1.46	1.30	1.20	1.24	1.14
August	0.67	0.57	1.11	1.01	1.30	1.20	1.24	1.14
September	0.65	0.55	1.67	1.57	2.50	2.40	1.24	1.15
October	0.62	0.52	1.94	1.84	1.31	1.21	1.24	1.14
November	0.75	0.65	2.11	2.01	2.68	2.58	1.25	1.15
December	0.65	0.55	1.92	1.82	-1.98	-2.08	1.24	1.14
Monthly average	0.72	0.63	1.75	1.65	0.87	0.78	1.25	1.15
Annualized monthly average	8.99	7.83	23.14	21.70	10.95	9.77	16.07	14.71

Source: UNCTAD secretariat estimates, based on data of the Instituto de Economia do Sector Público (IESP) (Brazil), Centro de Estudios de Estado y Sociedad (CEDES) (Argentina), Banco Central do Brasil, Banco Central de Chile, Banco de México and IMF.

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.

17-21 per cent for Argentina, Mexico and Venezuela in 1992 and for Brazil in 1991. That for Chile was 21 per cent in 1992 but preliminary estimates point to an increase to over 25 per cent in 1993.[62] By contrast, among the countries of South and South-East Asia mentioned in the analysis of the concentration of external financing for developing countries in section A, only in India and Indonesia were the 1992 ratios of gross fixed investment to GDP in the range of 21-22 per cent, those for the Republic of Korea, Malaysia, Singapore and Thailand, for example, exceeding 34 per cent.[63]

Attention is also frequently drawn to the vulnerability of Latin America's capital inflows to changes in relative interest rates, currency devaluations in recipient countries, and political shocks. The interest-rate differentials which are driving the arbitrage described above are large, so that the process is not likely to be much affected by small changes in United States interest rates such as those witnessed since early February. Nevertheless, much of the recent portfolio investment in Latin America has been motivated by the prospect of short-term profits, and such speculative flows of funds are susceptible to changes of direction not only in response to shocks with an immediate impact on relative rates of return but also to shifts in expectations linked to several different economic indicators, some of them of a global nature, and to perceptions regarding trends in recipient countries. It is thus of interest in this context that an outflow of about $11.5 billion from Mexico is estimated to have taken place during the early months of 1994 mainly owing to political uncertainties.[64] This figure is of a magnitude similar to estimates of flight capital repatriated to the country during 1989-1993 (and considerably larger than the temporary credit of $6 billion provided by the United States in March after the assassination of one of the candidates in the Mexican presidential election).

Another question raised by the recent capital inflows to Latin America is how far the increases in external financing have led to the restoration of normal relations between recipient countries and the international financial markets. Information concerning the ratings for the countries' debt instruments by major credit-rating agencies, the terms of their international bond issues, and their access to international bank lending indicates that progress towards normalcy so far remains uneven.

Table 19

YIELD SPREADS ON INTERNATIONAL BOND ISSUES, BY TYPE OF BORROWER, FOR SELECTED LATIN AMERICAN COUNTRIES, IN 1993 AND EARLY 1994

(Percentage)

Country/ sector	*Yield spread [a] (basis points)* 1993 *First half*	1993 *Second half*	1994 *First quarter*
Argentina			
Public	423	271	-
Private	549	365	294
Brazil			
Public	536	429	342
Private	605	442	415
Mexico			
Public	248	214	163
Private	562	335	328
Venezuela			
Public	446	223	-
Private	-	463	-

Source: Data from Merrill Lynch.

a The yield spread is the difference between the bond yield at issue and the prevailing yield for the bonds of OECD countries denominated in the same currency and with a comparable maturity. Figures are weighted averages.

None of the four countries, Argentina, Brazil, Mexico and Venezuela, has yet received a rating of investment grade for their foreign-currency-denominated debt from the credit-rating agencies, Moody's or Standard and Poor's. Among Latin American countries such a rating has so far been achieved only by Chile (from both agencies) and by Colombia (from Standard and Poor's). It has also been forthcoming from Fitch, Duff and Phelps and the National Association of Insurance Commissioners (NAIC) in certain cases for debt issued as private placements by entities from Brazil, Mexico and Venezuela.[65] Moreover, Standard

62 R.R. Miller and M.A. Sumlinski, "Trends in private investment in developing countries 1994. Statistics for 1970-92", *IFC Discussion Paper 20* (Washington, D.C.: The World Bank, 1994), table 1. The preliminary estimate for Chile in 1993 is from *Latin American Economy and Business*, March 1994, p. 8.

63 Miller and Sumlinski, *op. cit.*

64 *Latin American Economy and Business*, May 1994, p. 5, and *Latin American Weekly Report*, 16 June 1994, p. 260.

65 There are five institutions in the United States recognized by the Securities and Exchange Commission as national bond-rating companies - Moody's, Standard and Poor's, Fitch, Duff and Phelps, and McCarthy Crisanti & Maffei. There is often a bar on investment in assets rated as being of less than investment grade by institutional investors in that country. NAIC 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.

and Poor's has accorded a rating of investment grade to a number of peso-denominated issues of Mexican entities (for which the servicing capacity is considered more assured than for those denominated in foreign currencies). The ratings have been associated with average yield spreads for Argentina, Brazil, Mexico and Venezuela which, as shown in table 19, varied from 248 basis points (for Mexican public entities) to 605 basis points (for Brazilian private entities) in the first half of 1993, and from 214 basis points (for Mexican public entities) to 463 (for Venezuelan private entities) in the second half of 1993. Although spreads for these four countries have recently been tending to narrow, the ranges just mentioned remain significantly above those on international bond issues by South and South-East Asian countries.

As indicated by table 13, the reliance of Latin American countries on international bank lending as opposed to issues of securities in the 1990s has been limited. Slow growth of such financing reflects the influence of demand as well as supply, and the recorded increases in the exposure of BIS-reporting banks have also been affected by reduction of bank debt under restructuring agreements. But other available information none the less suggests continuing caution by banks over lending to these countries. For example, although short-term lending to Argentina, Brazil and Mexico connected to the financing of trade appears to have increased significantly during 1992,[66] this revival has been accompanied by an expansion of the proportion of banks' exposure to them which is covered by official export credit insurance. For Argentina the expansion was from 4.4 per cent at the end of 1991 to 5.9 per cent at the end of 1992 and 7.9 per cent in mid-1993 (the last figure possibly giving a misleading impression, owing to the effects of the reduction of Argentina's debt to banks under its restructuring agreement); for Brazil there was a rise from 4.9 per cent at the end of 1991 to 6.6 per cent in mid-1993; and for Mexico the corresponding increase was from 13.7 per cent to 17.3 per cent.[67] Other, more fragmentary, evidence points to particularly frequent recourse in medium- and long-term trade financing by banks for these and other Latin American countries not only to official export credit insurance but also to other techniques for the reduction of payments risk.[68]

D. The terms of export credits and trade financing arrangements

As noted in section A, although net flows of export credits[69] to developing countries have recovered somewhat since 1989, they continue to be lower than before the debt crisis. Export credits are determined by the interaction of demand and supply. Thus they respond not only to macroeconomic conditions, the pace of investment being especially important in this re-

66 BIS, *The Maturity and Sectoral Distribution of International Bank Lending, First Half 1993*, January 1994, p. 7.

67 OECD and BIS, *Statistics on External Indebtedness. Bank and Trade-related Non-bank External Claims on Individual Borrowing Countries and Territories*, January 1994. It is interesting to compare the figures in the text with those for Chile which has also experienced during the 1990s an increase in short-term international bank lending for financing trade but which enjoyed a better credit rating than other Latin American countries (as discussed above). The proportion of banks' exposure to Chile which was covered by official export credit insurance actually fell from 7.4 per cent at the end of 1991 to 6.6 per cent in mid-1993.

68 These techniques have included escrow accounts (into which agreed amounts of foreign exchange earnings would be paid) and collateralization as well as cofinancing from multilateral financial institutions. See "Latin American trade finance", *Euromoney*, May 1994, pp. 148-151, and C. Collyns *et al.*, *Private Market Financing for Developing Countries*, World Economic and Financial Surveys (Washington, D.C.: IMF, December 1993), chap. VI.

69 The export credits in tables 16 and 17 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 credits carrying "official" insurance or guarantees as "private export credits" (even in cases where the institutions with officially recognized mandates for this purpose are privately owned). 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, has contributed to blurring the distinction between official and private insurance in trade financing and payments. However, for the purpose of the present analysis NCM is treated, like its predecessor, the Insurance Services Group of ECGD, as a source of "official" insurance.

gard owing to the role of export credits in the financing of imported capital goods, but also to the costs and conditions applying to insurance from expert credit agencies (ECAs). As is shown below, these costs continue to be high and the associated conditions restrictive for the majority of developing countries, as well for the countries of Central and Eastern Europe, in both cases helping to restrain financing in this form. The costs and conditions attached to export credits, like their analogues in the private insurance markets, are also of more general interest as indicators of countries' perceived creditworthiness. Thus, for example, they are generally correlated with the costs of financing and payments arrangements for imports other than official credit insurance, such as charges on letters of credit and margins over inter-bank interest rates for à forfait financing. Similarities between the terms and costs of export credits and the availability of other financing and payments arrangements are illustrated further below for selected countries.

The costs of private export credits consist of interest, premiums on official insurance, and other transactions costs associated with any restrictive conditions on which such insurance cover is made available. The interest rates charged on financing for the imports of developing countries and countries 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 14),[70] and sometimes to other national rates. Especially in the latter case, they may also include a premium which, for costs of official insurance for export credits, is inversely related to a borrower's creditworthiness.

There is considerable inertia in the terms of official insurance cover from EXIM of the United States, ECGD of the United Kingdom and its successor institution for the provision of cover for short-term credit, NCM (which is described in footnote 69). As indicated by tables 20 and 21, changes have become more infrequent since early 1992, only countries of Latin America and Central and Eastern Europe having experienced them since early 1993. The outcome of this inertia is the continuing prevalence (shown in table 20) for both developing countries and economies in transition of instances[71] of credit insurance cover that is available only on restrictive conditions or not at all. In Latin America, the region which experienced the largest number of (favourable) changes in terms between early 1993 and early 1994, cover was available without restrictive conditions (i.e. on normal terms) in only 15 per cent of the instances recorded in the table for short-term credits and in 27 per cent of the instances for medium- and long-term credits. In Africa cover was available on normal terms in relatively even fewer instances (13 per cent for short-term credits and 23 per cent for medium- and long-term credits). For countries of this region cover was completely unavailable in 29 per cent of instances for short-term credits and 46 per cent for medium- and long-term credits. Among developing countries only for those of South and South-East Asia is there a relatively large number of instances (33 per cent for short-term credits and 42 per cent for medium- and long-term credits) where insurance cover is available without restrictions.

None of the countries of Central and Eastern Europe included in tables 20 and 21 has received insurance cover from EXIM or NCM without restrictive conditions since 1992. But in a number of instances complete unavailability of cover has recently been replaced by availability subject to restrictive conditions. More comprehensive information on the availability of official insurance cover (from five ECAs) to the countries of Central and Eastern Europe and the former republics of Yugoslavia is provided in table 22. For only six of the countries covered by the table (Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia) was cover available from all five ECAs, while it was not available from any of them for Albania, Armenia, Azerbaijan, Georgia and Tajikistan. Unfavourable changes during the last year have affected several countries of the former USSR, often resulting from a tightening by Hermes of its policy regarding cover. This tightening included the suspension of cover for credits to Armenia, Georgia and Tajikistan as well as a temporary suspension for credits to Russia (subsequently lifted for exporters from the eastern *Länder* of Germany). The tightening of policy was apparently in part the agency's response to an exceptionally high deficit in 1993, and has been associated with a shift to a new system of terms

70 Since early 1992 minimum interest rates under the OECD Consensus are determined principally by the "Commercial Interest Reference Rates" for different currencies or composite currency units shown in table 14. 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 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.

71 The concept, "instance", is explained in footnote c to table 20.

Table 20

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)

	Normal terms [a]		No cover [a]		Restrictive conditions [a]	
Region/period	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 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	18	19	43	44
Late 1992/early 1993	9	(8) [c]	20	(16) [c]	41	(11) [c]
Early 1994	9	(8) [c]	20	(16) [c]	41	(11) [c]
Latin America						
Late 1989	7	7	6	8	39	37
Early 1991	15	8	5	21	32	23
Early 1992	7	7	5	17	40	28
Early 1993	6	(5) [c]	5	(6) [c]	41	(15) [c]
Early 1994	8	(7) [c]	4	(5) [c]	40	(14) [c]
South and South-East Asia [f]						
Early 1990	16	16	3	3	29	29
Early 1991	16	16	3	3	29	29
Early 1992	16	16	3	3	29	29
Early 1993	16	(10) [c]	3	(3) [c]	29	(11) [c]
Early 1994	16	(10) [c]	3	(3) [c]	29	(11) [c]
Central and Eastern Europe						
Early 1990	3	1	4	4	5	7
Early 1991	2	1	5	4	5	7
Early 1992	1	1	3	4	8	7
Early 1993	0	(0) [c]	4	(3) [c]	8	(3) [c]
Early 1994	0	(0) [c]	1	(2) [c]	11	(4) [c]
Memo item:						
Highly indebted countries [g]						
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	7	22	19
Late 1992/early 1993	3	(3) [c]	3	(3) [c]	22	(8) [c]
Early 1994	4	(4) [c]	2	(2) [c]	24	(9) [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 from this date onwards are given in parentheses.

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

Table 21

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

(Number of instances)

	More favourable terms [a]				*Less favourable terms* [a]			
Region	*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 1992/ early 1993- early 1994* [c]	*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 1992/ early 1993- early 1994* [c]
Africa	-	1	-	-	1	-	2	-
Latin America	10 [d]	4	-	6	13 [d]	9	1	-
South and South-East Asia [e]	-	-	-	-	-	-	-	-
Central and Eastern Europe	-	5	-	4	1	5	1	-
Memo item:								
Highly indebted countries [f]	9	4	-	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 20.) 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 since late 1991/early 1992 (see footnote *b* to table 20).

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

which differentiates more sharply among countries according to political risk.[72]

The prevalence of restrictive terms on official credit insurance during recent years has reflected not only perceptions of borrowing countries' creditworthiness but also the pressures on ECAs (like those on Hermes already mentioned) resulting from their financial deficits (the extent of which is indicated in table 23). ECAs are generally under a long-term obligation to be self-supporting in their commercial operations, an objective difficult to achieve during a period of widespread interruptions of debt service, and the resulting pressures have recently been accentuated by the objective of holding down government expenditure in many countries. Since the 1980s, partly owing to the restrictiveness of the terms on ECA's insurance cover, there has been a growing interest in private credit insurance for financing and payments arrangements for the imports of developing countries and economies in transition. Although the terms on private insurance are sometimes more flexible than those of ECAs and more responsive to changes in creditworthiness, data on such terms (in the same source used for tables 20 and 21) indicate few recent changes, no change being recorded for the countries of Latin America and Central and Eastern Europe and one (in an unfavourable direction) for an African country, and three (one favourable and two un-

72 Even after the tightening of its policy Hermes has continued to make insurance cover available to more of the countries shown in table 22 than any of the other four agencies.

Table 22

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

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

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

a The Export-Import Bank (EXIM) of the United States; Hermes of Germany; Nederlandsche Credietverzekering Maatschappij (NCM) of the Netherlands; Export Credits Guarantee Department (ECGD) of the United Kingdom and Finnish Guarantee Board (FGB).

Table 23

PROPORTION OF EXPORT CREDIT AGENCIES [a] IN SELECTED OECD COUNTRIES THAT INCURRED CASH-FLOW DEFICITS, 1983-1992

(Percentage)

	1983	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Proportion:	83	65	74	70	83	65	65	71	83	68

Source: Information supplied by the the Berne Union.

a 1983-1989: 23 agencies in 19 countries; 1990-1992: 25 agencies in 20 countries.

favourable) for countries of South and South-East Asia.

As remarked above, perceptions of payments risk are reflected not only in the costs and other terms of insurance from ECAs, but also in the availability of the main types of financing and payments arrangements used for imports. This is evident, for example, in the payments arrangements recommended for different countries in the *Financial Times* newsletter, *International Trade Finance.* The main arrangements specified are (1) open account, (2) sight draft, (3) unconfirmed letter of credit, (4) confirmed letter of credit, and (5) cash in advance. The first two are appropriate for low degrees of payments risk, and the latter three for greater degrees, the five arrangements being ordered above according to increasing risk.[73]

As might be expected in the view of the prevalence of restrictive conditions associated with the provision of official insurance by EXIM and NCM (shown in table 21), for less than one third of Latin American countries[74] were the arrangements, open account or sight draft, recommended in March 1994 by the above mentioned newsletter (see table 24). This can be contrasted with the recommendation of these two arrangements for more than 90 per cent of the OECD countries in the table. Arrangements appropriate to greater payments risk were recommended for 70 per cent of Latin American countries, a figure which can be compared with a proportion of 77 per cent of instances in early 1994 where official insurance on short-term export credits was available only on restrictive conditions, and a proportion of 8 per cent where such cover was not available at all. Since March 1986 the share of arrangements recommended which are appropriate to low payments risk has fallen. However, among those appropriate to higher risk there has been a favourable shift involving an increase in the proportion of countries for which an unconfirmed as opposed to a confirmed letter was recommended. The changes in recommended arrangements for countries in Latin America which have taken place since March 1986 were less concentrated in the years 1990-1991 than were the changes in the terms of official insurance from EXIM and ECGD shown in tables 20 and 21.[75]

As shown in table 24, for countries of Central and Eastern Europe the recommendations of March 1994 were equally divided between unconfirmed and confirmed letters of credit. However, this picture may actually understate the extent of the difficulties faced by many of these countries with regard to payment arrangements, since other information indicates that for the great majority of them confirmed letters of credit were either available only at a high cost or not available at all.[76] As a result, in practice many of these countries are having increasing recourse to trade on a cash basis or to countertrade, one estimate, for example, indicating that in mid-1993 one third of Russia's imports involved countertrade.[77]

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73 Under *payment on open account* an invoice is sent to the importer at the same time as the shipping of the goods, payment being specified within a predetermined period of time. This arrangement requires no intermediary so that the associated transaction costs are at a minimum. However, it is also based on trust and is used mainly in trade between entities (such as inter-related companies) with a history of satisfactory transactions. Under payment by *bill of exchange* or *sight draft* the exporter draws a bill of exchange on the importer, such a bill being an unconditional order addressed by one party to another, requiring the latter to pay a specified sum on demand or at a fixed future date. Since such a bill is a negotiable instrument (which can be turned into cash immediately), the exporter thus obtains greater security than in the case of payment on open account. This arrangement does not require the interposition of a bank and the associated costs are low. *A letter of credit* is a written undertaking by a bank in response to the instructions of the applicant (the importer) to make payment to the beneficiary (the exporter) against prescribed documents. It provides the exporter with insurance against the commercial risk of non-payment by the importer since its validity is independent of the underlying transaction. However, especially when the bank issuing the letter of credit is the local institution in the importer's country, the exporter is not protected from political risk resulting from events in the importer's country such as the un-availability of foreign exchange or the imposition of foreign exchange control which make fulfilment of his contractual obligation impossible. This risk can be removed by a *confirmed letter of credit* under which another bank, typically in the exporter's country, adds its commitment to pay to that of the issuing bank. Confirmation of the letter of credit results in charges by the confirming bank additional to those of an unconfirmed letter of credit (which consist of the fees of the issuing bank and others associated with arranging for the payment to be made). In the case of *cash in advance* delivery of the goods is authorized by the exporter only after actual receipt of money from the importer. This arrangement is used for transactions where there is particularly a high risk of non-payment.

74 The sample of Latin American countries in *International Trade Finance* is not identical to that in the publication on which tables 20 and 21 are based.

75 In the case of only 3 of the 10 highly indebted countries in Latin America were either of the two payments arrangements appropriate to lower degrees of payments risk recommended in March 1986, and after various shifts in recommendations between March 1986 and March 1994 the figure had fallen to two by the latter date. (For a list of the highly indebted countries see footnote g to table 20.)

76 Information on confirmed letters of credit supplied by Jardine Credit Insurance Ltd.

77 *Business Eastern Europe*, 16 August 1993.

Table 24

PAYMENTS ARRANGEMENTS FOR COUNTRIES OF LATIN AMERICA AND CENTRAL AND EASTERN EUROPE

(Per cent)

	Open account	*Sight draft*	*Unconfirmed letter of credit*	*Confirmed letter of credit*	*Cash in advance*
Latin America					
1994	3	27	61	9	-
1986	3	34	38	25	-
Central and Eastern Europe					
1994	-	-	50	50	-
Memo item: **OECD countries** [a]					
1994	29	63	8	-	-

Source: *International Trade Finance* (various issues).
Note: Data refer to the situation in March of the year indicated.
a Excluding Turkey and the United States.

E. Rescheduling of official bilateral debt

The pace of official bilateral debt reschedulings in the Paris Club slowed down markedly in 1993. Eleven countries concluded rescheduling agreements in that year, against an average of 17 over the three preceding years. Paris Club activities, however, picked up strongly in the first half of 1994 with the conclusion of 13 agreements.

This pattern of reschedulings has been influenced by four key factors:

- Since 1992, 11 countries have graduated from the rescheduling process as they have resumed full debt servicing to Paris Club creditors. Several of these countries are in the middle-income category and predominantly indebted to private creditors. Two others (Poland and Egypt), mainly indebted to official creditors, received exceptional treatment from the Paris Club;
- The number of multi-year rescheduling agreements (MYRAs) has increased significantly on the basis of multi-year IMF arrangements.[78] MYRAs accounted for about one third of the agreements concluded from January 1990 to June 1994. By comparison, only 3 out of the 39 agreements concluded in 1988-1989 were MYRAs;
- Since the beginning of 1993, five countries have gone to the Paris Club for the first time. Three of them (Guatemala, Kenya and Viet Nam) rescheduled only arrears and are not expected to return to the Paris Club. The remainder (Algeria and the Russian Federation), however, are likely to require debt relief from official creditors over the next few years;
- Problems faced by a number of countries in negotiating new IMF arrangements

[78] Under the Extended Fund Facility (EFF), the Structural Adjustment Facility (SAF), the Enhanced Structural Adjustment Facility (ESAF) and the Rights Accumulation Programme (RAP).

have caused delays in reaching agreements with the Paris Club. The delays experienced by the CFA countries prior to the devaluation of the CFA franc in January 1994 were the single most important factor contributing to the slowdown in Paris Club activities in 1993. By contrast, seven CFA countries went to the Paris Club in the first half of 1994. There were, however, about 20 other countries for which Paris Club agreements had expired by the end of June 1994 and which were candidates for future reschedulings. Most of these countries were accumulating arrears.

The 50 per cent devaluation of the CFA franc revealed what an overvalued exchange rate for these countries had hidden for many years, namely their real poverty level and the true burden of their external debt, in terms of the domestic resource cost. As a result of the sharp drop in per capita income in dollar terms, Côte d'Ivoire and Cameroon slipped back into low-income status. At the same time, their creditworthiness had deteriorated to such an extent that they became IDA-only countries, and thus eligible for the enhanced Toronto terms, which they obtained from the Paris Club.[79] The budgetary repercussions of the realignment were particularly adverse. While rescheduling countries' external debt-servicing obligations, measured in CFA francs, doubled, in the short term the devaluation was not expected to generate a commensurate increase in government revenue.

The impact of the CFA franc devaluation on the budgetary burden of external debt was, however, mitigated by an external financing package which included, in addition to Paris Club rescheduling and private debt restructuring, multilateral assistance, particularly from IMF and the World Bank, and budgetary aid and debt relief from France. This relief included: (a) full cancellation of ODA debt owed by the 10 poorest CFA countries; (b) 50 per cent cancellation of ODA debt of the other four (Cameroon, Côte d'Ivoire, Congo and Gabon); and (c) cancellation of arrears to the *Caisse Française de Développement*. The relief totals FF 28.3 billion ($5.1 billion), equivalent to about 10 per cent of CFA countries' total external debt.

Among the newcomers to the Paris Club, there were two major debtor countries, Algeria and the Russian Federation. The first Paris Club agreement on Algeria's debt (June 1994) was a historic event for a country that had avoided debt rescheduling by fully meeting its debt-servicing obligations, albeit at an extremely high cost. Algeria had one of the highest debt service ratios among debtor countries - an average of 80 per cent during 1991-1993. Its agreement covered arrears and debt-servicing obligations falling due up to mid-1995, amounting to about $5 billion. The rescheduled amount will be repaid over 15 years, including a three-year grace period, with a graduated repayment schedule.[80]

The main features of the first Paris Club agreement on Russian debt (April 1993) were described in last year's *Report*.[81] The second agreement (June 1994) followed a similar pattern. It was again concluded in the absence of an upper credit tranche arrangement with IMF (a customary prerequisite for a Paris Club agreement), but this time within the framework of IMF's Systemic Transformation Facility. The agreement contains standard terms as well as exceptional clauses. In accordance with traditional Paris Club practice, the agreement reschedules 100 per cent of principal and interest payments falling due in 1994 with a maturity of 15 years, including a grace period of 3 years and a graduated repayment schedule. Beyond the norm, and in line with the 1993 agreement, official creditors agreed to reschedule: (a) all current maturities on post-cutoff date debt contracted in 1991; (b) all current maturities on short-term debt; (c) 60 per cent of 1994 moratorium interest, i.e. interest payments on the consolidated amount; and (d) 80 per cent of 1994 interest payments on previously rescheduled debt. All these debts have been consolidated over 7-10 years. The total amount rescheduled exceeds $7 billion, which (as for Algeria) is one of the largest in Paris Club history, although much smaller than the $15 billion consolidated in 1993. As a result of the agreement, debt-servicing obligations to Paris Club creditors for 1994 have been reduced to about $3 billion, against a $4.1 billion budgetary allocation for total external debt service.

A new initiative aimed at enhancing official bilateral debt relief for low-income coun-

79 Cameroon received enhanced Toronto terms on current maturities and Houston terms - those reserved for lower middle-income countries - on arrears. For a description of the Houston terms, see *TDR 1992*, box 1.

80 Under this new schedule, applied since 1992 to a number of middle-income countries, principal payments rise gradually, with a longer maturity, but a shorter grace period, than in conventional reschedulings (10-year maturity - including a five-year grace period - and a flat repayment schedule). The purpose of the new schedule is to avoid the hump in debt service payments at the end of the grace period that occurs in conventional reschedulings.

81 See *TDR 1993*, box 19.

tries was announced at the Naples summit in July 1994, where the G-7 expressed themselves in favour of "a reduction in the stock of debt and an increase in concessionality for those countries facing special difficulties." The low-income countries have so far benefited from the enhanced Toronto terms, which provide for a 50 per cent write-off of debt service due over a relatively short period (up to three years) and for consideration of a debt-stock operation after a three-year track record of adjustment. This new initiative is most welcome. It reflects a growing recognition of the inadequacy of the enhanced Toronto terms, and official creditors' desire to remove the debt overhang of low-income countries pursuing sound adjustment policies. The new political consensus should impart a strong impetus for early implementation of more favourable terms at the Paris Club. The Naples agreement opens the way for the adoption of the Trinidad terms, originally proposed by the United Kingdom in 1990. Under these terms, low-income countries would benefit from a two-thirds reduction in the stock of their official bilateral debt. For many of these countries, the Trinidad terms would go much further than existing practices towards reconciling debt-servicing obligations with their longer-term capacity to pay. But for several other poor countries saddled with an extremely heavy debt burden, the Trinidad terms would not, by themselves, remove their debt overhang.[82]

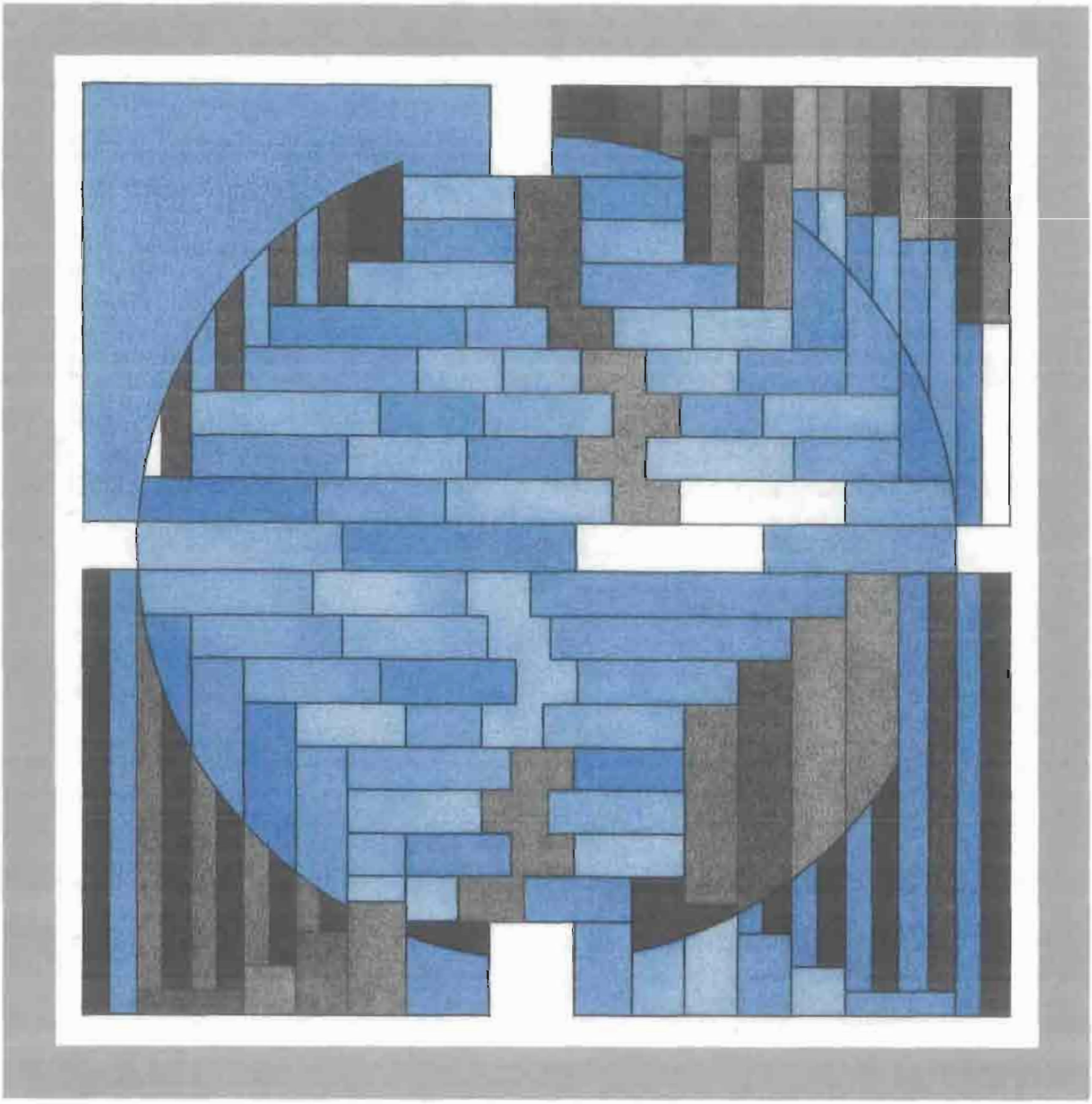
As was argued by the UNCTAD secretariat in previous issues of this *Report*, for a number of low-income countries additional country-specific measures, going beyond the Trinidad terms, will be necessary. These measures could include higher stock-of-debt reduction, of up to 100 per cent (the Paris Club is reportedly considering debt forgiveness of up to 80 per cent). They might also entail an increase in the amount of debt eligible for reduction, especially with regard to post-cutoff date debt and debt previously rescheduled on concessional terms, comparable action by non-Paris Club official creditors, commercial bank debt reduction, and multilateral debt relief.[83]

In addition to the scale of debt reduction, other aspects of the new terms would have to be worked out within the Paris Club, namely eligibility criteria and the time-frame for debt reduction. Eligibility criteria for debt reduction need to be urgently reviewed. At present, debt reduction in the Paris Club is limited to IDA-only countries. A number of severely indebted low-income countries, such as Nigeria, are excluded from the concessional treatment. As was proposed in last year's *Report*, eligibility should be widened to include, at a minimum, all severely indebted countries that are "blend" IBRD/IDA recipients. Setting a new time-frame for debt reduction involves decisions on when stock-of-debt reduction would start and on whether it would be granted in stages or all at once. In order to expedite the conclusion of exit rescheduling agreements for countries carrying out credible adjustment programmes, debt stocks should be reduced as soon as possible and in one go. ■

82 For an analysis of the enhanced Toronto terms and Trinidad terms, see *TDR 1991*, Part One, chap. II, sect. B.5; *TDR 1992*, Part Two, chap. I, sect. H; World Bank, *World Debt Tables 1993-1994* (Washington, D.C., 1993), Vol. 1, pp. 44-47; and M.G. Kuhn *et. al.*, *Official Financing for Developing Countries*, World Economic and Financial Surveys (Washington, D.C., IMF, April 1994), pp. 17-21.

83 Over the past 18 months, the trend toward increased flexibility in debt covered by rescheduling continued, particularly as regards post-cutoff date debt and moratorium interest. In several debtor countries, servicing obligations on debt contracted after the cutoff date have increased significantly. For rescheduling low-income countries, post-cutoff date debt accounted for about a quarter of their scheduled debt service to the Paris Club for 1993. These percentages are much higher for certain countries, especially those with very old cutoff dates. In response to this problem, and in line with a practice which began in 1990, the Paris Club deferred arrears on such debt in a few cases for up to three years, and for Russia it even rescheduled those arrears over several years. Furthermore, since 1993 there have been some additional instances (Peru and Russia) where Paris Club creditors have rescheduled part of the moratorium interest.

RETHINKING ECONOMIC POLICIES: LESSONS FROM EXPERIENCE



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Introduction

Beginning about a decade or so ago, thinking on economic policy took a radical turn. The turn was nowhere more apparent than with respect to development strategy and macroeconomic management.

The view gained ascendency that markets, and not Governments, hold the key to development. It was argued: that the international mobility of finance would allow the external capital requirements of developing countries to be met if there was an economic environment that would spontaneously attract private capital; that exports could be quickly lifted by reducing import barriers and devaluing the currency; that overall efficiency was maximized when resources were allocated through markets; that public enterprises were a drag on growth; that "government failure" was typical; and so on. The thrust of this thinking stood in sharp contrast to the "development economics" of the 1950s and 1960s, which had emphasized such factors as the pervasiveness of "market failures" rooted in underdevelopment; the limitations of the law of comparative advantage in the context of the particular international division of labour shaped by political factors; and rigidities in the economic structure and lack of response to market signals. These factors had been felt to require across-the-board policy interventions and extensive development planning.

The change of attitude was equally pronounced regarding macroeconomic policy. The Great Depression of the interwar years had led Governments to regard the level of aggregate demand as a crucially important determinant of growth and employment, and they increasingly sought to gear their monetary and fiscal policies towards ensuring that demand was neither too low nor too high. By contrast, the turn in thinking emphasized the dangers of managing demand. It saw monetary policy as influencing prices rather than output, and fiscal deficits as a drain on savings. Growth was viewed, rather, as being dependent on "supply-side" - i.e. microeconomic - factors, while employment levels were believed to depend primarily on the functioning of labour markets rather than the overall level of economic activity.

Some regard the turn in thinking as representing progress, based on the policy-making experience over the past half-century, while others see it as a regression of ideology to the laissez-faire of the last century. Perhaps the true picture is that the political and intellectual pendulum has been undergoing another swing: having moved too far in one direction, it is now moving too far in the opposite.

This thought has provided the point of departure for the two chapters that follow. The first looks at the role played by Governments in the seemingly miraculous development experience of a number of economies in East Asia, while the second examines the role of effective demand in the the lack-lustre performance of the major industrial countries. The reader is forewarned that neither chapter purports to say the last word on the policy issues involved - they are essays more in dissuasion than persuasion. But each addresses a fundamental issue which neither the theorist nor the practitioner can continue to ignore.■

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Chapter I

THE VISIBLE HAND AND THE INDUSTRIALIZATION OF EAST ASIA

A. Introduction

Among the many different growth experiences in the postwar period, those of a number of economies in East Asia, which have earned the appellation of "miracle",[84] stand out above all others. The fast pace of development in this region has been reflected in the steeply rising trends of both output and living standards, and has gone hand-in-hand with swift industrialization. The process has been driven by an impressive pace of capital accumulation, without which it would have been impossible so rapidly to improve methods of production and the quality of output, to diversify the range of goods and services produced and to compete successfully in world markets for manufactured products.

The key questions are: how did these economies overcome their savings and foreign exchange constraints - two factors often identified as crucial to development performance - so as to raise the share of investment in national income; and how did they translate capital accumulation into technological progress and productivity growth?

Numerous observers have sought to explain the success on the basis of the tools of traditional economics. Thus, it has been argued that high rates of savings and investment stemmed from macroeconomic stability, that strong foreign trade and productivity performance came from following the law of comparative advantage, and that the pattern of output closely approximated what would have been expected in a regime of laissez-faire. Explanations of this kind ascribe a minor role to government policy. It is argued that the State's positive contribution lay in its providing an "enabling environment" and certain public goods (such as basic education), and that direct government interventions in the East Asian economies were relatively few, transparent and "market-conforming"; it has even been sometimes argued that the selective interventions that were made proved to be either harmful to growth or ineffectual in changing its pattern.

However, not only is the orthodox explanation of savings and accumulation superficial, but also the argument overlooks the high degree of selective intervention, especially in the larger economies (Japan, the Republic of Korea and Taiwan province of China). One analyst has made the following observation:

> Ask any policy-oriented economist what a good policy regime should look like, and you are likely to get an answer of the following form. Successful programmes are likely to:
>
> - apply simple and uniform rules, rather than selective and differentiated ones;
>
> - endow bureaucrats with few discretionary powers;

[84] See *The East Asian Miracle. Economic Growth and Public Policy* (New York: Oxford University Press for the World Bank, 1993); see also the Special Section on this study in *World Development*, Vol. 22, No. 4, April 1994; D. Rodrik, "King Kong meets Godzilla: the World Bank and *The East Asian Miracle*" (London: Centre for Economic Policy Research), Discussion Paper, No. 944, April 1994; H-J. Chang, "Was selective industrial policy in East Asia unsuccessful? Some comments on the World Bank's *The East Asian Miracle*, Cambridge, 1994 (mimeo).

- contain safeguards against frequent, unpredictable alteration of the rules;
- keep firms and other organized interests at arms' length from the policy formulation and implementation process.

These notions derive from various bits and pieces of economic theory, including the theories of dynamic inconsistency in policy, investment under irreversibilities and rent seeking. The World Bank's policy recommendations, particularly in the area of trade policy, rely heavily on these or similar ideas.

The puzzle with respect to the high-performing Asian economies is that their policy-making style has been virtually orthogonal to the list above. Many of the interventions have been firm-specific, highly complex and non-uniform; bureaucrats have been endowed with tremendous amounts of discretion in applying policy; rules have been changed often and unpredictably; and government officials have interacted closely with enterprise managers.[85]

The main reason that government interventions in this region have appeared to be "market-conforming" lies neither in their fewness nor in the type of instruments used, and still less in the absence of bureaucratic discretion, but in the underlying character of the policy regime. Unlike many other Governments that intervened extensively, those in East Asia did so not to constrain the business sector as a whole in the interests of other classes ("populism"), and still less to replace private enterprise ("real socialism"); nor did they seek simply to extend favours to certain individual interests ("crony capitalism"). In the East Asian economies, the primary purpose of government intervention in the development process was to promote the interests of the business sector as a whole, and - most important - to do so by creating new wealth through capital accumulation and productivity improvement rather than by redistributing a given national income away from workers, farmers and other social classes. Its main aim can thus be said to have been to ensure that the behaviour of individual businesses accorded with the long-term interest of the business class as a whole in generating a rapidly growing volume of profits and capital.

The interventions have been pragmatic rather than based on a strict ideology. They have nevertheless had a clear rationale, namely to accelerate the pace of capital accumulation, technical progress and structural change, and hence economic growth, beyond what would have resulted from "laissez-faire". In essence, they have been directed at tackling a series of closely interrelated and mutually reinforcing "market failures" which typically hold back the process of investment and innovation in a late industrializing country. In particular:

- Business firms are more reluctant to invest and innovate, and thus achieve international competitiveness, when the costs of so doing are high and immediate whereas the benefits are uncertain and come after a considerable interval (the "infant industry" problem);
- Investment, structural change and innovation are also discouraged when all the costs are borne by the firm itself whereas part of the productivity gains are captured by others ("externalities");
- Similarly, a firm is discouraged from entering a new line of business or adopting a new method of production or organization if it has to bear all the costs of pioneering but stands to lose surplus profits to others that choose to wait and learn from its example (paucity of "Schumpeterian rents");
- A firm is also reluctant to put its capital at risk when investment plans of its customers and suppliers are uncertain, and vice versa (the "coordination problem");
- Because retained earnings are the main source of investment finance, corporate profitability influences not only firms' willingness to invest but also their capacity to do so; this is especially so since the amounts that banks and other financial institutions are prepared to lend usually depend on the firm's accumulated retained earnings and debt, and not just on the prospective rate of return on new investments (the "principle of increasing risk");
- Firms may be too small and undercapitalized to be able to take on large-scale investment and radical innovation, despite the presence of profitable investment opportunities.

The interventions that were made by East Asian Governments to tackle these problems took a variety of forms. They included "functional interventions" designed to affect the general mechanisms of production and resource allocation by facilitating the functioning of markets, but also numerous "selective interventions" designed to meet the differing needs and circumstances of specific industries and specific firms at different times. Whether

85 D. Rodrik, *op. cit.*, pp. 33-34.

"functional" or "selective", policy generally sought to achieve improvements in supply capabilities at the microeconomic level, as well as in the main macroeconomic aggregates.

The role played by government intervention in this region has been obscured by arguments about the effectiveness of industrial policy in countries at an advanced stage of development. Industrial policy in the context of late industrialization is a very different kettle of fish, for the very reason that developing countries, unlike the already industrialized ones, are seeking to "catch up". Since they are not initially operating in technological terms at the frontier of international best practice, for them promoting industrial development does not involve "picking winners" in a given technological race, but lifting the propensity to invest and promoting learning, including how to acquire mastery over readily available technologies and how to compete in mature product markets with long-established firms.

Industrial policy in successful East Asian countries has been predominantly implemented through the actions of private firms seeking profits. It has been said that in Japan, "the success of guidance from above was only made possible by dynamism in industrial circles".[86] Consequently, attempts to isolate those economic effects which can be attributed to government, as against the market, are misguided. The important point is that the type of industrial policy used worked through the interaction of government policy and the competitive strategies of private firms.

It is also important to bear in mind that the primary concern of industrial policy in these economies was not the composition of manufacturing capacity and output *per se*, but rather the dynamism and efficiency of the industrialization process as a whole. Consequently, the right criterion in assessing their efficacy is not whether or how far they caused the sequence of structural change to diverge from what normally occurs in the course of industrialization. The correct test is whether the interventions served to accelerate the process of structural transformation by promoting activities which would have been dismissed as uneconomic on the basis of the factor scarcities prevailing at the time, but which proved to be justified *ex post* - that is, after the policies taken as a whole had done their work in changing comparative advantage. In short, attention should not be focused narrowly on questions of short-term "resource allocation" seen from a strictly microeconomic perspective (which is the approach of analysts in the "marginalist" tradition). Instead, attention must be placed on the process of capital accumulation and dynamic learning processes by business firms and the institutional development required to lift an economy out of underdevelopment (factors which preoccupied the "classical" economists, including advocates of free trade such as Adam Smith and David Ricardo).

This chapter looks at those Asian economies that have made the greatest progress in economic development - namely, Hong Kong, Japan, Republic of Korea, Singapore and Taiwan province of China. Its purpose is not to provide a comprehensive explanation for their success, but to examine the nature and role of government intervention - "the visible hand" - in furthering the pace of capital accumulation and technological advance.

B. Economic performance in a long-term perspective

From the early 1950s until the first oil price shock in 1973, the Japanese economy grew very rapidly, at an annual average rate of around 10 per cent (somewhat slower in the 1950s and somewhat faster in the 1960s). This was associated with impressive increases in exports. These rose in value by 17 per cent per annum during the 1950s and 1960s, twice the rate of growth of world trade, raising Japan's share of world exports from 1.3 per cent to 6.2 per cent.[87] Since 1960 equally impressive growth also occurred in the four newly industrializing economies (NIEs) of East Asia. GDP grew on average at 8-10 per cent in each economy throughout the 1960s and 1970s; in the 1980s it ranged from 6.6 per cent per annum in Hong Kong to 9.3 per cent per annum in the Republic of Korea. In each case, growth was

86 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns in the Japanese Economy* (University of Tokyo Press, 1982), p. 23.

87 For postwar developments in Japan, see T. Nakamura, *The Postwar Japanese Economy: Its Development and Structure* (University of Tokyo Press, 1981), and T. Yanigahara, "Japan as a newly-industrializing country", *Journal of International Economic Studies*, No. 8, 1994.

associated with structural change. All four economies have experienced industrialization; in the two city economies this involved a shift away from entrepôt activity, whereas in the other two economies it involved a shift out of agriculture.

Industrialization had begun in Japan in the late nineteenth century. In 1955, when wartime reconstruction was completed, the primary sector accounted for 23 per cent of net domestic product and 41 per cent of employment. By 1970 the figures had fallen to 8.6 per cent and 19 per cent, respectively. Over that period, the secondary sector's share of net domestic product increased from 28.6 per cent to 43 per cent, and its share of the labour force from 23.5 per cent to 33.9 per cent. Growth in the manufacturing sector was particularly rapid; there was a 10-fold increase in the index of manufacturing output from 1955 to 1977. There was also a change in the structure of manufacturing output; for instance, the contribution of textiles fell from 18.2 per cent in 1951-1955 to 8.2 per cent in 1966, and that of heavy and chemical industries rose from 46.8 per cent to 60.3 per cent. Output of machinery (both consumer durables and capital goods) rose some 30-fold during the same period.

Some heavy industries had been developed in both Taiwan province of China and the Republic of Korea when they were under Japanese administration. In Hong Kong, the development of manufacturing began in the 1950s in association with the rupture of entrepôt links with China and the massive migration from the mainland, which helped raise the population of the colony from 600,000 to 2,370,000. There was also a large influx of capital, machinery, skills, market connections, and entrepreneurial capabilities from Shanghai and other parts of China.[88]

In 1960 Hong Kong had a clear lead in manufacturing over the other three East Asian NIEs; the sector contributed 26 per cent of GDP, as against 12 per cent in Singapore, 14 per cent in the Republic of Korea and 17 per cent in Taiwan province of China. By 1980, the proportion stood at 27 per cent in Hong Kong, but had reached around 30 per cent in the other three economies, where significant structural changes had taken place, with the share of heavy industry in total manufacturing output increasing in both Taiwan province of China and the Republic of Korea, and more skill- and technology-intensive industries developing in Singapore. In Hong Kong, the textiles and garment industry continued to dominate manufacturing activity, though there was also movement toward high-quality, high-value and fashions items.

These structural changes went hand-in-hand with a dramatic increase in manufactured exports. Whereas in 1965 the share of the four East Asian economies in total manufactured exports from developing countries was about 13 per cent, in 1990 it exceeded 61 per cent.

More recently, Indonesia, Malaysia and Thailand have also been regarded as being part of the East Asian "miracle" on account of their sustained high rates of growth of output, exports and investment, associated with a large influx of foreign direct investment. Like the NIEs, and in contrast to most other developing countries, they too show high rates of savings and investment, as well as dynamism in manufactured exports. However, having started earlier, it is the NIEs which have industrialized most successfully, to the extent that their living standards are not unlike those in developed countries. The rest of this chapter will focus on Japan and the NIEs, and in particular on the role played by government policy in accelerating industrialization.

C. Government-business relationships

During the period of rapid growth and industrial catch-up, Japan actively pursued a policy of promoting the development of particular industries (and of particular firms within them) to catch up with the advanced industrial countries of Western Europe and the United States. The relationship between government and business was broadly cooperative, with the Government seeking to advance the process of private sector capital accumulation as a whole and to induce dynamic private investment activity, the local commercialization of foreign technologies and aggressive entrepreneurial commitment to expand market share.

88 See L.C. Chau, *The Lessons of East Asia. Hong Kong: A Unique Case of Development* (Washington, D.C.: The World Bank, 1993), p. 15.

One popular way of describing this relationship is to refer to Japan as "Japan, Inc.", a term which suggests that the entire national economy is operated in concert like a giant corporation. However, this notion overstresses the degree of convergence of government and business goals, ignoring conflicts of interest which arose from time to time. In reality the Government, particularly through the Ministry of International Trade and Industry (MITI), was constantly searching for ways to ensure that its societal objectives were achieved through the actions of the private sector, pursuing, as freely as possible, its own goals.[89] Achieving this aim required specific institutional mechanisms for policy formulation and the deployment of particular tools of policy implementation.

Government policy in postwar Japan until the early 1970s was oriented not towards improving consumption levels and patterns, but towards modernizing equipment and facilities, increasing productivity and changing industrial organization and the structure of production. Accordingly, the strategy was geared towards upgrading the industrial structure, so as to attain a composition of manufacturing output and exports similar to that in more advanced countries, and encouraging the growth of larger firms with economies of scope while promoting standardization and specialization among smaller firms so as to capture economies of scale.

Government policy was consequently designed to correct a number of "market failures". But care must be taken in appreciating how this concept was understood. It was not defined in relation to microeconomic efficiency of resource allocation, but rather in relation to the ability of the market mechanism to achieve the strategic development goals set by the Government. Thus, the inability of the market to achieve certain industry-specific goals was viewed as market failure; or, more broadly, market failure was said to arise "when the goods and services deemed necessary by society cannot be easily or adequately provided through dependence on only the free economic activities of private sectors motivated by private profit".[90] Also, action was taken in anticipation of market failures, rather than *ex post*, and it has been suggested that there was a vast difference in this respect between the way that Japan and the United States treat market failure:

> At the risk of oversimplification, perhaps the United States' concerns can be described as reactive, *ad hoc*, and focused on market failures without reference to industry-specific goals. By contrast, Japan's approach is anticipatory, preventive, and aimed at positively structuring the market in ways that improve the likelihood that industry-specific goals will be achieved. There is a fundamental divergence in expectations and objectives and hence in policy actions. Whereas Americans are content to let the chips fall where they may, the Japanese prefer to remove as much of the element of uncertainty as possible from the market processes. Their disposition to bend, twist, and shape the market is analagous to their practice of using ropes, wires, and strings to bend and twist the trunks and branches of trees into shapes that fit the Japanese aesthetic composition of a landscape, garden or bonsai plant.[91]

Government policy was formulated in Japan in partnership with big business. The two key Ministries responsible for policy formulation and design in the macroeconomic and microeconomic spheres (the Ministry of Finance and MITI) closely coordinated their policies within the framework of an overall indicative plan, usually covering five years. The basic role of these plans was "(1) to present a forecast for the way the economy ought and can develop; (2) to point out the basic directions that the Government should follow in implementing its medium- and long-term economic policy management as well as to identify the priority policy objectives and means; and (3) to provide basic guidelines for household and corporate decisions".[92] The plan established business expectations of the lower limit of the growth rate during a five-year period and publicized medium-term government objectives. In formulating it a consensus was developed in two stages. First, politicians from the ruling party, academics and government officials exchanged views on the formulation of a plan proposal, and second, a more detailed deliberation of the proposal was made by the Economic Deliberation Council, a group which included business leaders, academics and former officials. The objectives and growth tar-

89 An institutional history of MITI written from this perspective is C.A. Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-75* (Stanford, CA: Stanford University Press, 1982).

90 The Japan Development Bank and Japan Economic Research Institute (JDB/JERI), *Policy-Based Finance: The Experience of Postwar Japan. Final Report for the World Bank*, 1993, p. 28.

91 D.J. Okimoto, *Between MITI and the Market. Japanese Industrial Policy for High Technology* (Stanford, CA: Stanford University Press, 1989), p. 11.

92 Cited from the economic plan of 1988 by T. Komine in "The role of economic planning in Japan", in J. Teranishi and Y. Kosai (eds.), *The Japanese Experience of Economic Reform* (London: Macmillan, 1993), p. 310.

gets of successive plans prepared by the Economic Planning Agency from 1955 to 1970 are shown in box 1.

In addition to this general plan, more specific "visions" were drawn up for particular industries. These were drafted by MITI, but it arranged study groups, research groups and deliberative councils to hear and incorporate the views of academics, industry officials, consumers and other interested parties.[93]

The deliberative council system and the industry associations played significant roles in coordinating the views both of the public and private sectors and of members of a particular industry. The deliberative council system was particularly important in the formulation of industrial policy. In the 1950s the main deliberative body for this purpose was the Industrial Rationalization Council, and in the 1960s it was the Industrial Structure Advisory Council. In addition, each industrial sector had its own council and board of enquiry to deliberate over individual issues related to that industry. These councils and boards numbered approximately 30 in the 1960s, and their members consisted mainly of business leaders, former government officials, academics, journalists, representatives from consumer groups and from the world of labour and finance, as well as of local government officials. The functions of the councils were information-gathering, interest coordination and persuasion. Their operation meant that policies were not unilaterally decided and enforced by the Government.

Many of the considerable number of industry associations had been set up under the encouragement of MITI after the war. Their function was to coordinate the views of industry and ensure that the relevant divisions of MITI designed policy advantageous to industry.

Besides these formal institutions, there were a number of informal policy networks. For instance, ties between government and business were reinforced by *amakudari*, a practice whereby officials leaving the bureaucracy on retirement take up high-level posts in private industry and industry associations.

The government-business relationship was facilitated by two features of Japan's pattern of industrial organization. Firstly, the market structure in many key industries, particularly the heavy industries, was oligopolistic, with firms organized into loose business groupings (*keiretsu*), see below. Secondly, large corporations dominated small and medium-size enterprises, which were an important source of employment and output throughout the catch-up period.

In prewar Japan, industrialization had been led by a handful of large diversified business groups (*zaibatsu*). These were family-based and generally consisted of a holding company that controlled several principal operating companies and their subsidiaries. In the occupation after the second World War, the *zaibatsu* were dissolved by breaking up the holding companies, purging companies of top management and prohibiting members of founding families from business activities. But in the 1950s *keiretsu* re-emerged as formerly *zaibatsu*-affiliated companies became affiliated to banks. There were six major *keiretsu*, centred on the Mitsubishi, Mitsui, Sumitomo, Fuji, Dai-ichi Kangyo and Sanwa banks. However, not all the large firms which grew rapidly in the postwar era were affiliated to such groupings (notable exceptions being Sony and Honda).

While ties amongst the firms within *keiretsu* were looser than ties amongst *zaibatsu* companies, members of each tended to hold each others' stock and to exchange information. In the postwar period, each *keiretsu* sought to have among its members at least one company from each major industry ("one-set-ism"). Each *kereitsu* also had a general trading company, *sogo shosha*,[94] which had wide intelligence networks that were particularly important both in developing exports and in securing cheaper imports. During 1960-1973, half of Japan's exports and almost two thirds of imports were handled by the 10 largest trading companies.[95] They also had an important function in providing credit for marketing activities of manufacturing firms.

Alongside the large corporations were a large number of small- and medium-sized enterprises. During the 1950s and 1960s, 30-40 per cent of workers employed in manufacturing were in small enterprises with less than 30 workers, and only 20-25 per cent were in large enterprises with 500 or more workers.[96] Subcontracting relationships between large and

93 This process is discussed in more detail in JDB JERI, *op. cit.*

94 D.S. Cho, *The General Trading Company: Concept and Strategy* (Lexington, MA and Toronto: D.C. Heath and Company, 1987).

95 M. Shinohara, *op. cit.*, p. 44.

96 See T. Nakamura, *op.cit.*, chap. 5.

Box 1

PLAN OBJECTIVES IN JAPAN, 1955-1970

Objective concerning	*Five year plan for economic self-support (1955)*	*New long-range economic plan (1957)*	*National income doubling plan (1960)*	*Medium-term economic plan (1965)*	*Economic and social development plan (1967)*	*New economic and social development plan (1970)*
Economic growth	Economic independence without United States aid.	Higher economic growth rate. Higher accumulation of capital.	Double per capita GNP in 10 years.	Stable growth. Correct dis-equilibrium caused by high growth.	Balanced economic growth.	Balanced growth with manageable balance of payments situation.
Employment	Offer employment opportunity to increasing population.	Absorb excess labour in agriculture and small business.	Rectify low wage and dual economic structure problem.	Efficient use of labour force.	Efficient use of labour force.	
Prices		Price stability of fundamental materials such as coal and electricity.	Cope with monopolistic corporate behaviour.	Reduce inflation.	Cut inflation.	Cope with wage, income and productivity problems.
Industry	Move from light to heavy industry. Strengthen industrial infrastructure. Increase production of staple foods.	Stronger industrial structure by promoting heavy and chemical industries.	Stronger industrial structure by promoting high value-added industries. Industrialize Pacific Belt area.	Modernize low-productivity sectors such as agriculture, small business and distribution. Stronger industrial structure.	Strengthen industrial foundation to cope with liberalization. Development of indigenous technology.	Promote information-intensive and high value added industries. Promote information-oriented economy.
World economy	Strengthen export competitiveness.	Promote exports.	Economic cooperation with developing countries.	Higher international status and transformation to open economy. Promote exports and liberalize imports.	Liberalization of capital transactions.	Contribute to international economic society. Active promotion of trade and investment liberalization.
Social questions	Restrain consumption and promote savings.	Eliminate poverty and illness. Stable life for low income families.	Promote social security system. Higher consumption both in quality and quantity.	Promote social welfare system. Stabilize land prices.	Promote social development.	Promote consumer protection. Build better pension system.

Source: T. Komine, *op. cit.* (table 12.2).

small firms were widespread, with firms like Toyota ordering automobile parts from parts producers in its affiliated network, and firms like Toray supplying thread to weavers in its network who pay weaving and processing fees. Wage levels differed significantly: in the late 1950s wages in the medium-sized enterprises were 50-60 per cent of those in large firms, while for small enterprises they were about 40 per cent. These differentials reflected the fact that whereas the large firms sought to take the pick of the graduates from the formal schooling system, the small and medium enterprise sector absorbed much of the surplus labour being transferred from agriculture to manufacturing. In the 1960s, the labour market situation tightened as the labour surplus disappeared, and the differentials in wage levels between large and small/medium firms diminished.[97]

The pattern of industrial organization in Japan had a number of favourable consequences for the formulation of industrial policy. Firstly, industrial consensus was made easier by the small number of large corporations, while subcontracting relationships provided a means for imposing discipline on the remainder. Secondly, the fact that the *keiretsu* were diversified meant that selective promotion of particular industries did not necessarily entail the selective promotion of particular business interests. Thirdly, the mutual stockholding among large corporations, and their special financial relationships with banks, encouraged a long-term business perspective geared towards increasing market share, which coincided with the long-term government objective of enhancing the international competitiveness of Japanese firms.[98]

In the Republic of Korea and Taiwan province of China, too, the Government had a strong commitment to growth through private business, which was sharpened in both economies at the end of the 1950s by political and security concerns. The two economies differed significantly in industrial organization,[99] which was in turn reflected in differences in government-business relationships. In Taiwan province of China (which received a large influx of entrepreneurs from the mainland) the main form of private sector enterprise was small- and medium-sized firms. By contrast, in the Republic of Korea it was the family-based business conglomerate, the *chaebol*, which was deliberately encouraged by government policy to correct the dearth of entrepreneurship. On the other hand, Taiwanese public enterprises were important, precisely because private firms tended to be relatively small.

Some figures can illustrate these differences. During the period 1966-1976, the number of manufacturing firms in Taiwan province of China grew by 250 per cent, while the number of employees per firm grew by 29 per cent. In the Republic of Korea, by contrast, the number of manufacturing firms grew by 10 per cent over the same period, while the number of employees per firm doubled.[100] In 1987 the biggest conglomerate in the Republic, Samsung, had a sales total of $21 billion, which was 40 per cent larger than the total sales of the 10 largest Taiwanese companies combined; and it had 160,000 employees, over 50 per cent more than the 10 biggest Taiwanese companies. In 1987, too, the top 10 companies in the Republic of Korea accounted for 63.5 per cent of the country's GDP, as against 14.3 per cent in Taiwan province of China.[101]

In Taiwan province of China the contribution to GDP at factor cost of public enterprises averaged over 13 per cent in the period 1958-1980, roughly the same as in Burma, Bolivia and India, putting it in the top decile of non-African developing countries. The public sector accounted for 30-40 per cent of gross fixed capital formation in the 1950s, 27-28 per cent in 1962-1968, and 30-35 per cent in the 1970s. Public sector investment was particularly important in the 1970s in establishing key upstream industries which required large-scale investments and business organization - petroleum refining, petrochemicals, steel and other basic minerals, shipbuilding, heavy machinery, transport equipment and fertilizers.[102] These industries required investments and business organization on a much larger scale than was possible for the private sector at the time.

The Republic of Korea's industrial organization facilitated an industrial policy similar to that of Japan. As in that country, there was an important lead agency formulating and implementing industrial policy, the Economic

97 For more detailed information on wage differentials see D. Friedman, *The Misunderstood Miracle: Industrial Development and Political Change in Japan* (Ithaca, NY: Cornell University Press, 1988).

98 An interesting discussion on the relationship between industrial organization and industrial policy is to be found in D.J. Okimoto, *op. cit.* He argues that the range and variety of convenient "access points" available for intervention is critical for understanding "how the Japanese Government can be both a minimalist State with a hands-off attitude toward the market economy and at the same time an interventionist State that extends its long arms to steer the market when it veers off course" (p. 151). One might add that it reduces private sector transactions costs associated with industrial policy.

99 For a comparison of government-business relations in Japan, the Republic of Korea and Taiwan province of China see C.A. Johnson, "Political institutions and economic performance: the government-business relationship in Japan, South Korea and Taiwan" in F.C. Deyo (ed.), *The Political Economy of the New Asian Industrialism* (Ithaca, NY: Cornell University Press, 1987).

100 R. Wade, *Governing the Market: Economic Theory and The Role of Government in East Asian Industrialization* (Princeton, NJ: Princeton University Press, 1990), p. 67.

101 G. Gereffi, "Big Business and the State", chapter 4 in G. Gereffi and D.L. Wyman (eds.), *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia* (Princeton, NJ: Princeton University Press, 1990), p. 96.

102 R. Wade, *op. cit.*, table 6.2 and p. 176.

Planning Board, and policy was framed within the context of indicative five-year plans. However, there was probably more direction of the private sector than in Japan.[103] The attitude of government towards business at the start of the 1960s was well-symbolized by the Law for Dealing with Illicit Wealth Accumulation, under which business leaders were arrested and then released to apply their entrepreneurial efforts to support national growth. Throughout the 1960s and 1970s, industrial policy was based on reciprocity between government and business, in which the Government gave special incentives to firms but required them to meet performance standards in line with national objectives.[104] The Government had the upper hand because (as in Japan) firms had a high debt-equity ratio, while (unlike in Japan) banks were publicly owned until the 1980s. The authorities in Taiwan province of China maintained a more arms'-length relationship with private business. However, there was some degree of guidance over the large corporations in the private sector, and, as already noted, many large firms were publicly owned.

D. Building firm-level capabilities, productivity and international competitiveness

One of the main objectives of industrial policy is to help firms become more efficient and competitive by strengthening their entrepreneurial, managerial and technological capabilities. The acquisition of such capabilities is not the automatic process assumed in much of economic theory; firms are not self-sufficient units, they do not command full knowledge of all possible technologies, and their learning processes are neither short, predictable nor costless. The process is a complex one. It requires not only incentives but also a willingness and ability to undertake investments in physical capital and skill creation, as well as technological effort and organizational change. It also requires external support systems to supply skills, physical facilities and technology infrastructure (such as industrial standards, quality assurance testing facilities and basic research).[105]

The process of capability building is particularly difficult in developing countries, where industrial skills, support services and industrial linkages are weak; besides, starting new activities is usually risky. In addition, a national firm in a late industrializing country usually enters mature product markets where there are well-established competitors that have already undergone a costly learning process. Its initial production costs are therefore often higher than those of foreign competitors, not only in production with high capital intensity and technological sophistication, but also in labour-intensive products.

The industrial policies of the East Asian NIEs and Japan during the catch-up period all sought to build up firm-level capabilities. One essential element was the provision of protection and incentives through the trade regime, but several other elements were also present. This section focuses on trade policy, technology policy, financial and fiscal measures to support capital investment, and competition policy, and describes some of the different outcomes in terms of industrial deepening in the four NIEs. As will become apparent, the measures adopted vary considerably among the countries. With the exception of Hong Kong, intervention has been highly selective, and, with the same exception, considerable industrial deepening has occurred.

103 For a detailed and perceptive discussion of this subject see L.P. Jones and Il Sakong, *Government, Business and Entrepreneurship in Economic Development: The Korean Case* (Cambridge, MA: Council on East Asian Studies, Harvard University, 1980).

104 This is a central theme in A. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989).

105 This approach, and the weakness of neoclassical analysis, has been elaborated by Sanjaya Lall in a sequence of writings, including: *Building Industrial Competitivness in Developing Countries* (Paris: OECD Development Centre, 1990); "Explaining industrial success in the developing world" in V.N. Balasubramanyam and S. Lall (eds.), *Current Issues in Development Economics* (London: Macmillan, 1991); "Technological capabilities and industrialization", *World Development*, Vol. 20, No. 2, 1992; "Understanding technology development", *Development and Change*, Vol. 24, No. 4, 1993; "Industrial policy: the role of government in promoting industrial and technological development", *UNCTAD Review*, 1994 (United Nations publication, Sales No. E.94.II.D.19). An analysis of World Bank policy on industrialization in selected Asian countries from this perspective is found in World Bank Operations Evaluation Department, *World Bank Support for Industrialization in Korea, India and Indonesia* (Washington, D.C.: The World Bank, 1992).

1. Policy ingredients

(a) Trade policy

Hong Kong did not protect domestic industries, and in Singapore tariffs were reduced after a brief import substitution industrialization strategy in the early 1960s. However, the three other countries, with sizeable domestic markets, all supported the development of national firms with protection via foreign exchange controls, import quotas and tariffs. Moreover, they liberalized step-by-step as specific industries became internationally competitive.

During the catch-up period Japan resorted to numerous protectionist measures, involving foreign exchange controls, import quotas and tariffs. Under the Foreign Exchange and Foreign Trade Control Law (of 1949), all foreign exchange receipts from exports had to be surrendered to the Government, which decided on their use. From 1952 onwards this task was carried out by the Budget Section of MITI, which thus gained strong power to influence the pattern of industrialization. Import restrictions played an important role in virtually all modern sectors in helping infant industries to become highly successful exporters.[106] They began to be slowly removed from the mid-1950s onwards. Liberalization was carefully phased throughout the 1960s, its timing for specific imports being related to progress in attaining international competitiveness. In some industries liberalization was in consequence considerably delayed. For example, technology imports, over which MITI exerted strong selective control in the context of its overall industrial strategy, were liberalized only at a relatively late stage, during 1968-1972.[107]

The main impetus for liberalization came from the need to meet multilateral obligations and from external pressure. The initial form of trade liberalization, starting with Japan's full accession to GATT in 1955, involved the gradual removal of import quotas and foreign exchange controls. Liberalized imports constituted 16 per cent of total imports in 1955, a proportion which rose to almost 93 per cent in 1964.[108] However, the reduction of import quotas was accompanied by an increase in tariffs. The ratio of tariff revenues to total import value rose from 3.2 per cent in 1956 to 7.3 per cent in the mid-1960s. Subsequently, tariffs were reduced in conformity with commitments in the Kennedy Round, and by 1975 the ratio of tariff revenues to total import value had come down to 2.9 per cent. After 1975 tariffs were reduced further, as a result of the Tokyo Round. Agriculture, however, was protected throughout the catch-up period and beyond.

In Japan (as in the Republic of Korea and Taiwan province of China) import protection was associated with incentives (or even compulsion) to export, such as tariff rebates, tax exemptions on export earnings and provision of short-term export credit. Unlike the two other economies, Japan, with its large domestic market, could provide a competitive spur through domestic competition policy (see subsection 1(d)). At the beginning of the 1950s a policy-based finance institution, the Export-Import Bank, was set up to provide suppliers' credits to exporters at low interest rates, particularly for financing exports of ships.[109] In the mid-1950s the Japanese External Trade Organization was established to fill a gap caused by the fact that manufacturers had been operating without detailed information about market opportunities ("blind trade"). In 1955 a Transactions Law gave MITI the power to exempt agreements among exporters regarding the terms of export (price, maximum export quantities, etc.) from the provisions of the Anti-Monopoly Law, and authorized MITI to use its own discretion, if necessary, to determine the appropriate terms of export. Special tax incentives were introduced in the early 1950s, including exemptions of up to 50 per cent of export revenues from taxes. Because of Japan's changed status in GATT, these were eventually replaced, from 1964 onwards, by special depreciation allowances tied to export performance.

Since production for both exports and the home market was heavily dependent on imported raw materials, an important aspect of trade policy in general, and export expansion in particular, involved measures to obtain cheap and assured supplies of raw materials. From the early 1950s Japanese firms were encouraged to invest abroad in resource-based production.

106 See M. Shinohara, "Causes and patterns in the postwar growth", *The Developing Economies*, Vol. VIII, No. 4, December 1970, p. 353.

107 T. Nakakita, *op. cit.*, p. 362.

108 The liberalization ratio is defined in this context as the ratio of liberalized import values (that is, duty-free imports plus imports with tariffs imposed) to total import values. See T. Nakakita, "Trade and capital liberalization policies in postwar Japan", in J. Teranishi and Y. Kosai (eds.), *op. cit.*, p. 363.

109 JDB/JERI, *op. cit.*, chap. V.

The Export-Import Bank provided finance to help ensure that the inputs required for exports could be secured. Loans for this purpose were also made available directly to foreign suppliers of such inputs.[110]

In the Republic of Korea there were two main periods of import liberalization: the mid-1960s, when quantitative restrictions were reduced but tariffs raised; and the 1980s, when both quantitative restrictions and tariffs were reduced. One commentator has noted that "the country not only delayed the promotion of import liberalization until it became somewhat confident in export expansion even after the shift to the export-oriented policy, but has also been cautious in the promotion of liberalization".[111] In Taiwan province of China nominal rates of protection remained over 40 per cent from the 1950s to the 1970s and reached a maximum of over 55 per cent in 1974.[112] Import controls were also extensive: over half of its imports by value were covered by non-tariff barriers in 1984.[113]

Protection in both the Republic of Korea and Taiwan province of China was highly selective, and accompanied by an "offsetting package", in which exporters could obtain imported inputs more freely and at international prices. The Taiwanese rebate system, through which most exporters could obtain duty- or tax-free imported inputs, was particularly important, and it is estimated that from 1970 to the mid-1980s total tariff collections were reduced by approximately one half through rebates, exemptions, and withdrawals.[114] In both economies effective protection and effective subsidy indicators reveal a complex pattern in the late 1960s, in which some industries were highly protected and others were not. In the 1980s the Republic of Korea had a two-track system of liberalization, with advanced technology products continuing to receive protection, while industries that had become internationally competitive were put on a fast track to liberalization.[115]

Protectionist measures were often designed to encourage industrial deepening. For example, the Taiwanese import control system was used to encourage efficient expansion of backward linkage industries and also to encourage technological upgrading by influencing capital goods imports. In the 1960s the criterion by which domestic producers could get an import licence for importing "controlled" raw materials and intermediate products rather than domestic substitutes was the magnitude of the price difference (which was calculated differently for exporters and for manufacturers producing for the domestic market). This gave encouragement to local producers of inputs to become price-competitive. Similarly, certain machinery imports were allowed if specifications could not be matched by domestic producers. This acted as an incentive for domestic producers to look for the latest foreign machinery, but also for domestic machinery manufacturers to upgrade.

Trade policy involved not only selective protection, but also export promotion. The measures included tariff rebates, tax exemptions on export earnings, short-term export credits and, in Taiwan province of China and the Republic of Korea, the establishment of export processing zones.

In the Republic of Korea the key incentives, namely automatic access to bank loans for working capital needed for exports and unrestricted and tariff-free access to imported intermediate inputs needed in export production, applied to both the direct exporter (such as a shirt manufacturer), suppliers of that direct exporter (manufacturers of cotton cloth) and to suppliers of those suppliers (producers of cotton thread). A domestic letter of credit was created to document actual orders which suppliers to exporters received from direct exporters. In this way, "export incentives" were provided for both direct exporters and indirect exporters, thereby furnishing incentives for import substitution in firms supplying exporters, as well as for exporters themselves.[116]

110 *Ibid.*, pp. 49-51.

111 K.S. Kim, "Trade and industrialization policies in Korea: an overview", paper prepared for a WIDER Conference on Trade and Industrialization Reconsidered, held in Paris (31 August-3 September 1991), published in G.K. Helleiner (ed.), *Trade Policy and Industrialization in Turbulent Times* (London: Routledge, 1993) and cited by C.I. Bradford Jr. in his *From Trade-driven Growth to Growth-driven Trade: Reappraising the East Asian Development Experience* (Paris: OECD, 1994, p. 23).

112 C.I. Bradford Jr., *op. cit.*, p. 24.

113 R. Wade, *op. cit.*, p. 117.

114 *Ibid.*, p. 140.

115 A. Amsden, "Trade policy and economic performance in South Korea", in M. Agosin and D. Tussie (eds.), *Trade and Growth: New Dilemmas in Trade Policy* (Basingstoke and London: Macmillan; New York: St. Martin's Press, 1993).

116 For a full account of export incentives in the Republic of Korea, see Y.W. Rhee, R. Ross-Larson and G. Pursell,

(b) Technology policy

The transfer and adaptation of foreign technology have been critical in the process of capability building in the East Asian NIEs and Japan during the period of industrial catch-up.[117] However, these economies have diverged widely in the extent to which they have relied on different forms of technology transfer (foreign direct investment, imports of capital goods, licensing or informal transfer arrangements) as a way of obtaining skills and technology.

In Japan, under the Foreign Investment Law (1950), the Government controlled the award of technology licences and FDI. Foreign investors wanting to licence technology, acquire stock, share patents, or enter into any kind of contract that provided them with assets in Japan had first to be licensed by the Foreign Investment Committee. The law was used to make patent licensing agreements the main formal channel of technology transfer and to screen technology imports through such agreements. In this screening process, the Government sought to influence which new products and production processes were introduced into the domestic economy, and at what time, to secure better contractual terms, including a lower price, for the Japanese firm negotiating a licensing agreement with the foreign firm, and to select the firms importing the technology, on the basis of their capabilities to use it productively.[118]

Foreign suppliers were encouraged to enter into licensing agreements with local firms, and royalties represented the only way they could profit from the Japanese market. In the negotiation process between the Japanese and foreign firm, MITI played a major role in improving both the terms of the agreement for the Japanese firm and the composition of technology imports. Sixty-three per cent of technology agreements were in the chemical and machinery sectors during 1949-1965, and 55 per cent during 1965-1972.[119] In the 1950s imported technology for consumer goods was discouraged. In the 1960s, however, such imports rose, with emphasis in the electrical machinery category shifting, for example, from manufacturers' machinery to colour television sets and room air conditioners; moreover, there were greater imports of duplicate technology and fewer of technology not already in use. In the television receiver industry about 200 licensing agreements were concluded from 1960 to 1967 with RCA, the leading United States manufacturer, that pioneered the development of technology in that area. MITI targeted colour television sets as a product of the future and promoted research and development (R&D) in integrated circuit technology, which paved the way for its application in the industry.[120]

During the critical period of industrialization, the Governments of Japan, the Republic of Korea and Taiwan province of China sought to "protect domestic technological learning" by screening FDI and controlling licensing agreements. Singapore, while maintaining an open door to FDI, has increasingly sought to attract investor interest in activities involving more advanced technology, whereas the Government of Hong Kong has followed a completely laissez-faire policy towards FDI.

The Republic of Korea put in place a technology screening policy similar to that of Japan in its catching-up period. Industry case studies show that the policy of negotiating technology imports significantly reduced the costs and enhanced the effectiveness of absorption of foreign technologies.[121] In recent years, Korean policy towards FDI has been relaxed for the purpose of obtaining advanced technologies, but FDI is nevertheless still of relatively minor importance as a vehicle for technology transfer. Similarly, policies in Taiwan province of China towards FDI, which have been characterized as "encouragement with caution", have entailed selective limitation

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Korea's Competitive Edge: Managing the Entry into World Markets (Baltimore, MD: Johns Hopkins University Press for the World Bank, 1994).

117 In addition to the works of Lall mentioned above, see C. Dahlman, B. Ross-Larson and L.E. Westphal, "Managing technological development: lessons from East Asia", *World Development*, Vol. 15, No. 6, 1987. For a more general discussion of technological change in the context of industrial strategy, see H. Pack and L.E. Westphal, "Industrial strategy and technological change: theory versus reality", *Journal of Development Economics*, Vol. 22, 1986.

118 For discussions of Japan's technology policy, see T. Ozawa, *Japan's Technological Challenge to the West, 1950-1974* (Cambridge, MA: MIT Press, 1974); M.J. Peck and S. Tamura, "Technology", chapter 8 in H. Patrick and H. Rosovsky (eds.), *Asia's New Giant: How the Japanese Economy Works* (Washington, D.C.: The Brookings Institution, 1976); A. Goto, "Technology importation: Japan's postwar experience", chapter 11 in J. Teranishi and Y. Kosai (eds.), *op. cit.*

119 M.J. Peck and S. Tamura, *op. cit.*, table 8.5.

120 See Y. Soubra, "Technological change and international competitiveness in consumer electronics: the case of the television receiver industry", *World Competition*, Vol. 13, No. 2, December 1989.

121 J. L. Enos and W-H. Park, *The Adoption and Diffusion of Imported Technology: The Case of Korea* (London: Croom Helm, 1988).

of such investment, through the establishment of lists of sectors in which investment was permitted; after the liberalization of 1988, all such investments not on a list of exclusions were authorized.[122]

FDI for technology transfer has been particularly important in Singapore, where it represented 15 per cent of gross fixed capital formation in 1971-1975, 16.6 per cent in 1976-1980, 17.4 per cent in 1981-1985 and 29.4 per cent in 1986-1991. Over the same period, the corresponding figures for Hong Kong were 5.9 per cent, 4.2 per cent, 6.9 per cent and 12.1 per cent; for Taiwan province of China they were 1.4 per cent, 1.2 per cent, 1.5 per cent and 3.5 per cent, respectively, while for the Republic of Korea, which has relied the least on FDI among the NIEs, they were 1.9 per cent, 0.4 per cent, 0.5 per cent and 1.1 per cent.[123] Singapore was the third largest recipient of FDI among developing countries in 1970-1980 and the largest recipient during 1981-1991.[124]

During 1985-1988, FDI stocks constituted 54 per cent of GDP in Singapore, 20-26 per cent in Hong Kong,[125] 8 per cent in Taiwan province of China and only 2 per cent in the Republic of Korea. The high level in Hong Kong reflects important transfers of funds by overseas Chinese during the period of expansion of industrial output and exports in the 1950s.[126]

Imports of capital goods have been an important form of technology transfer for all these countries. However, imports of capital goods were not always associated with FDI, particularly in the Republic of Korea. As in the case of FDI, some Governments have screened the import of capital goods. For example, in Taiwan province of China, such imports were screened until the late 1970s: the import of plant and equipment for new plants required approval, and approval was still required even in the late 1980s if a firm wished to qualify for fiscal investment incentives.

A specific form of technology transfer which is apparent in the East Asian NIEs is original equipment manufacture (OEM). It is based on international subcontracting with foreign buyers, whereby a local firm produces a good to the exact technical specification of a foreign company, which then markets it through its own distribution channels and under its own brand name. With this process, there are direct links between exporting and productivity improvement, and it may thus be possible for a local firm to begin to acquire a greater technological capability with regard to product design. This process has been important in some sectors, such as consumer electronics in Taiwan province of China and the Republic of Korea. Through OEM, foreign buyers promote and incorporate local firms into international markets and supply technological information.[127]

Japanese companies also invested in the promotion of domestic technological learning. They have been very active in the adaptation and commercialization of imported technologies. A notable feature of the process of technological improvement was the important effort put into R&D to adapt and improve imported technology. It has been estimated that in 1950-1968 62 per cent of imported technology was still in the rudimentary stages of development and required further adaptive R&D. Also, in a survey of all firms with assets of 100 million yen or more and about half the firms with assets of 50-100 million yen conducted in 1963, it was found that in one third of the firms R&D expenditure was allocated to: (i) improvement and modification of imported technology (particularly with a view to surpassing the product quality of foreign manufacturers); and (ii) production engineering and the layout of plant and facilities to house new equipment and machinery.[128] While R&D was mostly financed by the private sector, the Government provided some direct fiscal subsidies to firms to support this work, particularly trial manufacture. The amounts involved could be important. For example, out of the cost for one manufacturer of 100 million yen for the trial manufacture of machine tools in 1952-1955, the subsidy amounted to 44 per cent.[129] The rise of Japan as one of the world's technology leaders also stems in part from the attitude of the

122 See Chi-Ming Hou and San Gee, in R.R. Nelson (ed.), *National Innovation Systems: A Comparative Analysis* (New York and Oxford: Oxford University Press, 1993).

123 T.G. Parry, "The role of foreign capital in East Asian industrialization, growth and development", chapter 4 in H. Hughes (ed.), *Achieving Industrialization in East Asia* (Cambridge University Press, 1988), table 4.2.

124 UNCTAD, *World Investment Report 1993*, United Nations publication (Sales No. E.93.II.A.14), annex table IV.

125 S. Lall (1991), *op. cit.*, p. 147 (table 7.3).

126 S. Haggard and Tun-jen Cheng, "State and foreign capital in the East Asian NICs", in F.C. Deyo (ed.), *op. cit.*, p. 67.

127 M. Hobday, "Export-led technology development in the Four dragons: the case of electronics", *Development and Change*, Vol. 25, No. 2, April 1994.

128 Data drawn from T. Ozawa, *op. cit.*

129 JDB/JERI, *op.cit.* (table V-6).

Government and private firms towards R&D. Whereas United States and European firms have had a short-term horizon for investment write-off, Japanese manufacturers have taken a longer view.

As in Japan, domestic R&D has supported the adaptation and improvement of imported technology in the East Asian NIEs, most notably in the Republic of Korea. Formal R&D in that country was relatively unimportant in the first two decades of its industrialization (1963-1983), which emphasized technological adaptation and reverse engineering of imported products and processes. Thereafter, however, such research assumed a major role in technological capability-building for industrialization, reaching by the end of the decade 2.3 per cent of GNP - far higher than the 1.1 per cent that prevailed in Taiwan province of China and 0.9 per cent in Singapore.[130] While the private sector assumed the main role in the country's R&D efforts, the Government provided support in several ways, including direct subsidization of research, preferential financing of such activities, and a variety of tax incentives, such as reduced tariffs on imports of equipment and supplies needed for R&D, the deduction of related annual non-capital expenditures from taxable income, accelerated depreciation on industrial R&D facilities, and the exemption of real estate tax on R&D-related properties. A Technology Reserve Fund was also created whereby an enterprise can set aside up to 20 per cent (30 per cent for high-technology industries) of pre-tax profits in any one year, to be used for R&D activities in the subsequent four years.[131]

Another approach has been that of Taiwan province of China, where policy has concentrated on SMEs in the economy and the difficulties they face in undertaking R&D due to their limited resources. The Government has created institutions for carrying out technological R&D, as well as marketing and training that is relevant to the needs of SMEs in the information industry. It has also supported the hardware component of the information industry by promoting the development of electronics technologies and their diffusion in user industries.

R&D was part of a broader effort undertaken by these countries to build up a scientific and technological infrastructure. Singapore provides one of the outstanding examples. The Government created a "Technology Corridor" to ensure that investment, especially FDI, is attracted into activities that contribute most to the development of advanced technology domestically. These embraced in particular a technological university and the Singapore Science Park, the primary aim of which is to facilitate linkages between R&D and the industrial sector, as well as a wide range of specialized academic and polytechnic bodies, standards institutes and high-level training centres. This effort led to the emergence of Singapore as a major Asian centre for the location of subsidiaries of TNCs engaged in technologically sophisticated activities with a high domestic value added.[132]

(c) Financial and fiscal support measures

The Republic of Korea, Taiwan province of China, Singapore and Japan during the catch-up period all used various financial and fiscal support measures to facilitate investment in equipment and capital accumulation generally by increasing the availability of finance or cheapening its cost. In each case, these measures were applied selectively to promote the development of particular industries, and varied over time as industries developed.

In Japan, the Government expanded the supply of funds for industry through the so-called "indirect finance method" whereby credit was mainly (though not exclusively) allocated by private sector financial institutions under government guidance. The basic framework for this system was established through government action.[133] Firstly, the Government promoted the development of a system of industrial finance based on banks rather than capital markets. Secondly, it regulated private sector financial institutions so as to ensure sound business management and "the maintenance of credit order", through: (i) the segmentation of business fields, with, in particular, a division of labour between institutions supplying short-term and long-term finance (long-

130 See the report by the UNCTAD secretariat, "Technology transfer and development in a changing environment: the challenges of the 1990s" (TD/B/C.6/153 and Corr. 1), table 4.

131 See L. Kim, "National system of industrial innovation: dynamics of capability building in Korea", in R.R. Nelson (ed.), *op. cit.*

132 See Liew Mun Leong, "Industrial districts in developing countries" in *Technological Dynamism in Industrial Districts: An Alternative Approach to Industrialization in Developing Countries?* (UNCTAD/ITD/TEC/11), United Nations publication (Sales No. E.94.II.D.3).

133 For recent discussions of this framework, see JDB/JERI, *op. cit.* and J. Teranishi, "Financial sector reform after the war", chapter 7 in J. Teranishi and Y. Kosai (eds.), *op. cit.*

term credit banks and trust banks being established to serve the latter purpose) and the restriction, through the administrative guidance of the Ministry of Finance, of the maximum maturities of time-deposits in ordinary banks; and (ii) regulation of interest rates, including in particular the linking of deposit rates to the discount rate and the setting of maximum rates on short-term loans. More generally, the Government regulated new market entry and the opening of new branches, and gave administrative guidance on dividends. Thirdly, the financial system was insulated from international capital markets. Assets in foreign currency were not available.

With this framework, the Government sought to keep interest rates low and stable, and to set interest rates even lower in particular sectors at particular moments so as to provide additional incentives for investment. The basic discount rate, which was representative of interest rates generally, stood at 6-7 per cent in the 1950s and early 1960s, falling to around 4 per cent in the early 1970s.[134] The reduction of interest rates was particularly important, since firms sought a high gearing ratio. Moreover, the stability of interest rates allowed financial institutions not specifically designed to supply long-term credit, particularly the city banks, to provide long-term funds for investment in plant and equipment.

The Government also supplied industry with funds of its own or raised, under the so-called Fiscal Investment and Loans Programme (FILP), through institutions such as the Japan Development Bank. These provided "policy-based" finance to areas of the economy lacking access to private sector financial institutions (for example, small- and medium-sized enterprises) and preferential interest rates to specific industries at early phases of their development. These institutions played a critically important role when the foundations for rapid growth were being laid. During the period 1952-1955, the Government provided over one third of the total supply of external funds for new industrial equipment; thereafter this share fell, to 22.5 per cent during 1956-1960 and to 19.2 per cent during 1961-1965.[135] They were also important in the early stages of development of particular industries. For example, during the Basic Rationalization Plan for the machine tool industry, about 20 per cent of the funds for capital investment in specified machinery (such as metal-cutting machine tools, metal-processing machines and testing and inspecting equipment) and 28 per cent of investment in specified equipment for the automobile parts industry was supplied by the Japan Development Bank.[136] The proportion of fiscal and investment loan funds used to promote key industries subsequently declined from 16.6 per cent of total fiscal and loan funds in 1956-1960 to 6.3 per cent in 1966-1970.[137]

Fiscal measures were used to reduce the effective tax rate on corporate earnings and to allow new firms to retain higher percentages of profits. Tax exemptions and special depreciation allowances improved cost-benefit ratios of investment projects by increasing net cash flow. Like the policy-based loans, special depreciation allowances were industry-specific, and particularly high during early development phases for new industries.[138]

Special incentives were provided in the context of "industrial rationalization" programmes for particular industries designed by MITI in cooperation with the businesses concerned. Industrial rationalization involved an intense effort to reduce production costs and increase productivity based on the idea that "all aspects of a firm in any given industry have to be rationalized if the firm is to compete with other firms and survive in domestic and overseas markets".[139] It involved the adoption of new techniques of production, investment in new equipment and facilities, quality control, cost reduction, adoption of new management techniques, development of know-how and perfection of managerial control. This process has been characterized as "the attempt by the State to discover what it is individual enterprises are already doing to produce the greatest benefits for the least cost, and then, in the interest of the nation as a whole, to cause all the enterprises of an industry to adopt these preferred procedures and techniques".[140]

Legal authority for the Government to engage in enterprise rationalization was first given in 1952 with the Enterprise Rationaliza-

134 G. Ackley and H. Ishi, "Fiscal, monetary and related policies", in H. Patrick and H. Rosovsky (eds.), *op. cit.*, p. 206.

135 JDB JERI, *op. cit.*, table III.7.

136 *Ibid.*, tables V.8 and V.11.

137 J. Teranishi, "Financial system and the industrialization of Japan: 1900-1970", *Banca Nazionale del Lavoro Quarterly Review*, No. 174, September 1990, table 13.

138 See JDB JERI, *op. cit*, figure II-3.

139 Y. Yonezawa, "National economic independence and the rationalization of industry", in J. Teranishi and Y. Kosai (eds), *op. cit.*, p. 251.

140 Nawa Taro, quoted in C.A. Johnson, *MITI and the Japanese Miracle* ..., p. 27.

tion Promotion Law, which empowered the Government to guide designated companies in specified industries in improving technology and modernizing equipment, and to accord them preferential treatment (e.g. direct subsidies for the experimental installation and trial operation of new machines and equipment and special depreciation allowances for investments in specified types of equipment). Subsequently, legislation aimed to promote the development of specific industries, including the rationalization of the machinery and steel industries.[141]

The Republic of Korea's measures to promote capital investment were similar to those of Japan. Investment costs were reduced by keeping interest rates low, and designated industries were given priority in the allocation of bank credit (easily assured, since the banking system was nationalized), public investment funds and foreign exchange; they also received preferential tax treatment, including tax holidays and accelerated depreciation allowances. "Policy loans" at subsidized interest rates were particularly important, accounting for almost 60 per cent of total bank loans made from 1962 to 1985.[142] Special promotional laws were drawn up in the late 1960s and 1970s for machinery (1967), shipbuilding (1967), electronics (1969), petrochemicals (1970), iron and steel (1970), non-ferrous metals (1971) and textiles (1979). As in Japan, preferential loans carried conditions on the achievement of specific capability-building measures at the microeconomic level. According to the industrial rationalization component of the emergency measures of August 1972, enterprises in selected industries could be given special status if they aimed at: "1) specialization and vertical affiliation of production; 2) optimum scale and method of production and other goals through consolidation of enterprise; 3) liquidation or transformation of business; 4) optimization of equipment investments (including replacement or expansion of equipment); 5) increase of capital and other improvments in financial structure; 6) development of technology and innovation; and 7) other necessary matters not specified above".[143] The performance of firms on these criteria was assessed by an industrial rationalization committee. Export performance was also used as a criterion for preferential treatment.

In Taiwan province of China, the basic means to facilitate capital investment were the fiscal incentives provided through the Statute for the Encouragement of Investment, first promulgated in 1960, which listed specific tax incentives and criteria for eligible products and firms. The incentives included: tax holidays, accelerated depreciation allowances, investment tax credits, duty-free import of capital goods and reduced corporate tax rates. The list of eligible products changed over time. Initially it included important export categories (textiles and footwear), often requiring a minimum proportion of production to be exported. However, during the 1970s emphasis was placed more on secondary import substitution industries (intermediate and capital goods) and new export sectors.[144] Credit rationing and financial repression appear to have been much less important as policy tools than in the Republic of Korea and Japan. However, the Government indicated priority areas for bank lending, using lists of industries drawn up by the Planning Agency with inputs from the Ministries of Finance and Economic Affairs and the Central Bank, and with the active participation of the banks themselves. Moreover, as noted earlier, the public sector played an important role in the growth of investment, particularly in the 1970s, by establishing key upstream industries beyond the capacity of private firms.

In Singapore, tax incentives for investment targeted at specific industries were first introduced in 1959 with the Pioneer Industries Ordinance. Pioneer status was accorded to firms on the basis of their capital expenditure and type of technology, and carried exemption from the 40 per cent profits tax for a period of 5, 10 or more years. Export incentives were introduced in 1967, with a 90 per cent exemption for 5-15 years for export profits derived from large-scale investments. An Expansion Incentive was also introduced in the early 1980s, providing a five-year exemption on profits in excess of pre-expansion levels for firms investing more than S$10 million in machinery and equipment.[145] Priority shifted over time towards more technology-intensive and higher value-added industries.[146]

141 For case studies see JDB/JERI, *op. cit.*

142 H-J. Chang, "The political economy of industrial policy in Korea", *Cambridge Journal of Economics*, Vol. 17, No. 2, 1993, p. 141. This source also provides details of the special promotional laws referred to in the next sentence.

143 L.P. Jones and Il Sakong, *op. cit.*, p. 108.

144 See R. Wade, *op. cit.*, pp. 182-185, for details.

145 A. Young, "A tale of two cities: factor accumulation and technical change in Hong Kong and Singapore", in O.J. Blanchard and S. Fischer (eds.), *NBER Macroeconomics Annual 1992* (Cambridge, MA and London: MIT Press), p. 23.

146 For a list of these in 1975 and 1981 see C.M. Kng, L. Low and T.M. Heng, *Industrial Restructuring in Singapore:*

Hong Kong has been the least selective in policy, but in the mid-1970s the Government recognized the need to broaden the industrial base and upgrade the technological level of industry, and used as a specific tool for this purpose the allocation of leases on industrial estates. This was an important tool for industrial development as space was a critical limiting factor. The two industrial estates developed in the late 1970s were designed specifically for land-intensive and heavier industries. In allocating leases to industrial users, priority was given to "industrial processes, which, compared with existing manufacturing industry: (a) are significantly new or produce significantly new products; (b) involve a higher level of technology; (c) provide employment at a higher level of skill; (d) produce for sale on the local market products that are required by existing industriès; (e) produce a significant proportion of products for export; and (f) produce products with a high added value from local contents".[147]

(d) Competition policy

Competition policy played a major role in resource allocation and capital accumulation in the three economies which protected domestic production and restricted foreign direct investment, namely Japan, the Republic of Korea and Taiwan province of China.[148]

The basic framework for domestic competition policy in Japan was established in the late 1940s. Not only were the *zaibatsu* dissolved, but measures were also taken to weaken large monopolistic enterprises by partitioning some companies considered to have excessive market control. An Anti-Monopoly Law (AML) was passed prohibiting monopolies, requiring mergers to be screened, and banning cartels restricting trade, and a Fair Trade Commission was set up. These measures accelerated the trend towards the separation of ownership from management in large firms by introducing professional managers in the place of family involvement. Competition was also encouraged. Some industries, such as steel and automobiles, were made up of a small number of oligopolistic firms, while in others, such as textiles, there were a large number of competing firms. Growth in the 1950s saw declining concentration ratios in many industries, which can be particularly attributed to the entry of new firms into industries as they were developed. Nevertheless, as already noted, the financial system encouraged the emergence of *keiretsu*.

In the 1950s, MITI sought exemptions from the AML to implement industrial policy, and in the early 1950s special exemptions were made for small businesses, for exporting, and, in specific industries at specific times, to promote rationalization ("rationalization cartels") and to offset the effects of recession ("depression cartels"). Rationalization cartels were meant "to carry out concerted efforts to exchange or restrict technology, standardize goods produced, work out specializations by product line, or make common use of transport or storage facitilies". Depression cartels could make agreements on production quantities, sales quantities and price, and were authorized under certain conditions, "if supply exceeds demand, prices fall below average costs, and a number of producers are likely to go out of business".[149] In the period 1964-1973, the main types of cartels exempted from the AML were medium and small enterprises (607 out of 985 in 1973) and export cartels.[150] The cartels for the SMEs can be regarded as a way of providing them with countervailing power vis-à-vis the large corporations, and also as a means of promoting standardization and specialization.

MITI also sought to coordinate through administrative guidance the expansion of production capacity, in order both to achieve efficient scale plants and to manage the "excess competition" that emerged in the 1960s when too many firms sought to expand capacity simulataneously.[151] Mergers were also encour-

For ASEAN-Japan Investment and Trade Expansion, Asia Pacific Monograph, No. 3, Department of Economics and Statistics, National University of Singapore (Singapore: Chopman Publishers, 1988).

147 Hong Kong Industrial Estates Corporation, *Annual Report 1978-1979*, quoted in Y-P. Ho and T-B. Lin, "Hong Kong: Structural adjustment in a free-trade, free market economy", in H. Patrick (ed.), *Pacific Basin Industries in Distress: Structural Adjustment and Trade Policy in the Nine Industrialized Economies* (New York: Colombia University Press, 1991), p. 291.

148 For a recent discussion of competition policy in Japan and the Republic of Korea see A. Amsden and A. Singh, "Concurrence dirigée et efficacité dynamique en Asie: Japon, Corée du Sud, Taiwan", *Revue Tiers-Monde*, No. 139, July-September 1994.

149 R.E. Caves and M. Uekusa, "Industrial organization", in H. Patrick and H. Rosovsky (eds.), *op. cit.*, p. 486.

150 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns* ..., p. 44.

151 Administrative guidance is a specifically Japanese policy instrument which has been defined as follows:

> [Administrative guidance] is not legal compulsion restricting the rights of individuals and imposing obligations on citizens. It is a request or guidance on the part of the Government within the limit of the task and administrative responsibility of each agency as provided for in the establishment laws, asking for a specific action, or inaction, for

aged in the 1960s as a response to increasing liberalization, in order to strengthen technical and financial capablities. Some mergers had major effects on productivity. For example, after the merger of Fuji Steel and Yawata Steel in 1970 (which resulted in a new company, Nippon Steel, controlling 36 per cent of the industry's production volume), there was an improvement in technical capacity, and the number of patent applications doubled from 1,061 in 1970 to 2,090 in 1973. Because the company as a whole could assure an annual production of about 40 million tons, the Oita Mill in Kyushu could go on full "continuous casting", resulting in a "20 per cent reduction of equipment costs, improvement of slab/hotmetal ratio, reduction of per-unit energy requirements by one third and 20 per cent labour saving".[152]

Technology screening was used to sharpen competition as well as to upgrade technology. In sequencing new entrants MITI aimed not only to achieve economics of scale and avoid excess capacity, but also to promote competition. The usual approach was "staggered entry", i.e. permitting entry to only one (or very few) firms at a time. Early entrants obtained a monopolistic position in the Japanese market through which they could earn high profits. But additional entrants were introduced to provide competition when it was considered appropriate. Thus, for example, the pattern of new entrants to low-density polyethylene production was such that the first entrant (Sumitomo Chemical) in 1958 enjoyed a monopoly in the Japanese market until 1960 when a second entrant (Mitubishi Petrochemical) was allowed to obtain a technology licence with another foreign firm. Two further new entrants were admitted to the industry in 1962, one in 1964, two in 1966, one in 1968 and two in 1970. By that date, Sumitomo Chemical's share of the industry's capacity in Japan was down to 17.9 per cent.[153]

In managing this process, MITI tried to ensure that opportunities were distributed among all the major bank-based business groups. But what is crucial is that the screening process and sequencing strategy led firms to compete vigorously to be early entrants. This process improved both the search for technology and also the ability of the Japanese firms finally selected to absorb foreign technology. As one observer has put it: "To be qualified as an early entrant, a firm had to demonstrate its technological and financial capabilities to assimilate new technologies. Therefore the industrial groups competed in searching for promising new technologies, conducting preparatory research, finding an appropriate foreign licenser, and securing the necessary investment funds ... The preparatory research often consisted of 'backward engineering' and 'patent literature-based reproduction'. These approaches enabled Japanese firms, first, to know the real merits and demerits of a new foreign technology (that is, to decide whether to secure a licence or not); second, to prepare themselves technologically to absorb only the desired components of the foreign technology (that is, to 'unbundle' foreign technology, thereby enhancing their bargaining power in negotiating with the supplier); and third, often to come up with significant technological improvements in the course of 'reproduction'."[154]

In the Republic of Korea, entry restrictions were part of the Promotional Laws for specific industries passed in the late 1960s and 1970s, and regulations were also made on capacity expansion. In the Industrial Development Law (enacted in 1986) further measures were taken to prevent "excessive competition", including restrictions on capacity expansion, state-initiated mergers and coordinated capacity-scrapping and market-sharing arrangements. Such measures have also been applied to prevent excessive competition among domestic firms in foreign markets. For instance, the Government supported and regulated overseas construction activities through the Overseas Construction Promotion Act of 1975. A fairly large number of firms succeeded in gaining access to international markets thanks to special tax incentives. In the mid-1980s, when these markets started shrinking, the Government intervened and a number of small- and medium-size firms withdrew from the market.[155]

the purpose of achieving some administrative objective by the cooperation on the part of the parties who are the object of the administration (Testimony by the Bureau Chief of the Legal Department of the Cabinet in a hearing held by the Committee on Commerce and Industry of the House of Councillors, 26 March 1974, quoted in M. Matsushita, "The legal framework of trade and investment in Japan", *Harvard International Law Journal*, Vol. 27, 1986 (Special Issue), p. 376).

152 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns* ..., p. 46.

153 M.J. Peck and S. Tamura, *op. cit.*, p. 557.

154 T. Ozawa, "Government control over technology acquisition and firm's entry: the experience of Japan's synthetic fibre industry", *Cambridge Journal of Economics*, Vol. 4, 1980, p. 146.

155 See Y. Soubra, "The construction and engineering design services sector: some trade and development aspects", *Journal of World Trade*, Vol. 23, No. 1, February 1989.

During the late 1950s and 1960s, the Taiwanese Government encouraged the formation of cartels to regulate output and exports for paper, textiles, canned foodstuffs, steel products, rubber products, cement and monosodium glutonate. It subsidized exports by means of a levy on the domestic sales of each member and set quotas in proportion to each member's output. It also encouraged the unified and joint marketing of exports.[156] Control of entry was also used to prevent overexpansion, and new entries were staggered in synthetic fibres, polyethylene and other petrochemical derivates. Industry licensing of new plants stopped in the 1950s (though approval for technology continued to be required until the late 1970s) and there has been a limited encouragement of mergers.

2. Differences in industrial deepening

Japan and the four NIEs adopted divergent approaches to industrial policy. In Hong Kong the Government owned no manufacturing establishments, applied no tariffs or import restrictions, did not subsidize exports and did not interfere with firm-level activities beyond minimal regulation, whereas the Republic of Korea adopted a Japanese-type industrial policy, including the protection of domestic markets, technology screening, enterprise rationalization, financial repression, and restrictions on excessive competition. In between were Singapore, which relied heavily on FDI for technological acquisition and pursued a highly interventionist policy (via the screening of FDI and its statutory boards and government holding companies), and Taiwan province of China, which protected domestic production, but where the public sector set up backward-linkage secondary-import-substitution activities, and gave fiscal incentives to upgrade the industrial structure.

There were also major differences among the NIEs in the extent of the industrial deepening, which were not entirely due to industrial policy. The economies of Hong Kong and Singapore were far too small to seriously contemplate the establishment of heavy industries, and the scope for industrial policy was *pro tanto* much more limited. While such policies were neither absent nor ineffective, they were much more prevalent in the Republic of Korea and Taiwan province of China, where the size of the economy permitted much more intensive industrialization. Nevertheless, there was a clear association between the different types of industrial policy and changes in industrial structure, productivity and technological capability. Structural change has been much less rapid and extensive in Hong Kong than in the other NIEs. This is apparent from both UNIDO structural change indices[157] and indices of revealed comparative advantage.[158] Nevertheless, although there was product upgrading (from low-grade shirts, suits, and underwear to high-fashion apparel and leisure wear; increasing sophistication in the production of toys; and progression from the assembly of transistor radios to the production of electronic watches), Hong Kong continued to be a producer of labour-intensive products. The absence of structural change was associated with a much slower development of indigenous technological capabilities, with the result, according to a survey of leading businessmen and academics in the late 1980s, that "Hong Kong does not have either an adequate skill base or the technology capacity necessary to build new comparative advantage in manufacturing at either the scale or speed that is required".[159]

A further difference between Hong Kong and the other NIEs was its investment rate, which remained roughly unchanged at around 20 per cent of GDP from the early 1960s, whereas that of Singapore shot up from 9 per cent in 1964 to 43 per cent in 1983.[160] This phenomenal ascent might explain why Singapore, unlike Hong Kong, registered negative growth rates for total factor productivity; "Singapore has consistently pushed itself into technologies too far ahead of itself".[161]

The economies in which industrial deepening progressed most were those of the Republic of Korea and Taiwan province of China. It has been argued that their shifts in industrial structure merely conformed to the change in comparative advantage as the period of labour surplus ended and wages rose. The evidence for the latter economy is not easy to

156 For further particulars see R. Wade, *op. cit.*, p. 143.

157 See C.I. Bradford Jr., *op. cit.*, in particular table II.

158 See P.C.Y. Chow and M H. Kellman, *Trade - The Engine of Growth in East Asia* (New York/Oxford: Oxford University Press, 1993), tables 2.1-2.4.

159 *Far Eastern Business Review*, 12 October 1989, pp. 64-65, cited by S. Lall (1991), *op.cit.*, p. 142.

160 A. Young, *op. cit.*, pp. 14-15.

161 *Ibid.*, p. 43.

interpret, but it has been shown that by tracking its support on an industry-by-industry basis the Government led the market, in the sense of anticipating shifts in comparative advantage and seeking to attract resources into particular sectors; also, as already discussed, it used public enterprise to spearhead the establishment of secondary import substitution industries in the 1970s. For the Republic of Korea, the situation is clearer for the heavy and chemical industry (HCI) push: "without the virtually unlimited government support that was offered to HCI investments, no private agent would have been willing to bear the obvious risks".[162] In retrospect, of course, these industries could appear to conform to comparative advantage. As economies of scale were achieved, capacity utilization rates increased and technological capabilities developed, these industries became competitive on world markets - to such an extent indeed that POSCO, the state-owned steel industry in the Republic of Korea, became the most efficient producer of steel in the world. However, these changes strongly reflected the visible hand of government through subsidization of investment and support for acquiring technology.

An important difference between the Republic of Korea and Taiwan province of China relates to the pattern of industrial organization, which reflects the paucity of large-scale private business in the latter economy. The Republic of Korea has very high technological capabilities, possibly the highest in the developing world; in Taiwan province of China the industrial structure is "lighter", with greater emphasis on meeting market niches rather than mass production, less in-house R&D and less emphasis on creating brand names.[163]

E. Rents as incentives

As already pointed out, industrial policy in East Asia has been predominantly implemented through influence on the actions of private firms. It is possible to find examples of Governments almost coercing the private sector through the setting of performance standards, as when access to imports was linked to export performance. However, the centrepiece of industrial policy in East Asia has been the provision of incentives to induce firms to increase production capacity and productivity and to compete aggressively for increased market share. The incentives have been provided through a mix of selective protection, competition and "subsidies". Industrial deepening proceeded furthest in those countries where the international competitiveness of national firms was steadily built up, i.e. Japan, Republic of Korea and Taiwan province of China.

"Subsidies" to support industrial development were applied selectively and used particularly in the initial phases of establishing new industries. Fiscal support was provided by a range of special tax measures which reduced government revenue but promoted the accumulation of earnings by firms and their stability in the face of cyclical fluctuations or (as in the case of special depreciation allowances) reduced investment risks by shortening the period of investment recovery. But perhaps the most important "subsidies" came from keeping down interest rates and allowing domestic prices to deviate from international ones.

A critical feature of "getting the prices right" in order to encourage industrialization involved getting them "wrong" in the sense of not letting them reflect existing scarcities of factors of production.[164] This has been demonstrated by the World Bank in its recent major report on the "East Asian Miracle". In respect of conformity of national prices with international prices, the report shows that Taiwan province of China, the Republic of Korea and Japan fall within the fifth and sixth deciles of a sample of developing countries, with greater levels of price distortion than Brazil, India, Mexico, Pakistan, and Venezuela.[165]

It has recently been argued that "state-created rents" were an important mechanism through which industrial policy provided in-

[162] World Bank, *Korea. Managing the Industrial Transition*, Vol. I (Washington, D.C., 1987), cited by E. Eshag, "Successful manipulation of market forces: the case of South Korea, 1961-1978", *Economic and Political Weekly, Annual Number*, March 1991, p. 634.

[163] S. Lall (1994), *op. cit.*

[164] See A. Amsden, *Asia's Next Giant* ..., chap. 6.

[165] World Bank, *op. cit.*, p. 301.

centives to set up new industries.[166] This view is based on the observation that the risks of establishing new industries in late industrializing countries are very high and that, as with any innovative activity, high entrepreneurial profits are consequently required. For innovators at the frontier of technology, entry barriers associated with innovation result in rents which provide incentives for doing "new things". In late industrializing countries, however, the market mechanism alone cannot provide such rents. Even though a new activity may be highly risky, firms borrowing and adapting foreign technology face established competitors, who have much greater experience. Consequently, if the development of industry relies on the private sector, it is the State that has to create rents for the early entrants, particularly through the application of protectionist measures and by repressing interest rates and credit provision. It has been argued that industrial policy in the Republic of Korea worked through these rents, and that the most lucrative "subsidies" provided by the Government took the form of profits from sales on domestic markets made possible by protection which was conditional on export performance.[167] In Taiwan province of China rent creation was linked to exporting by tying the allocation of import licences to export performance, a practice which ensured that "those who get the windfalls ('rents') from importing scarce commodities are at the same time contributing to the economic success of the country by exporting".[168] A similar system was in force in Japan during 1953-1955, when, for example, trading licences were issued to trading companies selling Cuban sugar in Japan at 2 to 10 times the import price, provided that they allied themselves with a shipbuilder and could submit an export certificate showing they had used some of their profits to subsidize ship exports.[169]

The incentives provided by rents were most effective when the latter were distributed on a competitive basis. Private firms competed vigorously to win monopolistic positions, e.g. when government technology screening and the sequencing of acquisition of technology by different firms interacted to improve the process of technology importation.

The notion that the creation of rents was central to the establishment of new industries contradicts the political economy of rent-seeking of the 1970s and 1980s under inward-oriented trade regimes. Four critical differences would seem to lie behind the success of rent creation in promoting industrialization in the NIEs. Firstly, it was achievable through directly productive activities which served national interests. Secondly, rent-seeking costs, a form of transaction costs incurred in seeking rents (through activities like information collection, influence-peddling and bargaining) were kept low.[170] Thirdly, Governments acted to close off other non-productive channels of wealth accumulation, such as agricultural landlordism, urban real estate speculation and the exploitation of military and bureaucratic office for private gain. Fourthly, the realization of rents (and also other subsidies) was related to performance standards, including a requirement to export. This was of critical importance in the Republic of Korea and Taiwan province of China, where domestic markets could not support the cut-throat oligopolistic competition which prevailed in Japan during its high-growth period.

F. Productivity, industrialization and the balance of payments

In Japan during 1950-1973 and the four East Asian NIEs from 1960 to the late 1980s, rapid growth was associated with long-term changes in the balance of payments. As regards Japan, the process of rapid capital accumulation and productivity improvement began after the outbreak in 1950 of the Korean War. Special procurements by the United States army provided foreign exchange with which to import both the raw materials necessary for stepping up industrial production and the capital goods required for modernizing equipment. This "special procurement demand" amounted to about 30 per cent of foreign currency re-

166 H-J. Chang, "The political economy of industrial policy in Korea", *Cambridge Journal of Economics*, Vol. 17, No. 2, 1993.

167 This point has been made both by R. Wade (*op. cit.*) and A. Amsden (*op. cit.*).

168 R. Wade, *op. cit.*, p. 129.

169 C.A. Johnson, *MITI and the Japanese Miracle ...*, and JDB/JERI, *op. cit.*

170 See H-J. Chang, *The Political Economy of Industrial Policy* (New York: St. Martin's Press; Basingstoke and London: Macmillan, 1994).

ceipts.[171] In the 1950s and 1960s, however, foreign exchange remained a constraint on growth. When growth accelerated, the current account balance worsened. Typically, a boom was followed by a slowdown as the Government acted to restore external balance by restricting private investment (the most dynamic component of aggregate demand), reducing the supply of finance to industry through "window guidance", and thereby reducing imports.

By the end of the 1960s, the economy began to achieve persistent current account surpluses, reflecting a growing surplus on merchandise trade. Investment laid the foundations for export growth by expanding and modernizing production facilities, while rising exports made it possible to step up investment. Industrial policy gave momentum to this dynamic, encouraging private investment and innovation and directing it to those sectors where the expansion of international trade was likely to be highest and where the potential for productivity gains was greatest. This required the rejection of resource allocation according to static comparative advantage and the pursuit of a strategy of giving priority to building up the heavy and chemical industries. The rationale for placing emphasis on these industries has been explained as follows:

> There was a great outgrowth of industries that depended on low-wage labour during the prewar period and the postwar period of transition when Japan was plagued by shortages in capital. At the same time, these industries enjoyed an advantage from the viewpoint of the theory of comparative advantage. They manufactured and exported masses of cheap articles before the war. After the war, too, Japan's first exports consisted of such things as toys and other miscellaneous merchandise and low-quality textile products.
>
> Should Japan have entrusted its future to the development of those industries characterized by the intensive use of labour? That would perhaps be a rational choice for a country with only 5 or 10 million people, but Japan has 102 million people. If Japan had adopted the simple doctrine of free trade and chosen to specialize in this kind of industry, it would have sentenced its population to the Asian pattern of stagnation and poverty. Japan would have remained a weak link in the free world, thereby becoming a problem area in the Far East.
>
> The Ministry of International Trade and Industry decided instead to promote heavy industries that require intensive employment of capital and technology, industries such as steel, oil refining, petrochemicals, automobiles, aircraft, all sorts of industrial machinery, and electronics, including electronic computers. In terms of the comparative cost of production, these industries should be the most inappropriate for Japan. From a short-run, static viewpoint, promoting their development would seem to conflict with economic rationalism, but from a long-range viewpoint, these are precisely the industries where the income elasticity of demand is high, technological progress is rapid, and labour productivity rises fast. Without such industries it would have been extremely difficult to employ a population of 100 million and raise their standard of living to that of Europe and America. Logical or not, Japan had to have these heavy and chemical industries.[172]

Both the Republic of Korea and Taiwan province of China have also been able to turn current account deficits into surpluses through greatly improved trade performance. For the latter the trade balance first turned positive in 1971, and after recovering from the oil price shock of the early 1970s the economy was able to achieve persistent trade surpluses. These grew markedly in the 1980s, by the end of which reserves were the largest in the world (after Japan and Germany), equivalent to more than two years of imports. In the Republic of Korea the trade surplus turned positive only in the second half of the 1980s, since when the current account has also been in surplus.[173] Throughout the 1970s, it incurred current account deficits, which reached 10.9 per cent of GNP in 1974 and 8.7 per cent in 1980. Commercial borrowing served to sustain growth, and by 1985 the external debt had reached 52.5 per cent of GNP. But the high degree of export orientation rendered the debt service manageable. Debt service as a percentage of export earnings rose from 11.6 per cent in 1975 to 16.7 per cent in 1986, but with the achievement of current account surpluses the Government was

171 See M. Shinohara, "Patterns and some structural changes in Japan's postwar industrial growth", in L. Klein and K. Ohkawa (eds.), *Economic Growth: The Japanese Experience Since the Meiji Era* (Homewood, IL: Richard Irwin Inc. for the Economic Growth Center, Yale University, 1968), p. 281.

172 Statement by Yoshihisa Ojimi, Vice Minister, MITI, to the OECD Industrial Committee, 24 June 1970, cited in J. Abegglen and G. Stalk Jr., *Kaisha, The Japanese Corporation* (New York: Basic Books, 1985), pp. 71-72.

173 For discussions of the balance of payments of the Republic of Korea and Taiwan province of China from 1978 to 1987, see B. Balassa, *Economic Policies in the Pacific Area Developing Countries* (Basingstoke and London: Macmillan, 1991); see also C.I. Bradford Jr. and W.H. Branson (eds.), *Trade and Structural Change in Pacific Asia* (University of Chicago Press, 1987).

able by 1991 to reduce the ratio of total debt to GNP to 15 per cent.

Hong Kong and Singapore also achieved current account surpluses in the late 1980s. In these economies, re-exports (including, in Singapore, refined petroleum) and service exports were important. Trends are difficult to ascertain in the case of Hong Kong because of the absence of official balance of payments statistics, but re-exports apparently rose as a proportion of total exports.[174] For Singapore re-exports constituted approximately one third of total exports in the 1980s. Service exports have always been important to Singapore, and large surpluses in the services balance offset deficits in merchandise trade.

In Japan, the Republic of Korea and Taiwan province of China, the long-term transformation of the balance of payments was related to the improvement of the productivity and competitiveness of domestic industry. Because these economies are relatively poor in natural resources, expansion of manufactured exports was essential to finance the imports of capital goods, raw materials and intermediate inputs required for industrial growth; however, import substitution has also contributed. Differences in the degree of trade dependence reflected differences in the size of the internal market.

In Japan the internal market was large enough to allow the achievement of economies of scale and (oligopolistic) competition in heavy and chemical industries without reliance on export markets. In these industries the typical product cycle involved "learning by doing" through production for the protected national market and the associated rents (discussed in the previous section). Firms began exporting only once productivity had been sufficiently enhanced and the domestic market saturated. While these industries were being built up, the labour-intensive industries provided the main source of foreign exchange, with textiles contributing about half Japan's export revenue until the end of the 1950s.

Industrial policy played a similar role in transforming the balance of payments of the Republic of Korea and Taiwan province of China. The rapid expansion of labour-intensive exports in the 1960s created a market for imported intermediates and capital goods, while industrial policy encouraged secondary import substitution and further export development. Rapid output growth was again based on high levels of investment, involving substantial capital goods imports, and rapid export growth was promoted through the selective focusing of investments in order to improve productivity and to upgrade production in the first instance towards heavy and chemical industries, where exporting was more urgent than in Japan because the domestic market was too small to permit scale economies without monopolistic conditions.

Differences in market size were reflected in differences in the ratio of exports to GNP. In Japan this ratio was maintained at around 11 per cent throughout the catch-up period, but in the Republic of Korea it increased from 4.8 per cent (of GDP) in 1963 to 45 per cent in 1987, and in Taiwan province of China from 17.8 per cent to 60.7 per cent.

G. Profits, savings and investment

High rates of investment played a major role in promoting rapid growth. For instance the World Bank has estimated the contribution of physical and human capital accumulation at between 60 per cent and 90 per cent of per capita output growth.[175] It has indeed been argued that there is nothing extraordinary about the productivity growth rates of East Asian NIEs and that where they stand out mostly is in their investment rates.[176] In most countries, the initial boost to capital accumulation came from abroad. However, as growth accelerated, domestic consumption was made to lag behind income growth, allowing the domestic savings rate to rise over time.

In the immediate postwar period Japan's rate of capital accumulation was constrained

174 This proportion stood at 89 per cent in 1950 but had declined to 20 per cent by the early 1970s; see E.K.Y. Chen, "Foreign trade and economic growth in Hong Kong: experience and prospects", in C.I. Bradford Jr. and W.H. Branson (eds.), *op. cit.* Recent data indicate that re-exports had increased to 45-50 per cent of total exports by the mid-1980s (Y.P. Ho and T-B. Lin, *op. cit.*).

175 *The East Asian Miracle* ..., p. 58.

176 D. Rodrik, *op. cit.*, and A. Young, "Lessons from the East Asian NICs: A Contrarian View," *NBER Working Paper* No. 4482, October 1993.

by a low level of domestic savings. Initially, the United States procurement programme (referred to in the preceding section) helped to set off a self-sustained process whereby investment and growth generated both savings and export earnings. Thus, gross domestic fixed capital formation increased from 24 per cent of GNP in the early 1950s to almost 40 per cent in the late 1960s, and the ratio of private equipment investment to GNP doubled between the early 1950s and the late 1960s, reaching 17 per cent. The gross domestic savings ratio also rose rapidly, from about 24 per cent in the early 1950s to 36 per cent in the first half of the 1960s and to 40 per cent in the early 1970s.

For both the Republic of Korea and Taiwan province of China foreign savings were particularly important in the 1950s, financing 65 per cent of gross domestic investment in the former during 1956-1960 and 45 per cent in the latter. The latter also rapidly reduced its reliance on foreign savings, but in the Republic of Korea, where the increase in domestic savings was slower, foreign savings financed 39 per cent of gross domestic investment during 1966-1970, slightly over 30 per cent during 1971-1975 and 17 per cent during 1976-1980. In Singapore, where the rise in the investment rate was especially steep, there was a rapid increase in the savings rate, accompanied by continued heavy resort to foreign saving. During the 1970s capital inflows financed on average 35 per cent of gross fixed capital formation; this figure showed no tendency to decline in the 1980s.

In the 1950s capital flows to both the Republic of Korea and Taiwan province of China consisted principally of bilateral and multilateral loans. In the Republic of Korea external aid financed 80 per cent of total fixed capital formation during 1953-1962, whereas in Taiwan province of China aid from the United States financed almost 40 per cent of total domestic capital formation. In both economies bilateral and multilateral aid remained important until the mid-1980s, constituting 36 per cent of total capital inflows in the period 1961-1986. In the same period bank loans accounted for 44 per cent and FDI for 20 per cent of Taiwanese capital inflows, the corresponding figures being respectively 53 per cent and 7 per cent in the Republic of Korea. In Hong Kong, the transfer of funds by overseas Chinese amounted to approximately 40 per cent of gross domestic capital formation in 1949-1965.[177]

Be that as it may, without lifting domestic savings it would not have been possible to achieve the more than doubling of the investment ratio from the 1960s to the 1990s. Gross domestic savings increased from 10 per cent of GDP in 1965 in Singapore to 30 per cent during the 1970s and 42 per cent during the 1980s. In the Republic of Korea and Taiwan province of China the proportion was 4.2 per cent and 9.1 per cent, respectively, during the period 1956-1960. It subsequently rose rapidly in both countries, but more so in Taiwan province of China, where it averaged 32 per cent during the 1970s. While in the Republic of Korea the proportion was about 22 per cent in the same period, it rose to an average of 32 per cent in the 1980s. In Taiwan province of China the high rate already reached in the previous decade was maintained. Rapid income growth certainly explains much of the increase in the domestic savings ratio, since it permitted also rising consumption. However, income growth is not translated automatically into higher savings growth. For instance, the average savings rate in the newly industrializing countries of Latin America failed to show a significant increase from the 1960s to the 1980s despite a relatively rapid growth of per capita incomes; nor has it shown any tendency to rise in the revival of growth in the 1990s.

A satisfactory explanation for the rapid increase in domestic savings is still missing in the literature, even though it is extensive and attaches importance to savings. A complete explanation is beyond the scope of the present study. Nevertheless, it would appear that government intervention provides part of the explanation. By lifting profits it increased both the incentive of firms to invest and their capacity to finance new investment. Higher investment in turn raised profits, by enhancing both rates of capacity utilization and the pace of productivity improvement. Thus, the propensities to save and invest were both raised, as was the pace of technological advance and hence also the mass of profits.

The importance of the investment-profits nexus is indicated by the high share of corporate profits in value added. During the 1960s in Japan gross operating surplus in industry plus transport and communications was around 50 per cent of gross value added. For manufacturing alone the figure was around 55 per cent, compared to about 25 per cent in the United States and United Kingdom.[178] From the mid-1950s until the first oil crisis Japan's

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177 S. Haggard and Tun-jen Chen, "State and foreign capital in the East Asian NICs", in F.C. Deyo (ed.), *The Political Economy of the New Asian Industrialism* (Ithaca, NY and London: Cornell University Press, 1987), p. 89.

178 *OECD Economic Outook. Historical Statistics 1960-1990* (Paris: OECD, 1992), tables 7.2 and 7.4.

gross corporate savings ratio (retained gross profits as a proportion of corporate disposable income) averaged around 75 per cent, never falling below two thirds, and exceeding 80 per cent in the latter half of the 1960s.[179] Corporate savings as a proportion of GNP increased from around 7 per cent in the mid-1950s to over 17 per cent in the late 1960s. For the period 1960-1970 gross corporate investment averaged 22.7 per cent of GNP and corporate savings 15.3 per cent, whereas household investment and savings were 13.5 per cent and 8 per cent, respectively, and the government sector had a surplus (excess of government savings over investment) of about 2 per cent of GNP.[180] Thus, the household surplus (5.5 per cent of GNP) accounted for about 24 per cent of corporate investment and the corporate sector's own savings for 60 per cent.

The shares of corporate profits and savings in income started to come down along with corporate investment in the 1970s. They nevertheless stayed higher than in other major industrialized countries: in both manufacturing and transport and communication profit shares in gross value added were above 40 per cent in the 1980s compared to one third in the other G-7 countries. (As explained in the following chapter, this feature is causing underconsumption and recession in Japan.)

Profits were also an increasingly important source of corporate investment in the Republic of Korea. The average personal savings ratio was under 3 per cent during the 1950s and 1960s, while for corporate savings the ratio was twice as large. Nevertheless, corporate investment relied on transfers from the Government: the public sector accounted for almost 60 per cent of total domestic savings in the 1960s. The personal savings ratio rose during the 1970s, reaching over 9 per cent. During 1980-1984 personal savings averaged about 10.3 per cent of GDP and investment 5.3 per cent, resulting in a surplus of 5 per cent. However, corporate savings also rose. Business investment reached 20 per cent of GDP. More than 40 per cent of it was financed by corporate savings and one quarter by household savings: government and foreign savings accounted for 9 per cent and 25 per cent of total business investment, respectively.[181]

While there are very limited data on sectoral savings and investment and flows of funds in developing countries, available information suggests that what differentiates the East Asian NIEs, including the second-tier ones, is not household but corporate savings. Countries for which sectoral data are available, such as Colombia, Ecuador, India, Philippines and Turkey, have had savings rates similar to or higher than those of the East Asian NIEs. But while business savings in the Republic of Korea, Malaysia and Thailand reached 9 per cent of GNP, and in China 14 per cent, in the 1970s and early 1980s, business savings were almost zero in the Philippines, under 2 per cent in India, under 4 per cent in Ecuador and Turkey and around 5.5 per cent in Colombia.[182]

While trade, financial and competition policies protected profits and/or allowed them to rise (through, *inter alia*, rent creation, as discussed earlier in this chapter) above what would have been attained under free market conditions, fiscal instruments were used to supplement corporate profits in order to accelerate capital accumulation. As already mentioned, some of these were specific, targeting directly corporate profits and investment. They included tax breaks and special depreciation allowances to encourage enterprises to retain and invest profits. In Japan, such policies also played a catalytic role, since banks were more willing to make loans for investments qualifying for accelerated depreciation. Legislation allowed firms to put aside reserve funds against risks and exempted such funds from taxation, making it possible to defer tax payments on profits. Revenue losses from such special tax measures to promote investment are estimated to have been 8-13 per cent of total income tax revenues in the period from the late 1950s to the early 1970s. During the 1950s, the increase in the balances of tax-free reserves amounted to more than one third of total corporate savings. This proportion declined during the subsequent decades, for the incentives were reduced as the corporate sector was able to accumulate capital on its own.

One of the most important factors accounting for a rapid growth in corporate investment and profits was the pattern of shareholding and ownership in these economies, particularly Japan and the Republic of Korea. As explained in greater detail in *TDR 1991* (Part Two, chapter III), when the controlling interest is held by business groups

179 M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns* ..., pp. 174-175.

180 OECD, Department of Economics and Statistics, "Saving trends and behaviour in OECD countries", *Working Paper* No. 67, Paris, June 1989, annex I.

181 See P. Honohan and I. Atiyas, "Intersectoral financial flows in developing countries", World Bank *PPR Working Paper* No. 164, March 1989.

182 *Ibid.*

(or familes) with a long-term stake in the corporations, outside pressure to pay out dividends at the expense of corporate savings and investment is much weaker. Managers do not need to pay undue attention to how the market values their assets from day to day, and can concentrate instead on the long run. An internal capital market organized within business groups consisting of banks and firms connected by cross shareholding also improves enterprise performance by pooling and institutionalizing the risk associated with individual investment projects, and by improving investment decisions. Moreover, government guidance of investment decisions and monitoring of the use made of its support is much easier.

The bonus system, first adopted in Japan and then in the East Asian NIEs, was also an important mechanism linking private savings and corporate profits in East Asia.[183] A significant part of workers' pay was tied to company profits. In Japan such tying was estimated to have accounted for about 16 per cent of total wage payments during the 1950s, rising steadily to over 20 per cent during the 1960s. In the Republic of Korea such payments constituted between 14 per cent and 33 per cent, and in Taiwan province of China around 15 per cent, of the total wage bill during the 1970s. Since bonuses are paid as a lump sum at periodic intervals, they allow firms to have at their disposal an important part of the wage bill as interest-free funds. From the workers' point of view such withheld payments are forced savings, particularly in view of their limited access to consumer credit, which restricts their ability to spend in advance of receipt of the bonus. In any case, both theory and practice suggest that the propensity to save from such temporary and transitory incomes tends to be higher than the propensity to save from regular incomes. Indeed, a close correlation has been observed in Japan between the long-term increase in the temporary income ratio and the long-term savings rate.

The bonus system implies that workers' savings move in large part with corporate investment and profits: an investment boom leads to an increase in the revenues of firms, which in turn leads to an increase in workers' bonus income, which raises the savings ratio. This is also a main reason why household savings have been relatively high and rising in the East Asian NIEs.

Individual owners and unincorporated business provided another linkage between profits and private savings. An important characteristic of East Asian NIEs is their success in promoting small-scale enterprises. As already noted, in Japan there were numerous small enterprises, some of them unincorporated business, linked to large firms through subcontracting for the provision of goods and services. Similarly, individual proprietorship has been widespread among the East Asian NIEs.[184] Their savings are recorded as personal rather than corporate savings in national accounts statistics, but are clearly related to profits and investment rather than wages and consumption; the savings ratio from such income is likely to be higher than from wage income. The propensity to save and invest of small producers is further raised by the intense competition they face, which necessitates investment and productivity growth.

Thus, there are strong reasons for thinking that capital accumulation in East Asian NIEs was based on corporate profits and other profit-related income rather than on household savings proper.

It is generally held that policies to promote profits as the main source and drive for capital accumulation did not result in an unequal distribution of income. Indeed, as evidence clearly indicates, income distribution has been more even in East Asia than in Latin America. However, data often fail to reveal the origin of uneven income distribution by aggregating different sources of income. The absence of big land ownership appears to be the main reason for a more equitable income distribution in East Asian NIEs than in Latin America and most other middle-income countries. The difference between East Asian NIEs and other developing countries appears to be much sharper in the distribution of land than in the distribution of income. A comparison of East Asian NIEs (first-tier and second-tier) and Japan with a sample of eight developing countries (Argentina, Brazil, Egypt, India, Kenya, Mexico, Philippines, and Turkey) shows that the average Gini coefficient for land ownership around 1960 was 0.68 in the sample, against 0.45 in East Asian NIEs and Japan, while the average coefficients for income distribution were 0.50 and 0.39, respectively.[185] Since income is partly derived from land, this comparison suggests that differences in income distribution between these East Asian countries

183 See M. Shinohara, *Industrial Growth, Trade and Dynamic Patterns ...*, for further details.

184 *Ibid.*, pp. 157-158.

185 D. Rodrik, *op. cit.*, table 2. The Gini coefficient is a measurement of the degree of concentration in the distribution among a population of income, wealth, etc. It ranges from zero (perfect equality) to unity (perfect inequality).

and the other developing countries in the sample are much less significant when income from land ownership is excluded. For instance, for Argentina, Brazil and Mexico Gini coefficients for land are 0.87, 0.85 and 0.69, respectively, whereas in none of the East Asian NIEs nor in Japan does this coefficient exceed 0.47. This difference seems to account for much of the difference between Gini coefficients for overall income that ranges from 0.44 to 0.53 in Latin America but from 0.31 to 0.41 in East Asia.

Some of the difference in performance between East Asia and Latin America may have been due to differences in the pattern of expenditure. In Latin America, the affluent have a strong preference for high consumption with a high import content (direct or indirect), and Western-style, conspicuous consumption tends to be pervasive even among the less affluent and urban poor at the expense of satisfaction of more basic needs. By contrast, in East Asian NIEs consumption of top-income classes is much more moderate and highly oriented towards domestic, traditional goods.[186] However, the choice by Governments of the industries to be promoted also had a major influence on consumption habits. The more moderate Asian income elasticities of demand for foreign-type consumer goods allowed a more efficient sequencing of the industries in the course of the import-substitution phase than in Latin America: that is, promoting machinery and equipment and indigenously designed consumer goods before producing motor cars and other Western-style consumer durables. Domestic prices of machinery and equipment were kept low relative to those of consumer durables, and even when the domestic industry started producing and exporting Western-type consumer durables, their domestic prices were kept above world levels. These elements were behind the success both in exporting machinery and equipment and in proliferating modernized small- and medium-scale enterprises in traditional craft industries. They thus helped to avoid the kind of technological dualism that pervades Latin America.

H. Conclusions

The preceding discussion does not by any means constitute a full account of the "economic miracle" that took place in the economies under examination. Nevertheless, enough has been said to demonstrate that the miracle cannot be ascribed to "the market" alone. Certainly, business was driven by the profit motive and private enterprise was the dominant force in the economy. Yet, it is very doubtful whether without the guiding - and unusually visible - hand of government, the "animal spirits" of the entrepreneurial class would have reached such a high intensity, or flowed spontaneously into developmental activities in a sequence capable of ensuring a continuous dynamic momentum.

The economic policy regimes in the three largest economies discussed approximated neither to laissez-faire capitalism nor to comprehensive central planning. They had their own paradigm, consisting of a forced-pace advance of industrial capitalism under the auspices of a State that was simultaneously the servant and master of business enterprise. Interpretations based on examining their divergence from the traditional paradigm therefore miss the mark.

The fact that the Japanese model of industrialization was successfully adopted (and adapted) by the Republic of Korea and Taiwan province of China shows that it can be applied outside Japan. But that is not to say that that model, or these two variants of it, can be replicated everywhere. Each country confronts at any moment in time a unique situation which depends on a host of factors, including its own size, level of development, and past history, as well as the state of the world economy, something that is in constant flux. Besides, it must be borne in mind that a number of countries (including some in East Asia that opened their doors wide to FDI) have been able to develop successfully with policies bearing little or no resemblance to those of Japan; and various countries (for instance in Africa and Latin America) have failed precisely because they have treated government intervention as a panacea.

These differing experiences suggest that in the current state of knowledge - that of the authors of this *Report* as well as of others who may hold different views - it is not possible to provide simple and unambiguous recipes for development. Rather, there may not be one

186 For a discussion of these issues, see D. Felix, "Industrial development in East Asia: what are the lessons for Latin America?", *UNCTAD Review*, 1994.

single, universally applicable recipe, but several alternative ones, depending on time and place. Scepticism rather than faith may therefore be in order.

But one cannot stop there. The challenge of development is too vast, especially in African and other least developed countries. Economists cannot rest content with interpretations of the past; they must also find solutions to the problems of the present and the future. Rethinking development policy is therefore a task of great importance and urgency. It has not yet been successfully accomplished; nor will it be as long as the methodologies deployed neglect, by sins of either omission or commission, the true record and rationale of the political economy of Asian capitalism. However, there is reason to be optimistic on this score. Facts, after all, can be more stubborn than paradigms. ■

Chapter II

THE DEFLATIONARY GAP AND ADJUSTMENT IN THE NORTH

A. The origins and consequences of imbalances

The more closely the constituent parts of an international economy are linked together through trade and financial flows, the greater will be the influence of global demand on economic performance. A chronic excess of global demand will make for persistent, perhaps accelerating, inflation and shortages of labour and primary commodities, just as a chronic demand deficiency will produce persistent, even mounting, unemployment and depressed prices for raw materials; the latter will also encourage conflicts among countries as they try to capture a larger market share for themselves. By the same token, instability in world demand will generate fluctuations in the level of activity in individual economies, as well as in key economic variables such as the rate of interest and exchange rates. It will also alter the distribution of income within and among nations and the size of the gap between industrialized countries and less developed ones.

The question of global demand figured prominently on the international agenda when the postwar system was drawn up at Bretton Woods. All participants agreed on the need to avoid a repetition, even on a smaller scale, of the experience of the Great Depression of the interwar years. In that period global demand was extinguished on a massive scale, inflicting huge losses of output and employment and causing a catastrophic decline in commodity prices, as well as the disintegration of the world economy through protectionism, ad hoc controls on exchange and payments and the creation of trade blocs and other devices adopted by individual countries to capture a larger share of world demand for themselves or, at least, to insulate themselves from the transmission of negative economic impulses from outside their borders.

Neither the Bretton Woods arrangements nor the floating exchange rate system that took its place in the 1970s were properly equipped to ensure that the major economies pursued macroeconomic policies that yielded an adequate pace of global demand expansion. Nevertheless, the preservation of high global demand did not figure prominently on the international agenda. In the 1950s and 1960s this was largely because Governments generally sought high levels of employment and capacity utilization (though not so high as to push the world economy into excessive inflation). The 1970s were characterized by substantial differences in national policy responses to the first oil price shock; while some countries continued to pursue policies to support employment and income growth, others sought to defeat cost-push inflation by restrictive macroeconomic policy. It was expected that exchange rate adjustments would serve to make these diverse policy choices compatible internationally.

The second oil price shock, at the end of the 1970s, produced national policies that were more uniform. Demand management to stabilize employment and output was generally rejected in favour of reduced government involvement in the economy and the introduction of measures to enhance market-based adjustment. None the less, diversity remained as the European Economic Community decided to return to a system of fixed exchange rates, while the United States shifted to a policy of targeting monetary aggregates, leaving interest and exchange rates free to fluctuate. There was also unintended diversity in budgetary policies: the Reagan Administration's neo-liberal programme in practice created a massive demand stimulus, while Western Europe pursued policies of fiscal retrenchment. In this period the need for the management of global demand was by and large denied owing to a perception that the inflationary threat was uppermost and a growing belief that it was best tackled not by coordinated demand management but by each country "putting its house in order" by means of restrictive monetary and fiscal policies and liberalization and deregulation aimed at the supply side of the economy.

This policy shift in the 1980s has produced acute instability in the world economy, with adverse consequences for all countries, in particular developing countries, as well as a legacy for the 1990s that continues to present acute difficulties for policy makers everywhere. Not only are disparities in demand creation a prime source of international imbalances and tensions, but insufficiency of the overall level of demand has also proved once again to be a major impediment to sustained growth. These twin phenomena have been responsible not only for problems that are readily identifiable as being cyclical in origin, but also for problems that can easily give the impression of being structural.

It was the demand imbalance created by the disparities in the mix and stance of monetary and fiscal policies both across and within countries in the 1980s which produced the well-known international imbalances, with trade and budget deficits in the United States and surpluses in Western Europe and Japan. The growth differential in favour of the United States, together with high interest rates which, by attracting capital inflows, caused dollar appreciation and reduced United States competitiveness, brought about a considerable deterioration in the country's trade balance. Flexible exchange rates were thus unable to resolve the problems created by diversity in macroeconomic policies, and finally direct policy coordination designed to engineer dollar depreciation was attempted in the Plaza Agreement of 1985.

Since fiscal stimulus and corporate tax reductions in the United States swelled profits, notwithstanding the loss of competitiveness due to dollar appreciation, United States firms felt little pressure to respond to international competition by investing in new plant and equipment in order to cut costs. The depreciation of the dollar after the Plaza Agreement also eased the pressure to adjust. The major increase in investment expenditure was in commercial real estate, driven not by the need to increase productivity or satisfy increased demand, but by changes in the regulations governing the financing of such ventures; financial deregulation also rendered mergers and acquisitions of existing productive assets more attractive than new investment.

As the United States market expanded more rapidly than the ability of domestic suppliers to meet demand in the early 1980s, foreign suppliers increased their exports, and many established distribution and sales operations in the United States on a permanent basis. Japanese firms were especially involved in this movement, and the emergence of what later came to be viewed as a structural Japanese trade surplus dates from this period.

The Government of Japan reacted to developments following the Plaza Agreement by loosening monetary policy and introducing financial deregulation in an attempt to stimulate domestic demand without incurring budget deficits. However, the reaction of Japanese firms served to perpetuate, rather than correct, the trade imbalance. Given the weakness of the stimulus to domestic consumption, they fought to preserve their share of United States markets by reducing costs and investing in more productive equipment in order to compensate for the appreciation of the yen. This "adjustment" was facilitated by the sharp decline in borrowing costs and the stock market boom which resulted.

At the end of the 1980s both the United States and Japan moved to tighten fiscal policy to reduce government indebtedness, and to tighten monetary policy to throttle asset-price inflation. Just as for goods, the process of bringing the asset-price inflation under control imposed heavy costs on the real economy. Falling asset prices caused capital losses, and where asset acquisition had been financed by borrowing, the result was potential insolvency. This process eventually affected a wide range of other countries, including Australia, France, Sweden and the United Kingdom, all of which found their banking systems weakened to the point of potential insolvency as loan values declined and borrowers defaulted. The rise in interest rates also increased the cost of carrying debt, and reduced disposable incomes of net debtors. The deterioration in balance sheets and the decline in disposable incomes resulting from the reversal in asset prices had a sharp negative impact on business and consumer confidence, since income was devoted to a lowering of indebtedness rather than the financing of expenditures.

By the beginning of the 1990s, this process of debt deflation had brought the longest postwar expansion of the major industrialized economies to an end. However, as explained in *TDR 1993*, the legacy of debt deflation continues to be reflected in the balance sheets of firms, households and financial institutions. Consequently, the past years have been dominated by the attempts to use income to cover losses and reduce the debt on balance sheets: firms have sold operating units and cut costs, households have reduced their expenditures, and banks have taken capital losses and cut down on their lending. In the United States and most European countries this process has largely been completed, but in Japan it continues, for banks as well as business firms.

The debt deflation process made the recession that began in 1990 significantly different from past cyclical downturns: the overall decline in output, though in general smaller than in past recessions, lasted longer and led to an apparent decoupling of output and employment, since unemployment continued to rise even when output growth resumed.

These features have been most evident in the United States. Not only were both the downturn and the recovery much weaker than in previous cycles, but also movements of employment and output diverged as the combined pressure of increasing foreign competition and rising interest costs, in conditions of record high debt, finally pushed United States firms into downsizing and restructuring their capital stock. Since continued job uncertainty led households to save rather than spend, on at least two occasions recovery has been aborted by a lack of support from consumer spending. The other side of the coin of industrial rehabilitation has been rates of increase in productivity in the United States not experienced since the 1960s. This, together with weak labour markets and dollar depreciation since 1985, has restored the competitiveness of its manufacturing industry. Further aided by a Latin American import boom resulting from the surge in capital flows to that region, United States manufactured exports have been growing at an annual rate of nearly 10 per cent since 1990.

Increased United States competitiveness has drastically changed conditions for other countries. In particular, Japan has found adjustment to the situation (compounded by the appreciation of the yen vis-à-vis the dollar) far more difficult than the earlier adjustment to the two oil crises and the Plaza Agreement. The fact that it is still in recession, despite the repeated introduction of short-term measures to boost the economy, suggests that the adjustment to debt deflation is incomplete and that the demand shortage is deep-rooted.

The United States upturn also brought into sharp relief the inadequacy of demand creation in Europe. In the 1980s, the Western European economies pursued restrictive policies to fight inflation and reduce fiscal deficits, while strong United States growth, by increasing the demand for exports, offset much of the depressing effects of these policies on growth. However, faced with policies that were increasingly constrained by the actions of the United States and Japan, European countries moved to create an area of policy independence by revitalizing the process of economic integration through the reduction or abolition of national restrictions within EEC. The establishment of a single European market was intended to boost growth via supply-side policies without requiring an increase in government expenditure. These decisions prompted a major increase in investment in the late 1980s, and demand received a further boost from German unification in the early 1990s; these developments helped to forestall recession in the European economies. However, the path to monetary union set out in the Maastricht Treaty required substantial reductions in net government expenditures. What is more, these needed to be initiated just as the downturn was occurring in other industrialized countries (as discussed in *TDR 1993*). The Bundesbank's decision to slow German growth through tighter monetary policy soon put deflationary pressure on EU members, and the recession which had started in the United Kingdom and the United States soon spread to the continental economies of Western Europe.

As a result, those countries that remained in the Exchange Rate Mechanism (ERM) and continued to impose fiscal restriction to satisfy the convergence objectives for monetary and political union were faced with the same problem as Japan, and firms were under the dual pressure of inadequate demand at home and increased competition from abroad. Their response has been to cut costs by shedding labour, which has served further to extinguish demand and postpone recovery. By contrast, performance in those countries that have suspended participation in the ERM and have diverged from the Maastricht objectives has improved.

It is for these reasons that hopes for expansion in Western Europe once again hinge on the ability to expand exports by increasing market shares at the expense of the United

States and Japan and that attention has become focused on "competitiveness". However, this objective will be difficult to attain, given that firms have been slow to restructure, particularly in Germany, compared to those in the United States. European recovery is therefore likely to be halting, as it was earlier in the United States. Its pattern will also continue to be heterogeneous: those countries that have used currency devaluation to increase exports and have lowered interest rates rather than cut budget expenditures will grow more rapidly than (and in part at the expense of) others. The question thus arises whether the convergence process will not need to be reconsidered.

Thus, the United States, Japan and the countries of Western Europe are all counting on rapid export growth, but they cannot all succeed simultaneously in increasing their exports by reducing labour costs. This difficulty of harmonizing national policy goals is being aggravated by the fact that currency movements are now reinforcing the competitiveness of the country which is most advanced on the road to restructuring and recovery, namely the United States, while those that are least advanced and thus most in need of a currency depreciation to boost exports in fact are experiencing currency appreciation. Monetary conditions have begun to be tightened in the United States and, at the first sign of recovery, the decline in European interest rates is being slowed or even halted. In the United Kingdom pressure appears to be building up for a rise in interest rates to offset expected inflationary pressure, and the Bundesbank has indicated that it will now concentrate on reducing the current growth of the money supply, suggesting that further interest rate reduction will be modest, or absent altogether. This can only retard the cyclical recovery which may, in any case, not be as rapid as expected because of the restructuring of industry. If interest rates in Europe were to rise while growth continued to remain modest, the turmoil in the foreign exchange markets in the summer of 1993 could be repeated, with foreign exchange markets attempting to impose interest rate reductions in Europe and increases in the United States by selling the dollar and the weaker European currencies against the Deutsche mark. Such action would do little to solve the underlying problem of recovery, which lies in the deficiency of global demand.

B. Recovery and adjustment in the United States

Competitiveness in world markets has been a matter of concern to the United States since the 1960s, when the dollar shortage of the immediate postwar years turned into a dollar glut. However, the country's freedom of manoeuvre vis-à-vis other industrial countries was constrained by the political imperatives of the Cold War. With the collapse of communism in Eastern Europe in the late 1980s, and with international trade and finance producing an increasing impact on domestic conditions, the United States now seems poised to pursue policies to strengthen and defend its international economic position. This situation creates increased potential for conflict.

The new economic policies introduced in the United States during the 1980s greatly impaired the international competitiveness of domestic industry. The tightening of monetary policy both doubled the international value of the dollar and raised the cost of capital to United States manufacturers. Consequently, when the recession was reversed by tax reductions, bringing about the 1983-1984 boom, domestic output could not fully satisfy the rapid increase in demand, and the United States lost its surplus on manufactured and agricultural goods trade. The fiscal expansion supported demand for those firms that were naturally sheltered from foreign competition; many others faced the choice between bankruptcy or relocating production abroad. Cost-reducing investment to meet foreign competition did not take place on a large scale because of the very high cost of finance, and foreign suppliers began to look upon the United States market as a permanent source of demand.

The other side of this demand support was an increasing public sector deficit and swelling public indebtedness in the United States, in part because of tax reductions but also, and very much so, because the high level of interest rates meant that interest payments accounted for a substantial proportion of the increasing deficit. Consequently, monetary policy had an immediate and direct impact on the budget deficit. The upshot was the creation of an imbalance of the United States budget deficit alongside that of the trade deficit, as well as the loss by the United States of its position as a net international creditor.

The new regime of high interest rates was accompanied by the deregulation of financial markets, which induced firms to invest by merger or acquisition of existing capital assets rather than having them newly produced. These operations were usually financed by borrowing against the value of the newly acquired assets, thus sharply increasing the leverage of the resulting corporate entities; and in many cases the projected earnings were insufficient to cover the interest obligations on the increased debt. Firms thus joined the Government in a rapid expansion of their outstanding debt at high interest rates.

The international debt crisis which followed the shift in monetary policy in 1979 and the appreciation of the dollar meant that United States banks had to find not only ways to recover losses, but also new sources of business. Banks thus increased lending to finance corporate mergers and acquisitions, and expanded their lending to households for consumer loans, often against equity in their homes; they also increased their direct financing of commercial real estate projects. High interest rates also created difficulty for thrift institutions, since their assets consisted of long-term mortgages at fixed interest rates. In an attempt to resolve the thrift crisis by allowing these institutions to increase their earnings, legislation was adopted which granted them increased freedom to lend against more risky projects. This deregulation created an additional source of finance for real estate construction projects. The boom in commercial real estate investment brought increasing demand to the economy just as the impact of the supply-side tax changes was wearing off.

Thus, business firms, consumers and the federal Government all raised their indebtedness to unprecedented levels, while financial institutions increased their lending against more risky assets such as high-yield securities, merger and acquisition bridge financing and real estate. In short, recovery in the United States in the 1980s was driven by spending financed by increased indebtedness relative to income. Manufacturing investment was not only weak, but also concentrated in areas (such as office equipment) which added little to competitiveness.[187]

The increase in overall indebtedness meant that both corporate profits available for spending on investment and household incomes available for spending on consumption became increasingly sensitive to movements in interest rates. As the international debt crisis eased, the Federal Reserve again directed monetary policy towards reducing the rate of inflation. Restrictive monetary conditions in late 1986 and early 1987 brought about a collapse in bond prices which eventually spread to the stock market in October 1987. However, the market break had little impact on the real economy, and the rate of inflation again started to rise. Consequently, the Fed resumed its policy of tightening in 1988, pushing real short rates above 4 per cent by 1989 and imposing rising interest servicing costs on the highly indebted economy. This policy was complemented by tax increases and introduction of a less expansionary fiscal policy, with the result that growth slowed from nearly 4 per cent in 1988 to virtually zero by the end of 1990.

From 1989 on, slower income growth, combined with rising interest rates, magnified the impact of high levels of debt accumulation on profits, and thus on disposable income, and forced both business and households to adjust their balance sheets by reducing expenditure and indebtedness. The squeeze was even tighter on the banking system as the expected demand for the commercial real estate ventures failed to materialize, leading to bankruptcy, a collapse of market prices, bank insolvencies and sharp cuts in lending.

The combined effect of record indebtedness, rising interest rates and falling domestic sales pushed firms into intense restructuring. Restoring profitability involved streamlining managerial structures, laying off workers and undertaking investment designed to reduce unit labour costs. It also meant strengthening international competitiveness; aided by the fall in the dollar, United States firms started seeking foreign sales more aggressively to make up for the loss of domestic markets resulting from the balance-sheet adjustment by households.

In reaction to the weakness first in the financial system and then in the economy in general, the Federal Reserve started to reduce short-term interest rates, thus providing relief not only for the banks, but also for firms and households, which were able to refinance debt at substantially lower interest servicing costs. Banks found that they could restore profitability at little risk by borrowing at low short-term rates and investing in medium-term government securities. This eventually produced a boom in

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[187] For a fuller account, see *TDR 1986*, chap. II, sect. B.4.

securities markets, thereby lowering long-term interest rates, which helped finance the investment required for the industrial restructuring; new equity issues became important for the first time in over a decade. Moreover, households were able to refinance mortgage obligations at substantially lower rates, producing large increases in disposable incomes.

Thus, the fall in interest rates played a direct and crucial role in restoring balance sheet positions and supporting the recovery in investment. Taken together, the interest-sensitive sections of the economy (consumer durables, residential construction and capital goods) expanded considerably. Spending was also boosted by the fall in the share of interest costs in disposable incomes; falling interest rates and debt refinancing meant that spending could rise without a fall in savings ratios; and once the uncertainty over the labour market situation was quelled by a sustained expansion in new jobs during 1993, consumers chose to take advantage of their lower interest payments to increase their spending rather than reduce their indebtedness. This is what eventually produced the movement to a strong recovery at the end of 1993.

The extent of the adjustment that has taken place in the United States is reflected by the fact that whereas the 1983-1984 boom was associated with a sharp increase in the structural federal budget deficits, the structural deficit is now predicted to fall sufficiently (from over 2 per cent of GDP in 1993 to around 1 per cent by the end of fiscal 1994) to stabilize the ratio of government debt to GDP. The deficit in the current fiscal year is likely to be about \$35 billion below the \$235 billion originally envisaged - a return to figures not seen since before the 1980s.

Fixed investment expenditures have increased as sharply as in 1983-1984, but the nature of the investment has been different. By mid-1993 investment in information-processing equipment was increasing at 20 per cent per annum, double that for industrial equipment. This indicates a shift in the structure of United States manufacturing from basic consumer durables such as automobiles to the higher technology (computer-semiconductor-telecommunications) sectors; the latter now account for 8 per cent of industrial production compared to only 5 per cent for automobiles, despite the recovery of the competitiveness of the United States automobile industry.

The most striking feature of the industrial sector is the much greater increase in labour productivity, now estimated at above 2.5 per cent per annum, something not seen since the 1960s; some quarterly rates have been in excess of 5 per cent. Unit labour costs fell by as much as 2.8 per cent in 1993, after being virtually constant the year before.

Increased competitiveness due to higher productivity growth and lower wage growth, coupled with a cheaper dollar, has been translated into stronger export performance. Exports to other G-7 countries have remained relatively stable during the last three years despite recession, but grew by almost 8 per cent per year to the rest of the world. Since total exports from the United States have risen faster than world trade (see Part One, chapter II), the United States has increased its share of global markets. Exports now account for about 20 per cent of domestic industrial production and over 10 per cent of GDP. Since the value of the dollar in trade-weighted real terms is currently well below the 1980 level (as well as below the level that prevailed during the period of strong export expansion in 1988-1990), United States exports and the trade balance could improve considerably as the world economy expands.

However, this restructuring, while increasing productivity, has also made the expansion initially hesitant by reducing employment. In the first quarter of 1991 job growth was negative; in the second quarter of 1992 it was still zero. However, since the first quarter of 1993 employment has been increasing vigorously. The improvement in employment prospects brought a rebound in consumer confidence and consumer expenditure which, together with the steady increase in investment and exports, was responsible for about a 7 per cent annual rate of GDP growth in the last quarter of 1993. The number of new jobs created reached 200,000 per month in that quarter and in the succeeding one, and 450,000 in March 1994 alone. If this trend continues, unemployment will decline as job creation exceeds the growth in the labour force.

The strength of the factors behind the recent employment growth is, however, fragile. First, further recovery of consumption depends on a continued increase in employment, which cannot be taken for granted since firms are continuing to restructure; corporate layoffs announced for the first quarter of 1994 were up by 11 per cent over the year before. Second, household balance sheets will cease to benefit from falling interest rates. The Federal Reserve increased the Federal Funds rate by 125 basis points (bp) in four steps between February and May, and the discount rate in May by 50 bp. Mortgage rates have risen by 150 bp from their lows, and real long-term interest rates are now around 4.5 per cent, which is likely to dampen the growth of consumer demand. Third, the rate of expansion in new housing starts cannot be sustained, for both financial and demographic reasons. Fourth, overall fiscal policy is becoming increasingly restrictive; as noted above, the deficit in 1994 will be lower than expected.

All of these factors suggest that expansion will slow down. The first quarter estimate for GDP growth of around 3 per cent, which was also affected by bad weather and natural disasters on the west coast, suggests that the exceptionally rapid expansion at the end of 1993 has not been carried over into 1994. However, the expectation is that both exports and investment will continue to perform well enough to preserve a growth rate of 3-3.5 per cent over the next two to three years without any substantial change in the inflation outlook.

In addition to these productivity and price considerations, there has been the shift noted above in the structure of manufacturing, and thus of exports, to the "computer-semiconductor-telecommunications" sectors, for which both domestic and foreign demand is growing rapidly and in which economies of scale are appreciable. This will in turn have a positive impact on investment expenditures, which will be increasingly dominated by what could be called a Schumpeterian shock of "creative destruction" as both work and leisure are transformed by the changes foreseen in the higher technology sectors. Thus, investment in new technology will remain high and expectations of earnings growth are likely to facilitate its financing. Bank balance sheets have now been strengthened sufficiently, and most banks more than meet their minimum risk-adjusted capital ratios. Indeed, the fall in the yield differential over the last year or so[188] should encourage banks to resume their traditional function of lending to business borrowers. Bank lending has indeed started to increase once again, and further expansion should take place primarily in lending to small- and medium-sized firms.

The recent performance of the United States economy in any case is not strong compared to past recoveries. The average expansion of output in the first year of earlier postwar recoveries has been 6 per cent, as against the roughly 3 per cent expansion for the whole of 1993, in a recovery which reached its second anniversary in the middle of that year. Even the accelerated expansion of the fourth quarter is not far out of line with prior experience; on a comparable basis the current recovery is roughly 50 per cent behind the postwar average for cyclical recoveries. Industrial production expanded by nearly 9.5 per cent in 1983, as against only 4.8 per cent in 1993 (and an estimated annual rate of 7.7 per cent in the first quarter of 1994).

Capacity utilization, reported to have reached some 83.5 per cent in early 1994, is the highest for four and a half years, and official figures show only a 1.6 per cent increase in potential capacity. It is probably this feature more than any other which has caused concern at the Federal Reserve that the pace of economic expansion should be slowed, since a 3 per cent growth rate when capacity increases at only half this rate and there is already a historically high degree of capacity utilization suggests that excess demand should soon start to appear. However, given the strong increase in business investment, the estimate of a 1.6 per cent increase in capacity is probably on the low side, and conversely the estimate of 83.5 per cent for current capacity utilization is likely to be on the high side. Indeed, the inflation rate has been remarkably stable in the face of drought, floods, earthquakes and unseasonably cold weather that have hit the economy over the last two years. The overall inflation rate appears to have stabilized at some 2.5-3 per cent as measured by both the consumer price index and the price deflator implicit in the national accounts. It is generally accepted that the consumer price index now overstates inflation by as much as a full percentage point; the current inflation rate is thus the lowest since the first half of the 1960s. The fear that the economy will exceed its productive potential, and thus have to be reigned in by tight monetary policy, seems therefore exaggerated.

Moreover, industrial restructuring will continue, with further layoffs, as evidenced by the fact that it is precisely the companies operating in the telecommunications areas which have introduced the deepest retrenchment programmes. In consequence, labour costs will continue to fall and the labour market will remain generally weak, although demand for some types of skills is likely to outstrip supply and exert pressure on wages. Such pressures in the labour market should be seen as a natural counterpart of industrial restructuring rather than as an indicator of excess aggregate demand. Besides, part of the relative increase in pay will be reversed as supply expands in response to the improvement in incentives. The correct policy response would be to take measures to stimulate supply, for instance in the areas of education and training, rather than to restrain demand.

188 In this period the difference in yield between 30-year and 3-year treasury bonds fell from 350 bp to 200 bp.

In conclusion, current recovery in the United States is governed not so much by traditional cyclical factors as adjustments to the distortions of the 1980s. Monetary easing played a major role in facilitating both balance sheet and industrial restructuring. The early period of recovery was dominated by increasing investment expenditures and exports. Recovery became sustained once job growth returned and consumer confidence recovered, but since labour shedding continues, monetary policy will continue to play a major role in determining the strength of recovery and the pace of overall job creation. If the restructuring process is to be successfully pursued, it needs to be conducted not only on the basis of purely cyclical considerations, but also with reference to the underlying adjustment in the productive and financial structure.

C. Underconsumption and trade surplus in Japan

On three occasions during the last two decades the Japanese economy has had to make adjustments under conditions of continual appreciation of the yen: after each of the two oil shocks and after the Plaza Agreement. However, annual growth in GDP never fell below 2 per cent. By contrast, the present downturn started with a sharp decline in industrial production (by almost 8 per cent in late 1991) and GDP growth fell continuously from 4.3 per cent in 1991 to only 1.1 per cent in 1992; and there was virtual stagnation in 1993. The Japanese economy has thus experienced its most severe downturn since the war. The fact that the economy continues to stagnate, despite the introduction in 1993 of a government stimulus and the subsequent acceptance of a tax rebate to increase consumer demand, suggests that the current depressed conditions may not be the result merely of cyclical factors, either domestic or foreign.

The attempt to remedy the international imbalances that emerged in the 1980s has had a major impact in Japan. The expansionary monetary policy introduced in the aftermath of the Plaza Agreement of 1985 brought about a period of low interest rates; the Bank of Japan pegged the official discount rate at 2.5 per cent continuously for nearly two years. One result was a bubble in stock exchange and real estate prices and a sharply increased bank exposure in these areas.

The impact of the collapse of the stock market and of land prices on the financial system is well known, but little attention has been paid to the unprecedented investment boom that accompanied the financial bubble. The share of investment in GDP rose from around 21 per cent in 1985 to peak at around 28 per cent in 1990, above the previous high of 26 per cent achieved immediately after the first oil crisis. Private investment increased by around 35 per cent in this period.

Whereas after the first oil price shock investment was directed at bringing about the requisite structural adjustments, the expansion of capacity in the 1980s reinforced the tendency toward dependence on large-scale export-oriented manufacturing. As the yen rose against the dollar after the Plaza Agreement, Japanese producers responded not by trying to switch sales to the domestic market but by enhancing productivity and reducing costs in order to preserve their markets in the United States. These efforts were facilitated by the extremely low financing costs resulting from the financial market bubble.

Although Japan's dependence on foreign trade is relatively small (exports are under 15 per cent of GDP), the fact that the investment was driven primarily by the quest for exports meant that growth which appeared to be led by domestic demand was in fact driven by the search for markets abroad. The main reason was that government demand was held in check and consumer demand tended to follow rather than lead income growth. The counterpart of the increased capacity created by the investment was increased reliance on export sales to ensure profitability. Since Japanese manufacturers typically require over 90 per cent capacity utilization to break even, export sales have played a much more important role in determining the level of corporate profits than indicated by their share in total sales. The expansion of capacity in the 1980s thus made it increasingly important to preserve the trade surplus which had emerged in 1983-1984. As in Germany, the growth of manufactured exports brought an increase in manufacturing employment at a time when most of the advanced economies were going through a process of deindustrialization whereby the source of employment growth was shifting from manufacturing to services.

The Bank of Japan tightened monetary policy in 1990 just as the economies of the United States and Western Europe entered into recession. The stock exchange bubble, the real estate bubble, the productive capacity bubble and the manufacturing export bubble all burst together. Japan then experienced the same combination of domestic debt deflation and declining external demand as in the United States, but with the addition of continuous currency appreciation.

The additional capacity from the investment boom thus quickly became excess capacity. Several other changes which had been produced by the adjustment to the 1980s also pushed in this direction. Restructuring in the United States economy eroded Japan's competitiveness; a number of developing countries, in Asia and elsewhere, provided additional international competition; and Japan came under increasing pressure from the United States to take action to reduce its export surplus.

As the cyclical downturn became prolonged and extended throughout the industrialized economies, export sales fell below the break-even point, and the earnings of Japanese firms declined, in some cases turning negative (utilization rates are now around 70 per cent). Industry has acted to slow the rise in wages and to shed labour. The increased unemployment and fears of further job losses, together with the pressure on wages, have brought the first reduction in consumer spending in the postwar period.

The Japanese trade surplus continued to rise, not because of exports but because of a declining propensity to consume. Moreover, as the yen appreciation increases the dollar value of the trade surplus, the yen is coming under further upward pressure, squeezing profit margins. In response, firms have sought to reduce excess capacity by cutting down on investment (which fell 8.6 per cent in 1993 and is expected to fall another 5 per cent in 1994), shedding labour and relocating production to countries with lower labour costs. The resiting of production abroad has also been encouraged by pressure from the United States to cut the export surplus. Capital flows to South-East Asia increased by more than 20 per cent in 1991-1992, exceeding $7 billion. As a result, there has been a redistribution of the Japanese trade surplus; the surplus with Asia has risen much faster than that with the United States, reaching $53.6 billion in 1993, and thus exceeding that with the United States of $50.2 billion.

This is not a sustainable adjustment process. The repatriation of Japanese funds from the United States tends to appreciate the yen vis-à-vis the dollar, thereby further squeezing profit margins and stimulating further resiting abroad. Besides, although resiting helps preserve the profitability of the company undertaking it, it does so at the expense of domestic consumer demand and puts upward pressure on the yen. In any event, although resiting gives an initial boost to exports of plant and machinery, the output subsequently generated competes with production in Japan itself and elsewhere. The current stagnation in Japan cannot be remedied by an upturn in world demand, since it is rooted in domestic sources. Each delay in finding a remedy and each failure in negotiations with the United States aggravate the problem by prompting further yen appreciation.

It is therefore not surprising that the main indicators of economic activity have been moving erratically. Real GDP and industrial production both declined in the last quarter of 1993, but consumer spending rose for the first time in two years. This improvement was reversed in the spring of 1994, when household spending fell by a record 4.3 per cent in March compared with the same month a year earlier. Movements of other indicators, such as the continuing decline in car production, falling department store sales and increasing corporate bankruptcies, suggest that the economy has not yet stabilized. The outlook for a recovery in private domestic demand is therefore highly uncertain, at best. Investment has continued to decline, and this year's wage round will leave average real earnings unchanged. Taking into account the 1.8 per cent increase in disposable incomes which will result from tax rebates in fiscal 1994, personal consumption is likely to rise by less than 1 per cent.

Besides, the negative impact of the collapse of the stock market and real estate bubbles is still being felt as balance sheet restructuring continues in both the manufacturing and the financial sectors. Aside from the depressing effects of bankruptcies and reduced household wealth on consumption, the most direct effect has been the extremely slow growth of bank lending, partially because banks were reluctant to lend when trying to rebuild capital (even though in most cases their risk-adjusted capital ratios were above the prescribed international minimum levels). The results announced for the fiscal year 1993 show that bad loans are still a serious problem for the

Box 2

THE COOPERATIVE CREDIT PURCHASING COMPANY OF JAPAN

In order to help commercial banks cope with the considerable volume of non-performing loans in their portfolios, the Japanese Federation of Bankers' Associations created in January 1993 the Cooperative Credit Purchasing Company (CCPC). With an intended life span of 10 years, the Company is to purchase non-performing loans collateralized by real estate, at a discount from commercial banks, with money borrowed from the banks selling the loans. The Government has agreed to treat the amount of the discount as a loss, 40-50 per cent of which can be set off against corporate taxes. CCPC is expected to repay the loans to the banks, presumably during the second half of its life span, either by collecting payments from debtors or by having the collateralized property sold on the market. In addition to resolving the problem of non-performing loans, CCPC is expected to help reinvigorate the depressed real estate market.

The first round of purchases was conducted by CCPC during several weeks prior to the end of March 1993 (the last month of fiscal 1992). Total purchases by the end of the fiscal year had reached Y452 billion, the loans having a face value of Y682 billion. After a quiet interval, banks again unloaded a large amount of non-performing loans to CCPC in September 1993, just before the end of mid-year accounting period of fiscal 1993. During fiscal 1993 as a whole, CCPC bought loans to the tune of Y1,779 billion, with a face value of Y3,838 billion. In the six months ending 31 March 1994, it bought a further Y1,177 billion of loans, with a face value of Y2,654 billion. In March 1994 alone, the face value of loans bought totalled Y1,663 billion, or 63 per cent of the total for the second half of fiscal 1993. Banks tend to rush to CCPC in March (the last month of the fiscal year) and September (the end of the first half of the fiscal year), in order to shore up profits.

The average ratio of the purchase price to the face value of the loans bought by CCPC was 66 per cent up to March 1993 (51 per cent for those bought in the first half of fiscal 1993 and 44 per cent in the second half). Further purchases are likely to require a larger discount, as the overall quality of the remaining loans is less attractive. As of March 1994, CCPC had been able to retrieve Y30 billion, or 1.3 per cent of the total purchase prices, including Y26 billion resulting from liquidating 87 units of collateralized property.

The disclosed total of the non-performing loans among the 21 leading commercial banks (11 city banks, 3 long-term banks and 7 trust banks) amounted to Y12,774 billion at the end of March 1993. By end-September, the figure stood at Y13,758 billion. As a result of intensified efforts by these banks, the amount of non-performing loans began to decline, and stood at Y13,574 billion by the end of March 1994; however, this still constituted more than 3 per cent of the total outstanding loans of these banks. As a result, banks have become very prudent in extending new loans, thus prolonging the present recession.

In fiscal 1993, the major banks wrote off twice as much in bad debts as in the previous year, by selling securities, real estate and other assets in order to build up financial resources needed for CCPC transactions as well as the general loss reserves. Many smaller regional banks are likely to have to merge in order to survive.

A number of shortcomings of CCPC have been identified. First, its operations have been small in relation to the level of outstanding non-performing loans. Second, it tends to help larger banks that can afford to lend money to it. Third, the continued operation of CCPC may discourage the natural development of a secondary market for non-performing loans. Finally, the Company has failed to liquidate an important part of the collateralized property of the purchased loans because of continued depression of the real estate market.

commercial banks and the industrial investment banks. In its first year of operation, the Cooperative Credit Purchasing Company, which was set up to help the banks remove bad debts, has not been able to fulfil its objectives to any significant degree (box 2). Furthermore, in view of their revised investment intentions, firms have not been eager to borrow. The financial situation has also been made more difficult by the clear reluctance of the Bank of Japan to risk repeating the experience of the 1980s of excessive liquidity creation. Granted, nominal rates are extremely low by historical standards (the discount rate is 1.75 per cent), but that does not mean that monetary policy is especially expansionary; the consumer price index has not risen at all and producer prices have been falling (by about 2 per cent per annum since 1990). Therefore, unlike United States policy in 1991-1993, which drove down real short-term rates almost to zero, monetary policy in Japan is not particularly stimulative.

In the 1980s unemployment in Japan varied much less in response to variations in output than in other countries. However, at 2.9 per cent in February 1993 it reached its highest level for six and a half years. Manufacturing employment, which as noted, had bucked the global trend and increased during the 1980s, fell by 450,000 in 1993. Indications point to continued restructuring in manufacturing. Plans recently announced by large firms point to an average labour shedding of nearly 12 per cent, and estimates of excess labour in manufacturing, which employs around 15 million workers, run as high as 2-2.5 million. If, as seems increasingly likely, large Japanese export-oriented firms return to labour practices similar to those applied in the adjustment to the oil crisis in the 1970s, the unemployment rate could well double over the next two years, to around 5-6 per cent. As with the United States adjustment in the beginning of the 1990s, the layoffs affect disproportionately white-collar employees with high discretionary incomes. With both job security and real wages under pressure, even consumer-led recovery becomes less probable.

The tendency of the Japanese economy towards underconsumption could be offset, in the longer run, by measures to redistribute income from profits to wages. To that end, it would be helpful to expose the protected sectors of the economy to greater internal and foreign competition, including domestic markets for exported goods that have been shielded from foreign competition, retail distribution and the market for services, thus allowing a greater inflow of cheap foreign imports, reducing domestic prices of consumer goods and services and eliminating the large differences that exist between domestic and international prices in areas such as real estate and consumer durables and non-durables, including foodstuffs. In a word, the consumer goods sector would be deregulated. It has been estimated that the introduction of American-style discount retailing would add about 10 per cent to consumer purchasing power and would also reduce oligopolistic profits. Since the proportion of wages that is saved is much smaller than is the case for profits, such a redistribution would produce a direct stimulus to consumer expenditures and a larger one than would a temporary tax rebate. By doing so, it would bring a sharp increase in imports and hence help keep down the value of the yen, which would improve the competitiveness of exports. It would also facilitate a structural shift in favour of services, the share of which in GDP is considerably lower than in other advanced countries (about 55 per cent, compared to almost 70 per cent in the United States and the United Kingdom). In this way, the Japanese economy could reduce its reliance on manufactures (which account for almost 30 per cent of GDP, compared to about 20 per cent in the United States and the United Kingdom) and on an export surplus.

However, it would be difficult politically to bring about such a policy shift quickly enough to counteract the current recession. The thrust of the burden of such an adjustment would be on farmers, small shopkeepers and employees of small and medium enterprises supplying the big exporting firms. These constitute a predominant political constituency . While they would stand to gain as consumers, their losses would be more rapid and more discernible than their gains.

Consequently, it may be necessary to tackle the problem in the short run by substantially increasing net government expenditure, but this immediately raises the question of financing. Because of the recession, the ratio of government expenditures financed by deficit bond issues has already risen sharply, from 13.5 per cent in fiscal 1992 to a (predicted) 29 per cent in fiscal 1994. So far, government supplementary budgets have largely been directed at shoring up domestic asset prices through financial support schemes, and it was only after great resistance from the Ministry of Finance that a tax rebate was agreed in order to support consumer spending. Additional public spending is needed, though it would require floating deficit bonds, something which the Ministry of Finance is committed to avoid and the Bank of Japan is committed not to finance.

Monetary policy, too, can play an important role. As already noted, real interest rates are still high, and domestic credit and money supply have been sluggish. Meanwhile, balance sheet restructuring remains to be completed. Monetary loosening is therefore indicated, even though memories of the finance bubble are still fresh.

D. Stagnation and unemployment in Western Europe

In the 1970s and early 1980s, Western Europe, like the United States, experienced sharply falling growth rates and rising unemployment. However, while the United States attained rapid recovery in 1983-1984, the European economies continued to stagnate. During 1974-1985 there was on average no increase in employment in the 12 countries constituting the present European Union (EU), compared to an annual increase of 1.8 per cent in the United States and 0.7 per cent in Japan. Gross fixed capital formation was also stagnant, whereas it averaged an annual volume increase of 2.1 per cent in the United States and 1.7 per cent in Japan. Europe clearly appeared to be lagging behind.

This stagnation (described as "eurosclerosis") was generally attributed to excessive national regulation of production and to inflexible labour markets. As part of the response to this situation, the single European market was designed to eliminate regulatory constraints and create a unified market equal in size to that of the United States and Japan, as a base from which larger and more efficient European firms could better compete in international markets. Thus, as the United States attempted to eliminate its deficits, and the Plaza Agreement produced the depreciation of the dollar and a consequent loss of European competitiveness, European firms shifted their attention to the development of the internal market: the volume of gross fixed capital formation increased by 8.8 per cent in 1988 and 7.3 per cent in 1989. At the end of the decade, an additional impulse to European demand and investment came from German unification, as the economy of Germany grew rapidly and provided a market for European exporters. The consequence was a growth of employment by around 1.5 per cent per year and a fall in unemployment (to 8.3 per cent in 1990, from 10.7 per cent in 1986). However, unemployment in the Community/Union remained high compared to the United States (around 5.5 per cent) and Japan (2.5 per cent).

The next step in the process towards complete union was the formulation of the convergence conditions for formal monetary and political union contained in the Maastricht Treaty. As explained in *TDR 1993*, some of these conditions - in particular the 3 per cent limit on government budget deficits, the 60 per cent limit on the ratio of debt to GDP, and the avoidance of currency realignments in the two years before monetary union - required a number of Governments to further tighten their already restrictive monetary and fiscal policies. This further widened the European deflationary gap at the very time when the Bundesbank was tightening monetary policy to slow down domestic expansion and the English-speaking economies of Europe were going into recession. The combined impact of these factors on incomes and government finances moved the constituent national economies even further away from the Maastricht targets, creating a conflict between convergence towards monetary union and income and employment growth.

The ability to maintain exchange rate stability was also weakened. As the Bundesbank continued to increase interest rates, other members of the European Exchange Rate Mechanism (ERM) felt obliged to follow suit to preserve their fixed parities. Central parities under the European Monetary System had been largely stable since 1987, and there was an assumption that these parities would need to be preserved until the European Monetary Union came into force. Thus, as the recession deepened and income and employment growth fell, even countries with weaker internal demand conditions than in Germany were forced to increase interest rates and reduce public expenditure. Foreign exchange markets concluded that the political limits of output and employment losses were being approached, threatening the commitment to prevailing ERM parities. In September 1992 the markets forced a lira devaluation (leading to an exchange rate that proved to be unsustainable) and pressure soon spread to sterling; both countries concerned suspended their participation in the ERM. Pressure was also exerted on the currencies of Spain, Portugal and Ireland, all of which eventually reduced their central parities.

As a result of the restrictive policies introduced in order to meet the convergence criteria, the Bundesbank's tightening of monetary policy and the recession in the United States, investment growth turned negative in Western Europe in 1991. In the EU countries internal demand growth was roughly zero and employment declined by 1.3 per cent in 1992; by 1993, both private consumption and total domestic demand were declining, GDP fell by 0.4 per cent and unemployment was again over 10 per cent. Thus, despite the move towards an internal market capable of reducing dependence on international markets, prospects for expansion appeared once again to hinge on increasing exports to the rest of the world.

Italy and the United Kingdom, which were forced to opt out of the ERM in September 1992, and Spain, which sharply devalued in the last quarter of 1992, have all benefited from a substantial export stimulus to demand and have employed the freedom they have gained over monetary policy to reduce interest rates relative to those in Germany. In the United Kingdom, there was also an increase in domestic demand, though its contribution to GDP growth was less than that of net exports; in the other countries mentioned, domestic demand has continued to fall. The already stimulative fiscal policy in the United Kingdom, combined with rapid reductions in interest rates, quickly brought about recovery in the economy to growth rates above 2 per cent and a reduction in unemployment. Despite fears of increased inflation, the rise in the price level has remained around 2.5 per cent. In Italy a sharply deflationary fiscal policy, introduced to bring government indebtedness under control, was largely compensated by a rapid and sustained expansion in exports after the devaluation mentioned above, while interest rate reductions permitted a reduction in debt servicing costs and prevented fiscal policy becoming even tighter. The revival of industrial production at the end of 1993, which seems to have carried over into 1994, suggests that the economy is poised for recovery. Inflation has in fact fallen despite devaluation, due partly to weak demand conditions, but also to the elimination of automatic wage agreements, which has held the rise in wages below that of prices. Thus, profitability in the export sector has improved, providing the basis for expanded investment should there be an increase in demand.

In Spain the contribution to demand of net export growth in 1993 was almost sufficient to offset the decline in private domestic expenditures, and the fall in GDP was limited to 1 per cent. Interest rates have also been reduced, to the lowest levels in real terms since Spain acceded to EEC. Continued export growth is feeding through to domestic demand, which revived in the first quarter of 1994, indicating that it may well join exports in leading Spanish recovery. In line with the experience of the United Kingdom and Italy, the inflation rate has also declined, and is below 5 per cent. Along with Denmark, which is stimulating domestic demand through fiscal measures, Spain and Italy are thus likely to be the first European economies to recover after the United Kingdom.

Growth prospects are much dimmer for those economies, such as France and Belgium, that have not used the freedom gained over monetary policy as a result of the decision of August 1993 to introduce wider fluctuation bands. The exchange rates of these countries were quickly brought back into the earlier narrow bands as more restrictive monetary policies were adopted, and they have chosen to loosen monetary policy in step with the reduction of rates in Germany. Since the policy of the Bundesbank is to bring about a reduction of domestic inflation rates, and none of these countries is suffering from excessive inflation, the result has been an even greater conflict between domestic demand policy required to support output and employment and the commitment to monetary union.

The negative impact of this more restrictive policy on unemployment led the new French Government elected in 1993 to adopt a somewhat more active fiscal policy stance. The measures taken to boost private consumption appear to have reversed the falling trend of GDP, which for the year as a whole was almost 1 per cent below 1992. In addition to specific measures, such as those to support automobile sales, the Government recently announced that it would propose further tax reductions in the forthcoming budget. In order to prevent any consequent divergence of the debt and deficit from the Maastricht targets, large-scale privatization of public sector enterprises is being undertaken.

The situation in the Benelux countries, which are the most closely integrated with the German economy, is less promising. In Belgium GDP fell by 2 per cent in 1993 and the Government has introduced a sharply contractionary fiscal policy in an attempt to reduce outstanding public debt and move closer to the Maastricht criteria. Any expansion of demand will have to come from exports, which are heavily dependent (to the extent of some 80 per cent) on the markets of other EU countries. The Belgian franc came under pressure last summer, but as in France the monetary authorities have tightened policy to bring its parity back within the narrow fluctuation band. While the Netherlands avoided a decline in output in 1993, employment has declined dramatically; unemployment increased by 33 per cent in the first quarter of the year. At times the guilder has even been stronger than the Deutsche mark, but monetary conditions remain extremely tight. The Government is still overhauling its social policy and will contribute little directly to an increase in demand. Thus, prospects for recovery in the Netherlands, too, will depend very much on the growth of other EU markets.

By far the most serious recession in the continental Western European economies has been in Germany, where GDP contracted by almost 2 per cent in 1993 as both private and public demand fell. Gross fixed capital formation fell by nearly 6 per cent, despite a housing boom in the eastern *Länder*, and private consumption by over 1 per cent. Household saving is at a record low, and both retail sales and new car registrations fell sharply in spring 1994. The Government has announced additional measures which will act both to reduce public expenditure and to increase household tax revenue by around 3 per cent in 1995. Thus, in this instance, too, sustained recovery will depend on exports. As for the Benelux countries, however, most German exports are to other EU countries, where markets are hardly expanding. Germany's problem can be summed up thus: the export markets which are expanding are precisely those in which the Deutsche mark has appreciated the most, while those in which Germany has gained competitiveness are those which are dependent for their recovery on Germany itself.

To sum up, for both Germany and the Benelux countries, the outlook for recovery in 1994 depends crucially on a recovery of world demand and/or capturing a larger share of world demand (including their shares in the markets of the United States and the developing countries), through a depreciation of the Deutsche mark relative to the dollar. German exports increased at the end of 1993 and the beginning of 1994, particularly to the United States, Central and Eastern Europe and the Far East, but the Deutsche mark appreciated continuously throughout the second quarter of the year, despite the negative growth differential with the United States and a narrowing positive interest rate differential. Strong export growth will require the elimination of the positive interest rate differential with the United States, leading to a depreciation of the German currency. Given that the Fed seems to have concluded its current round of raising interest rates, this implies considerable monetary easing by the Bundesbank. However, the Bundesbank appears unwilling to take this route. Indeed, had it been so willing, prospects for recovery would not depend on exports in the first place.

The growth of domestic credit in Germany at around 10 per cent and the fact that the associated expansion of M3 is about triple the Bundesbank's target rate of 4-6 per cent do not necessarily reflect greater demand pressure; nor are they independent of the way monetary policy is conducted. Some of the increase in M3 simply reflects the weakness of the dollar and the shift of funds out of the United States into short-term mark-denominated assets. Indeed, the same volatility which made the United States securities markets unattractive has also been transmitted to Europe, where long-term rates have risen and investors have suffered capital losses. They have thus preferred short-term assets, which increase M3. This tendency has been reinforced by the belief that the Bundesbank may have reached the end of its rate-cutting cycle: thus, expectations of capital loss arising from further increases in long-term rates dominate investors' behaviour. Indeed, it seems that it was in part to counter these expectations that the Bundesbank moved to cut both the Lombard and the discount rates by an unexpected half-point in May in order to steepen the yield curve and induce investors to invest in long-term bonds. However, bondholders must be persuaded that rates will continue to move down over time, and every large downward adjustment makes this appear more unlikely. On the other hand, if the policy of steepening the yield curve is successful, it becomes extremely attractive for speculators to borrow short-term funds for investment in medium-term securities, thereby increasing bank lending and M3. Thus, while there can be no doubt that the increase in the money supply in Germany is excessive, it is not clear that it has been caused by factors which are directly related to effective demand, rather than to the volatile conditions in the financial markets, some of which stem from monetary policy.

Exchange rate adjustment is unlikely to provide the expected stimulus to export growth in Western Europe in 1994. As long as countries concentrate on convergence at the expense of investment and growth, productivity will lag and exports will lose competitiveness. All that can then be expected is that the pattern of halting and uneven recovery will be maintained. A more direct demand stimulus is thus necessary, via a considerable relaxation of monetary policy and easing of fiscal retrenchment, with a view to stimulating consumption as well as investment that increases both productivity and employment. It is worth emphasizing that an increase in exports to third countries cannot act as the driving force for investment, which must come from within.

The main obstacle to faster expansion is constituted by the extremely high levels of real interest rates, which impede investment and raise current production costs. The interest rate burden creates, in turn, pressure to reduce labour costs, but the result is higher unemployment and depressed consumer demand.

On one view, the answer to the problem of slow growth and high unemployment lies in improving international competitiveness via increased flexibility in labour markets and tax incentives for job creation. Such measures may be desirable, but no recovery plan will be successful if it depends on capturing market share from other countries. Western Europe suffers in general from demand deficiency - something which the single European market was not designed to tackle. Generating the right conditions in EU requires, *inter alia*, lifting the restrictions on policy that have been agreed. One way to do this would be to postpone the monetary union indefinitely and to suspend the Maastricht targets. Another would be to cut the Gordian knot of economic convergence by deciding that monetary union should come into force by 1996 or even earlier. Inflation rates have now converged to a differential of around 3 percentage points, the highest prevailing rates being around 4 per cent, which was the average rate experienced in Germany in 1960-1984. The differential for long-term interest rates is also about 3 percentage points. It is primarily in the deficit and debt targets that there is major divergence, but those countries farthest from the targets are also those which are growing most rapidly and, given their adjustment policies already in place, are likely to move most rapidly toward convergence.

While Western Europe, as well as Japan, is seeking rapid export growth, there are a number of factors which suggest that the impact of the United States expansion on the rest of the world will be different in the 1990s than in the 1980s. First, its pace will be slower, since United States monetary policy is being adjusted to that end and the fiscal stance is also dampening activity. Second, and more important, the dollar is not appreciating (see box 3). Indeed, this has confounded analysts, who have been predicting a sharp appreciation for some 18 months; concerted central bank intervention to prevent depreciation was even required in the spring of 1994. Consequently, the exchange rate is not undermining the international competitiveness of the United States exporters. Third, the United States recovery, which has been led by investment, has sharply increased productivity and, together with low wage growth, has reduced unit costs. Thus, the United States will retain competitiveness in the recovery, and its trade balance will deteriorate much less than in the 1980s; in other words, the United States demand stimulus to the rest of the world will be much less pronounced than in the 1980s. This suggests that current forecasts of a significant export-led recovery in Western Europe may be unrealistic.

The question arises whether the Fed will in due course raise short-term interest rates sufficiently to produce a positive differential capable of reversing short-term capital flows, thereby inducing a dollar appreciation that would stimulate European exports. However, it would be self-defeating, since it would slow down growth in the United States by both reducing domestic demand and increasing imports and so set back the process of United States international adjustment. It would also increase the probability of bilateral trade conflicts.

It is sometimes argued that raising short-term interest rates helps to reduce long-term rates by lowering inflationary expectations. However, recent experience in the United States has produced just the opposite effect: higher short-term rates have prompted a rise in domestic long-term rates, which has spread to bond markets in other financial centres. If this were repeated, tighter monetary policies in the United States would dampen recovery in those countries with currencies linked to the Deutsche mark, and perhaps even produce a replication of the foreign exchange crisis of the summer of 1993. Further, any sustained increase in long-term rates would cause a reversal of funds which have moved to Latin American and other emerging markets. This, too, would hurt European recovery through a reduction of exports to developing countries. Monetary tightening in the United States is not the remedy for recovery in Western Europe. Indeed, it is more likely to have the opposite effect, both directly and by promoting financial instability in that region and Latin America.

On the other hand, if the dollar strengthens as a result of interest rate reduction in Germany, Western Europe would benefit from both increased competitiveness for its exports and increased domestic demand (via the impact of lower interest rates). The resulting increase in world demand would also reduce tensions in the ERM and the risk of financial instability.

Box 3

CAPITAL FLOWS AND THE RECENT BEHAVIOUR OF THE DOLLAR

The main reason why predictions of the rapid appreciation of the dollar proved wrong is that they assumed that the global economy was in a purely cyclical downturn. However, capital movements have been governed by the interplay between adjustment and cyclical demand factors.

As the German economy expanded after unification, increased imports soon eliminated its large current account and trade surpluses. This was accompanied by a reversal of capital flows, which changed from a net outflow of DM 25 billion in 1991 to a net inflow of DM 198 billion in 1993. At the same time in Japan, which was suffering from the after-effects of the financial bubble, there was a sharply reduced flow of capital to the United States as funds were repatriated to cover losses in the domestic market. Thus, in both Germany and Japan capital outflows were reversed or sharply reduced as a result of non-cyclical factors. Simultaneously, United States investors were initiating a process of international portfolio diversification, driven not only by the low interest rates used to support recovery but also by the expectation of capital gains from the expected falls in interest rates in Europe and the rise in share prices in emerging markets. This was a source of substantial capital inflows into developing countries (see *TDR 1993*), which has made them an expanding source of demand for developed country exports. Thus, the net flow of funds to the United States declined, and the dollar remained weak until signs of recovery became apparent in 1993.

The recovery prompted a reduction in the negative United States short-term interest rate differential, which was expected to produce a substantial strengthening of the dollar. However, the initial rise in United States short rates in February 1994 translated into a crisis in bond markets and substantial capital losses for investors in United States securities. The capital losses led investors to move from securities markets into short-term investments, where the potential reversal of the interest rate differential in favour of the United States was not sufficiently attractive to prevent dollar depreciation. This market situation roughly coincided with the breakdown of trade discussions with Japan and persistence of a widespread belief that the dollar would be encouraged to fall vis-à-vis the yen, an opinion which was reinforced by political developments in Japan. These factors accelerated the movement of funds out of the United States and initiated the recent period of dollar weakness. With the intentions of the Fed unclear, and with the Bundesbank appearing to have slowed interest rate reductions, the potential for a reversal of the interest rate differential was reduced substantially. The dollar's value thus became governed by uncertainties over the situation with regard to Japan and the future direction of United States security prices. The decline in the United States trade balance in early 1994 further increased flows of dollars into the exchange markets.

Thus, the behaviour of the dollar had little to do either with the cyclical conditions of the economy, which were moving in the direction that had been anticipated by the market, or with the prospect for increased future inflation, but was associated rather with uncertainty over the policies of the Fed and the Bundesbank and regarding United States-Japan relations. The weak dollar continues to favour United States exports and expansion rather than recovery in Europe and Japan. Whether this pattern continues will depend largely on the configuration of national monetary policies.

E. Conclusion

Over the past decade, the performance of the major market economies, and *pro tanto* of the world economy, has been seriously impaired by problems of demand. The degree of global demand deficiency has not been constant; indeed, fluctuations in the pace of demand creation have been only too evident. Nevertheless, a deficiency of demand has been the general rule. It is largely because of that deficiency that the basic factors of production - labour and raw materials - have been in excess supply globally, with unemployment rates in the developed countries rising to extremely high levels and, conversely, primary commodity prices falling (until very recently) to record lows. Similarly, the large imbalances among the major market economies have also to an important extent been a reflection of the success with which some countries have been able to increase their share of global demand at the expense of others.

Increasingly, surpluses are again being valued not only as a means of financing long-term foreign investments (or concessional loans or grants), but also as a prop to economic activity at home, while deficits are once again deplored not only because of their implications for indebtedness but also, and even more so, because of their impact on jobs and profits. The mercantilist notion that countries should seek growth by improving their overall competitiveness vis-à-vis other countries is fast becoming accepted as an axiom, but it is very largely a mistaken one. Competitiveness is a relative concept. While one country can improve its international competitiveness (and thus, perhaps, its growth performance), that is not possible for all countries at the same time.

What each and every country can do is to improve productivity; and international flows of trade may facilitate or even promote this process. But it is of cardinal importance to bear in mind that improvements in productivity do not by themselves generate the increase in purchasing power necessary to translate them into higher levels of output. They are therefore of little use unless they are matched by an enlarged expenditure flow. Unless sufficient additional demand is created *pari passu* with an increased potential for supply, technical advance will yield a reduction not only in the ratio of inputs to output but also in the absolute level of use of inputs. Moreover, conditions of tight global demand will result in advances in knowledge and techniques being associated not so much with growth of total incomes as with pressures on individual countries to increase their market share at the expense of others. In short, global demand deficiency is a recipe for wasting the world's productive potential and an invitation to conflict among nations.

The level of global demand is not an accident of fortune. No individual country is large enough on its own to regulate its level, but it is within the power of Governments acting collectively to ensure that it is normally compatible with worldwide growth and equilibrium. It is to this task that the international community should now turn, beginning with the following policy approaches:

- Western Europe needs to bring down interest rates substantially for a prolonged period, and to reschedule its fiscal adjustment to when recovery is well under way;
- Japan needs to loosen its monetary policy and undertake fiscal expansion, while taking measures to increase the propensity to consume;
- the United States needs to be cautious in applying monetary brakes so as not to stifle the recovery of investment and employment and the improvement in productivity.■

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Annex to chapter II

CONTROLS ON INTERNATIONAL CAPITAL MOVEMENTS

A. Introduction

The recent trend towards liberalization of international capital movements in most parts of the world economy has been accompanied by growing agreement concerning the potential benefits of long-term international investment, so long as it is subject to certain restrictions and conditions. But there is no such consensus as to the benefits of short-term capital movements, even though these too are now increasingly covered by measures of liberalization. Policy makers' concerns regarding short-term capital movements derive mainly from the volatility of many of the transactions through which such movements are effected. Unless offsetting action is taken, this is easily translated into volatility of exchange rates, asset prices and interest rates, foreign exchange reserves, and the supply of domestic financing. Therefore such movements are capable of exerting a powerful influence on an economy, including resource allocation, consumption and investment.

The unfavourable effects of such volatility have been extensively analysed in the literature.[189] For example, volatility of exchange rates, asset prices and interest rates tends to shorten time horizons for investment decisions, to raise transactions costs, and to increase firms' incentives to maintain higher mark-ups and greater financial reserves. Moreover, volatility blurs the signals which the exchange rate should give for resource allocation. Volatility of interest rates and asset prices increases wealth holders' preferences for liquid as opposed to longer-term financial instruments, thus exerting upward pressure on long-term interest rates. The volatility of exchange rates and of foreign exchange reserves tends to exert a deflationary impact on the world economy owing to the asymmetry in pressures for adjustment on countries with weak currencies as opposed to those with strong ones. Protection against some of these unfavourable effects at a microeconomic level, particularly those arising from the volatility of exchange and interest rates, can now be purchased in the form of forward, futures, option and swap contracts. However, such contracts still leave several risks uncovered, especially those faced by developing countries, and they can be expensive.[190] Moreover, increased buying and selling of such contracts have opened up new opportunities for speculative profits and are thus capable of adding to the very volatility against which they afford protection.

Section B of this annex discusses mainly different techniques and instruments for controlling international capital movements, and section C the regimes for such movements. In the case of developed countries the regimes covered are international ones, the focus being on those of OECD and the European Commu-

189 For a survey of the literature see the UNCTAD secretariat, "The exchange-rate system", sect. B, in *Compendium of Studies on International Monetary and Financial Issues for Developing Countries* (United Nations publication, Sales No. E.87.II.D.3), and *TDR 1990*, Part Two, chap. I, sects. B and C.

190 Concerning the coverage of such contracts see, for example, *TDR 1988*, Part One, chap. II, sect. D. The sale of such contracts has been an important source of revenue to the financial sector.

nity, whereas the developing-country regimes reviewed are national ones. The latter discussion is necessarily selective and is intended to highlight, and distinguish between, features reflecting longer-term policy objectives and those driven by shorter-term considerations (amongst which special attention is paid to problems caused by the recent rise in capital flows to some developing countries). Section D takes up proposals for curbing speculative international capital movements. Since there is an extensive literature on the contribution of macroeconomic policies to the attainment of this objective, greater detail is reserved for proposals for a tax on foreign exchange transactions and for measures affecting banks' balance-sheet management designed to increase the costs of engaging in foreign exchange speculation.

B. Modalities of policies towards international capital movements

1. Definitions

Broadly speaking, international capital movements involve changes in the claims of a country's residents on non-residents in the form of real capital assets and financial instruments. There is a close correspondence, for example, between the categories of claim included under this heading and the items other than reserve assets covered in the capital and financial account of the balance of payments.[191]

In the Articles of Agreement of IMF there is no explicit listing of international capital transactions, which are defined as those other than current.[192] By contrast, both the OECD Code of Liberalization of Capital Movements and the EEC Directives concerning capital movements provide detailed lists of capital transactions. Thus, the 1992 edition of the OECD Code[193] lists direct investment, the liquidation of such investment, operations in real estate, operations in securities on capital markets, operations on money markets, operations in collective investment securities, operations in negotiable instruments and non-securitized claims not elsewhere specified, credits directly linked with international commercial transactions or with the rendering of international services, personal capital movements, financial credits and loans not elsewhere specified, sureties, guarantees and financial back-up facilities, the operation of deposit accounts, foreign exchange operations not elsewhere specified,[194] and disposal of non-resident owned blocked funds. As might be expected in view of the overlapping of the memberships of the EU and OECD, the list of international capital transactions specified in the annex on nomenclature of the EEC Council's 1988 Directive on capital movements[195] is similar (though not identical).

2. Controls on capital transactions

Controls on transactions involving inward and outward flows of capital can be im-

[191] IMF, *Balance of Payments Manual*, 5th edition (Washington, D.C.: IMF, 1993), chap. XVI.

[192] Article XXX(d) specifies that "payments for current transactions means payments which are not for the purpose of transferring capital, and includes, without limitation: (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities; (2) payments due as interest on loans and as net income from other investments; (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and (4) moderate remittances for family living expenses." In cases where these guidelines are not sufficient for the purpose of classifying transactions as "current" or "capital", the Fund "may, after consultation with the members concerned, determine whether certain specific transactions are to be considered current transactions or capital transactions".

[193] *Code of Liberalization of Capital Movements* (Paris: OECD, March 1992).

[194] Inclusion of foreign exchange operations here is a little surprising in the absence of further specification of the purpose for which such operations are carried out.

[195] Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty (88/361/EEC), reproduced in *Official Journal of the European Communities*, No. L 178, Vol. 31, 8 July 1988, pp. 5-18.

posed by Governments to further several different objectives of economic policy. These include both longer-term objectives, typically related to national development, and those of macroeconomic policy. Controls under the first heading may be intended to ensure that capital owned by residents is invested locally, or that certain types of economic activity are reserved partly or wholly for residents. Although the objectives of development policy are long-term, their achievement may require several different kinds of intervention in the financial system and thus may include shorter- as well as longer-term instruments and operations (including shorter-term international capital movements). Thus, controls on capital flows imposed for macroeconomic reasons are often closely connected to other measures of monetary policy designed to influence holdings of short-term monetary and financial instruments. The objectives of such controls include the avoidance of unwanted appreciations or depreciations of the currency, reductions in the volatility of the exchange rate, and preventing the abortion of domestic monetary or fiscal measures directed at levels of investment or overall expenditure through offsetting inflows or outflows of external financing.

A large number of different measures are available to Governments for controlling international capital movements, some of them with a broad incidence and others aimed more specifically at more narrowly defined sets of transactions.[196] In the case of outflows of foreign direct investment (FDI) or medium- and long-term portfolio investment the controls may take the form of licensing procedures, taxes imposed on purchases of securites abroad by residents, and two-tier exchange rates. Different variants of the latter measure have been used. The most common involves a more unfavourable rate for capital transactions.[197] Inflows of medium- and long-term portfolio investment may also be subject to licensing. Furthermore, they may be limited by ceilings on levels of foreign ownership in some or all sectors (which may include reservation for investment by residents in certain cases). Access to foreign direct investors may be granted only on conditions designed to contribute to development or other national policy objectives.

Controls over short-term capital movements have to contend with the very large number of methods available to take advantage of opportunities for profit in the international markets for financial instruments. Amongst OECD countries such opportunities have progressively increased in response both to the liberalization of the international financial regime and, since the 1970s, to the proliferation of new financial techniques and instruments made possible by the rapid development of computer technology and electronic communications. Short-term capital movements are not necessarily effected via short-term financial instruments, since the profits which motivate such movements may be best achieved through transactions involving longer-term assets, as is often true if there are liquid secondary markets for such assets. Thus, control of short-term movements may include techniques discussed above in the case of foreign direct investment (FDI) and medium- and long-term portfolio investment. But it must also be directed at the many other ways in which individuals and enterprises lend, invest, borrow or otherwise take financial positions at short term, with an actual or potential impact on the movements of funds between currencies.

To some extent this objective can be met by controls on transactions which are clearly of a capital rather than a current nature, such as the buying and selling of short-term financial instruments issued abroad. But in practice control of outward capital movements is likely to be impossible without recourse to more general measures of exchange control, many of which would also typically be part of a regime for restricting payments for current international transactions. These include the requirement for official permission to open foreign bank accounts, limitations on the size and use of currency holdings abroad, restrictions on the amount of foreign currency that can be taken abroad by travellers, and regulations concerning the physical export and import of bills of exchange, securities, insurance policies and

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196 No attempt is made here at a complete classification of controls over international capital movements. For further discussion see, for example, R.W. Edwards, *International Monetary Collaboration* (Dobbs Ferry, New York: Transnational Publishers, 1985), pp. 449-454; A. Watson and R. Altringham, *Treasury Management: International Banking Operations* (London: The Chartered Institute of Bankers, 1986), chap. 7; and R.W. Mills, "An evaluation of measures to influence volatile capital flows" and "The regulation of short-term capital movements in major industrial countries", chaps. 6 and 9 of A.K. Swoboda (ed.), *Capital Movements and their Control* (Leiden: A.W. Sijthoff, 1976).

197 A stringent variant was deployed by the South African government during much of the 1960s and 1970s with the objective of isolating the market for the country's securities among non-residents from that among residents (which, *inter alia*, made it less likely that declines in securities prices would be accompanied by drains of foreign reserves). This was achieved by restricting transactions by non-residents in South African securities to those with other non-residents (and sometimes also limiting transfers of its currency for capital transactions by non-residents to those made through the purchase and sale of such securities).

bank notes. Thus, countries which do not restrict payments for international current transactions have to frame their regimes of capital controls in such a way as to avoid impeding such transactions. This may entail measures designed to ensure that certain payments are indeed for purposes which can be classified as relating to current, and not capital, transactions.[198]

Inward as well as outward capital movements can pose problems for macroeconomic management. Examples of measures directed at such movements since the 1950s as part of macroeconomic policy are provided mainly by European countries. But more recently, as described below in section C.6, there has also been recourse to them by developing countries which have experienced large capital inflows. Controls over inward capital movements include those discussed earlier which are directed at inflows of medium- and long-term foreign investment. Restrictions on inflows may also be extended to other financial instruments, such as short-term money-market paper and fixed-income securities with relatively short maturities. Other measures in this context comprise forbidding banks to pay interest on the deposits of non-residents or even requiring negative interest rates on such balances, limitations on banks' liabilities denominated in foreign currencies, and the imposition of differentially high (and possibly non-interest-bearing) reserve requirements on increases in such liabilities or in banks' liabilities to non-residents. Furthermore, special taxes may be levied on credits from abroad - a measure affecting non-financial as well as financial enterprises - and cash deposits with the central bank, equivalent to a certain proportion of foreign borrowing by non-financial enterprises, may be required, a measure pioneered by the former Federal Republic of Germany in 1972 (the *bardepot*).

The response to unacceptably high capital inflows has also taken forms such as the encouragement of increased foreign investment by financial institutions and intervention in the forward exchange market to encourage short-term capital outflows. An alternative approach to controls and the encouragement of outflows is to attempt to check the inflows through changes in interest rates. However, in the face of capital movements with the potential for generating substantial fluctuations in exchange rates and thus large returns from shifting funds between currencies, the changes would probably need to be very large, and might thus be in conflict with the achievement of other macroeconomic objectives.

C. Regimes for international capital movements

1. *Introduction*

There is considerable variation in national regimes for international capital movements. Amongst OECD countries the long-term tendency has been in the direction of liberalization, although periods of instability in international money markets have often led to widespread recourse to restrictions, subsequently relaxed as calmer conditions returned. The tendency towards liberalization accords with the thrust of the OECD Code of Liberalization of Capital Movements (reviewed in subsection 3) and the pertinent EEC Directives (reviewed in subsection 4). Among developing countries controls over capital transactions remain the norm. However, during recent years there have been substantial changes in the regimes of some developing countries in Latin America and South and South-East Asia. The longer-term thrust of these changes has been in the direction of liberalization, and some of its effects are illustrated by the discussion below in subsection 5. However, more recently the Governments of some of the countries in question have taken measures designed to restrain capital inflows, owing to the problems caused by their rapid expansion (as described in subsection 6).

Obligations regarding international capital transfers are included not only in agreements covering several countries (such as the OECD Code and the EEC Directives) but also in the North American Free Trade Agreement (NAFTA) and in Treaties of Friendship, Com-

198 Foreign exchange controls designed to obtain statistical data or to segregate capital from current transactions are consistent with IMF article VIII which, as described below, is concerned with the elimination of restrictions on current transactions (Edwards, *op. cit.*, p. 394).

merce and Navigation (FCN Treaties). The latter typically include provisions relating to various rights of foreign direct investors such as those regarding entry for business and residence, the practice of professions, the acquisition of property, patents, taxes, the remittance of earnings and capital, competition from State-owned enterprises, and expropriation or nationalization.[199] For OECD countries the provisions of such treaties as to capital transfers have been largely superseded by the multilateral agreements mentioned. In the case of FCN Treaties with a developing country as one of the parties, it is difficult to evaluate how far they have had effects on freedom for external payments going beyond those resulting from obligations undertaken vis-à-vis IMF (described in subsection 2), but any such effects have probably been fairly limited.

2. *The IMF regime*

The only global regime applying to international monetary movements is that of IMF, but the most important obligations in its Articles of Agreement relate to current and not capital transactions. These obligations are set out in articles VIII and XIV. The first of these articles prescribes the obligation not to impose restrictions on payments and transfers for current international transactions without the Fund's approval. The second specifies transitional arrangements for member countries not yet willing to accept the obligations of article VIII. These arrangements permit a country to maintain and adapt to changing circumstances the restrictions on payments and transfer for current transactions in force on the date when it became a member of IMF. At the end of 1992 all of the countries which were members of both IMF and OECD had article VIII status, but this was true of only a minority of the Fund's total membership (80 countries out of 178).

On international capital movements IMF article IV contains the statement that one of the essential purposes of the international monetary system is to provide a framework facilitating the exchange of capital among countries. This statement is included among general obligations regarding exchange arrangements. In the more specific references to capital transfers in article VI.3 provision is made for the exercise by member countries of such controls as are necessary to regulate international capital movements so long as they do not restrict payments for current transactions or unduly delay transfers of funds in settlement of commitments. Section 1 of this article also gives the Fund the authority to request a member country to impose controls to prevent the use of resources from its General Resources Account to finance a large or sustained capital outflow. Interestingly, the language of article VI.1 also reflects a variant of the distinction between longer-term lending and the capital movements required by non-speculative international business, on the one hand, and those due to movements motivated by short-term international differentials in actual or expected rates of return on financial instruments, on the other.[200] Thus, this section of the article states that nothing in it "shall be deemed ... to prevent the use of general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business".

Member countries' right to impose capital controls was further recognized in a 1956 decision of the Executive Board, which states that "Subject to the provisions of Article VI, Section 3 concerning payments for current transactions and undue delay in transfers of funds in settlement of commitments: (a) Members are free to adopt a policy of regulating capital movements for any reason, due regard being paid to the general purposes of the Fund and without prejudice to the provisions of Article VI, Section 1; (b) They may, for that purpose, exercise such controls as are necessary, including such arrangements as may reasonably be needed with other countries, without ap-

[199] The relevant provisions of FCN Treaties are surveyed in F.A. Mann, *The Legal Aspect of Money* (Oxford: Clarendon Press, 1982), pp. 524-530.

[200] In section VII of the 1943 Keynes Plan, "Proposals for an International Clearing Union", which treats the control of international capital movements, attention is drawn to the importance "(a) of distinguishing long-term loans by creditor countries, which help to maintain equilibrium and develop the world's resources, from movements of funds out of debtor countries which lack the means to finance them; and (b) of controlling short-term speculative movements or flights of currency whether out of debtor countries or from one creditor country to another". The dividing line between non-speculative and speculative movements of international financing is not easy to draw, and the quotation above is open to the criticism that it omits shorter-term financing arrangements related to international trade. Nevertheless, thinking like that in the quotation left an inprint on IMF's Articles of Agreement, and some kind of assumptions about the dividing line have since been an explicit or implicit part of the continuing debate about the desirability of, and modalities for implementing, capital controls.

proval of the Fund".[201] The rights specified in this Decision have been understood to include discriminatory currency arrangements for the purpose of controlling capital movements subject to the provisos mentioned. *Inter alia*, they have legitimized liberalization of capital movements within OECD and EEC/EU without any obligation to make its benefits more generally available.[202]

3. The OECD Code

The OECD Code of Liberalization of Capital Movements dates from 1961 and reflects the generally favourable view of its member States concerning the free movement of capital. Nevertheless, for policy purposes the Code discriminates among categories of capital movement. Furthermore, it acknowledges, firstly, that the advantages of free capital movements depend on a country's overall economic and financial position (a consideration which in practice has served to justify granting greater leeway regarding restrictions to OECD countries at lower levels of development) and, secondly, that the social costs of such movements can outweigh their benefits for countries during periods of economic and financial disturbance or balance-of-payments pressures.

Thus, article 1 of the Code states that "Members shall progressively abolish between one another, in accordance with the provisions of Article 2, restrictions on movements of capital to the extent necessary for effective economic cooperation". Article 2 specifies that "Members shall grant any authorization requested for the conclusion or execution of transactions and for transfers specified in an item set out in List A or List B of Annex A to this Code" subject only to reservations as to particular categories of transaction listed in Annex B to the Code, and to derogations granted in certain circumstances.

Large and potentially destabilizing international capital movements can take place through items included in Lists A and B. List A includes direct investment, certain securities transactions and a variety of financial operations linked to international trade in goods and services involving residents, while List B covers, *inter alia*, operations in short-term financial instruments.[203] Capital movements in the former list are judged to have closer links to normal international business in the form of investment, merchandise trade, or cross-border transactions in services. The right to make reservations regarding items in List A is more restricted than for those in List B, and is available only when the item is first added to List A, its definition is extended, or the obligation to liberalize it first applies to a country adhering to the Code. Items in List B are generally regarded as more sensitive, in many cases owing to the likelihood that they will more frequently be part of purely speculative international capital movements. Thus, countries adhering to the Code have the right to enter reservations regarding such items at any time. This flexibility is intended to encourage countries to enter reservations only when clearly necessary and to withdraw them as soon as is feasible since they can enter them again subsequently, a right not available in the case of List A.

Article 7 of the code provides for more general derogations from its obligations. Clauses (a) and (b) allow derogations of a fairly general character - "if [a Member's] economic and financial situation justifies such a course" and "if any measures of liberalization taken or

201 Executive Board Decision No. 541-(56/39), 25 July 1956.

202 Edwards, *op. cit.*, p. 457.

203 In the 1992 edition of the Code List A comprised direct investment and its liquidation; sales of real estate; operations in securities in capital markets (other than those already covered under direct investment); operations in collective investment securities; credits directly linked with international commercial or service transactions in which a resident participates; sureties; guarantees and financial back-up facilities directly related to international trade or international current invisible operations, connected to international capital transactions in which a resident participates, or in all other cases for sureties and guarantees but not for financial back-up facilities; the operation of deposit accounts by non-residents with resident institutions (other than those which are related to operations in money markets); capital transfers arising under life assurance contracts; miscellaneous personal capital movements other than those in connection with gaming; physical movement of securities, of other documents of title to capital assets and of means of payment; and disposal of non-resident-owned blocked funds.
List B comprises purchases or building of real estate; operations on money markets (generally understood as operations involving financial instruments with an original maturity of less than one year); operations in negotiable instruments and securitized claims not included amongst the securities covered by List A or the money-market operations just mentioned; credits granted by residents to non-residents with a direct link to international commercial or service transactions in which no resident participates; financial credits and loans not elsewhere specified in List A or List B; financial back-up facilities in cases not directly linked to international trade, international current invisible operations or international capital transactions, or where no resident participates in the underlying transaction; operation of deposit accounts by residents with non-resident institutions (other than those which are related to money-market operations); operations in foreign exchange not elsewhere specified; and personal capital movements in connection with gaming.

maintained [under the Code] result in serious economic and financial disturbance in the Member State concerned" - and are not in principle limited in time. A number of the less developed OECD member countries have made use of article 7(a). Article 7(b) was invoked by France to justify controls on capital outflows in response to its currency crisis of 1968, and by various countries in balance-of-payments surplus in the 1970s to justify restrictions on capital inflows. Temporary derogation is available under article 7(c), "if the overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious". This clause has been invoked fairly frequently by OECD countries with balance-of-payments problems.

The Code has the legal status of an OECD Council Decision binding on the organization's member countries.[204] Interpretation and implementation of its provisions as well as proposals for the extension of the scope of its measures of liberalization are the responsibility of OECD's Committee on Capital Movements and Invisible Transactions. So long as a country which has made reservations regarding items in List A or List B or which has suspended or not applied measures of liberalization under article 7 complies with the notification and review procedures specified in the Code, it continues to benefit from liberalization by other member countries.

Since 1961 the scope of the Code has been subject to a number of revisions, the most recent being in 1989. The pre-1989 revisions either extended the Code's coverage to new operations and instruments or (in 1984) placed non-resident direct investors on the same footing as residents with respect to the right of establishment.[205] The changes of 1989 resulted in an extension of the obligations of the Code to almost all capital movements, and brought certain items hitherto covered by List B into List A, for which the procedures regarding reservations are more stringent.[206] Some of the newly covered items were placed in List A, some in List B. However, several with special importance in the context of speculative capital movements (such as operations in money-market instruments, operations in negotiable instruments and non-securitized claims not elsewhere specified, and certain short-term credits and loans) belong to the latter group.

As of 1992 only Luxembourg, of the OECD member countries, maintained neither reservations nor derogations under the Code, but for several other countries the number of items covered by reservations was less than 20 per cent.[207] The categories of transaction most subject to reservations since the 1960s have involved the admission of securities to capital markets other than those in the country of the originator and certain types of loans and credits, but there have also been widespread reservations on particular categories of direct investment, operations in real estate, and the buying and selling of securities. Derogations under article 7 increased sharply in the 1970s, in the early part of the decade for capital outflows and subsequently for inflows. Thus, examination of experience under the Code indicates that while there has been a long-term reduction in the number of reservations member countries maintain regarding particular items, the level of derogations under article 7 is likely to remain sensitive to the degree of stability prevailing in international currency markets.

4. The EEC/EU regime

Until the second stage of economic and monetary union comes into force, the main features of the regime for capital movements in EEC countries are those prescribed by the Council Directive on the subject of June 1988.[208] This represented a substantial movement towards complete liberalization in comparison with earlier directives since the beginning of the 1960s. The revisions of the Treaty of Rome agreed at Maastricht in December 1991 reinforce this tendency. With the inception of the third stage of economic and monetary union, the countries adopting a single

204 OECD, *International Direct Investment Policies and Trends in the 1980s* (Paris: OECD, 1992), pp. 47 and 49.

205 OECD, *Liberalization of Capital Movements and Financial Services in the OECD Area* (Paris: OECD, 1990), p. 8.

206 The obligations of the Code were extended to operations on money markets; operations in negotiable instruments and securitized claims not included in List A or among money-market operations; a wide variety of credits and loans both directly connected to underlying commercial and service transactions and not so connected; most categories of sureties, guarantees and financial back-up facilities not previously covered by the Code; the cross-border operation of deposit accounts; the purchase and sale of foreign exchange; and the physical transfer of means of payment. *Ibid.*, pp 52-55.

207 The summary account of reservations and derogations under the Code in this paragraph is based on *Liberalization of Capital Movements and Financial Services in the OECD Area*, pp. 39-47 and 63-72 (which provide diagrams showing the experience regarding the liberalization of different categories of capital movement).

208 See footnote 195 above.

currency will have no further need for a regime covering international capital movements between each other, but there will still be such movements between these countries and the rest of the world.

The 1988 Directive abolishes restrictions on capital movements between residents of EU countries subject only to provisos concerning the right to control short-term movements during periods of financial strain and to take the measures necessary for the proper functioning of systems of taxation and prudential supervision and for the provision of information for administrative purposes, as well as for law enforcement more generally.[209] Moreover, measures directed at the regulation of banks' liquidity are to be limited to what is required for domestic monetary policy (a provision which considerably limits, if it does not actually eliminate, such regulation as part of policy towards international capital movements). The Directive also states that member countries should endeavour to attain the same degree of liberalization of capital movements with third countries as with each other.

The Directive acknowledges that short-term international capital movements may seriously disrupt the conduct of monetary and exchange rate policies, "even when there is no appreciable divergence [between countries] in economic fundamentals". In such circumstances countries affected may be authorized by the Commission to take protective measures with regard to a specified list capital transactions.[210] In sufficiently urgent cases they are permitted to take such action unilaterally, while at the same time initiating consultation procedures with the Commission and other EU countries. The Directive also provides for action, taken after consultation with other member countries, to counteract the effects of monetary and financial disturbances resulting from large short-term capital movements to or from third countries.

Prior to the 1988 Directive the EEC regime for capital movements involved prescriptions which provided Governments with greater leeway for restricting different categories of transaction. According to article 67 of the Treaty of Rome, "During the transitional period and to the extent necessary to ensure the proper functioning of the common market, Member States shall progressively abolish between themselves all restrictions on the movement of capital belonging to persons in Member States and any discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested". Article 73 permitted the introduction of capital controls in response to disturbances in the functioning of a member's capital market due to international capital movements. Articles 108 and 109 authorized the use of protective measures more generally by countries experiencing serious balance-of-payments difficulties.

More detailed guidelines were contained in a Directive of 1960 and another of 1962.[211] These Directives divided international capital transactions into four categories,[212] corresponding to four lists, with different liberalization obligations applying to each. A

209 As in the case of earlier directives, transition arrangements are specified for various countries, mainly those which acceded to the Community more recently than its six original members. These are not discussed further, since they do not affect the thrust of EU policy.

210 The capital transactions included in the list are operations in money-market instruments, operations in current and deposit accounts with financial institutions, operations in units of collective investment undertakings for investment in money-market instruments, short-term financial loans and credits, personal capital movements in the form of loans, the physical import and export of money-market instruments and means of payment, and miscellaneous other short-term capital movements.

211 First Directive (of 12 July 1960) for the implementation of Article 67 of the Treaty (921/60) and Second Council Directive of 18 December 1962 adding to and amending the First Directive for the implementation of Article 67 of the Treaty (63/21/EEC), reproduced in European Communities, Monetary Committee, *Compendium of Community Monetary Texts* (Brussels-Luxembourg, 1974).

212 List A comprised direct investments and their liquidation, investments in real estate, a wide range of personal capital movements, short- and medium-term credits in which a resident participated, specified sureties and other guarantees, transfers under insurance contracts, payments in connection with intellectual property, transfers required for the provision of services, death duties, damages, and certain refunds. For transactions covered by List A EEC countries were to "grant all foreign exchange authorizations required for transactions or for transfers between Member States". In other words such transactions were freed from exchange control (but not necessarily from other forms of regulation). List B covered operations in securities traded on stock exchanges. In this case EEC countries were to "grant general permission for the conclusion or performance of transactions and for transfers between residents of Member States". List C contained the issue and placement of securities, various other securities operations not specified in List B, and various medium- and long-term loans and credits as well as sureties and guarantees not specified in List A. For items in List C EEC countries were to "grant all foreign exchange authorizations required for the conclusion or performance of transactions and for transfers between residents of Member States", unless "such free movement of capital might form an obstacle to achievement of the economic policy objectives of a Member State", in which case the country in question, after consultation with the Commission, was permitted to maintain or reintroduce the exchange restrictions on capital movements operative on the date when the 1960 Directive entered into force. List D contained a set of items which can be the vehicle for short-term speculative capital movements (such as money-market operations, cur-

Directive of March 1972[213] actually required that EEC countries should have available and be able to use certain instruments of monetary policy required for the control of international capital movements and for the neutralization of their effects on domestic liquidity. These instruments included the following: rules governing investments on the money market and payment of interest on deposits by non-residents; the regulation of loans and credits which were not related to commercial transactions or to provision of services and were granted by non-residents to residents; the regulation of the net external positions of credit institutions; and the fixing of minimum reserve ratios, in particular for the holdings of non-residents. This Directive, which was adopted during the period of intermittent turbulence on currency markets of the early 1970s, was repealed as part of the 1988 Directive on international capital movements discussed above.

It is not clear precisely what status the 1988 Directive will have with the beginning of the second stage of economic and monetary union in 1994. The Maastricht Treaty replaces articles 67-73 of the Treaty of Rome with new articles 73a-73g, whose prescription of freedom of capital movements is less qualified. Thus, article 73b states that "Within the framework of provisions set out in this Chapter [on capital and payments] all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited". There continue to be provisos concerning disruptive capital movements both between EU member and third countries (article 73f) and more generally (articles 109h and 109i, which reproduce much of the language on the same subject contained in articles 108 and 109 of the Treaty of Rome, which were mentioned above).

Once the third stage of economic and monetary unions starts, the safeguards provided for in articles 109h and 109i cease to apply to countries moving to a single currency (though they continue for countries with a derogation from this movement). In the case of the single-currency countries, only article 73f regarding disruptive capital movements between EEC members and third countries will remain in force. This article states that "Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB [European Central Bank], may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary". Thus the circumstances in which measures can be taken are carefully circumscribed and the measures themselves are limited in time.

5. *Features of regimes for foreign portfolio investment in some developing countries at the beginning of the 1990s*

The regimes for inflows of foreign portfolio investment and outward capital transfers in a selection of developing countries at the beginning of the 1990s can be used to illustrate the way in which policy concerns regarding these subjects are reflected in such countries' regulations.[214] In this subsection the focus is on the parts of the regulatory framework as of late 1991 or early 1992 which typically were the outcome of an extended process of policy formation and reflected long-term objectives. The responses in some developing countries from 1991 onwards to problems resulting from sharply increased capital inflows are taken up separately in the next subsection.[215]

The countries whose regimes are discussed in this subsection are Argentina, Brazil, Chile, India, Republic of Korea, Malaysia, Mexico, Singapore, Taiwan province of China, and Thailand.[216] The remarks refer mainly to

rent and deposit accounts with banks, short-term loans, and the physical import and export of financial assets). Transactions in such items did not have to be liberalized.

213 Council Directive of 21 March 1972 on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity (72/156/EEC), reproduced in *Compendium of Community Monetary Texts* (*op. cit.*).

214 Large parts of these regimes do not distinguish between portfolio and direct investment. Since this annex is concerned mainly with the more internationally mobile forms of international investment and disinvestment, the discussion here concentrates on regulations pertinent to the former.

215 Other measures by developing countries affecting capital transactions since early 1992 are not covered in this annex.

216 The description of the regimes in these countries is based on IMF's annual report, *Exchange Arrangements and Exchange Restrictions*, that of the International Finance Corporation, *Emerging Stock Markets Factbook*, the report by the United States Department of the Treasury, *National Treatment Study. Report to Congress on Foreign Government Treatment of US Commercial Banking and Securities Organizations, 1990* (Washington, D.C., 1990), and K.K.H. Park and A.W. van Agtmael, *The World's Emerging Stock Markets* (Chicago, etc.: Probus Publishing Company, 1993). Information in these different sources is not always completely consistent.

the situation as of 1991 or early 1992. All of these countries have recently been of growing interest as developing-country destinations for international investment. Of the nine countries in the group which were members of IMF only Brazil and India had not accepted the obligations of IMF article VIII as to the liberalization of current international transactions. As one might expect, the discussion of regulations concerning inflows highlights the influence of policy objectives involving national development and ownership. Restrictions on outflows were more closely related to the exigencies of macroeconomic management and the strength of countries' external payments positions.

In only one country (***Singapore***) were there no restrictions on capital outflows and on direct and portfolio investment by non-residents. While continuing to pursue objectives involving a high degree of indigenous ownership of securities firms, its Government has permitted involvement of its securities markets in global financial trading. The regime for capital movements of ***Argentina*** had been substantially liberalized by a series of measures since 1989. Previously, prior approval was requested for a wide range of inward foreign investments, exceptions being reinvestment of profits and new investments which had no implications for the national ownership structure of the enterprise in question and which were intended to foster the activities for which an earlier initial investment had been approved.

The regimes of the other countries in the sample were characterized by greater restrictiveness. In ***Malaysia*** restrictions on inflows of foreign investment concentrated mainly on ownership levels. Approval of direct or portfolio investment abroad by Malaysian residents was generally not required so long as it was not financed by domestic borrowing. Likewise, the main restrictions on foreign investment in ***Thailand*** involved the reservation of certain activities for nationals. Direct investment abroad (above a certain threshold) and foreign portfolio investment by Thai nationals required official authorization.

In the case of ***Taiwan province of China*** restrictions on inflows of foreign investment were aimed not only at the extent of external ownership and control of the country's economy but also at the quality of investors. Furthermore, policy towards foreign investment was concerned with the effects of associated financial flows on the foreign exchange market. In 1982 the Government introduced a policy of permitting participation by non-residents in Taiwanese equities through mutual funds. In January 1991 the policy of opening was supplemented by allowing qualified non-resident institutional investors to make purchases of Taiwanese shares. In order to be eligible for permission to engage in such portfolio investment, an institution had to be a large and well established bank, insurance company, or fund manager. There was an overall ceiling on the total amount of equity investment by such institutions, and further limits applyed to particular investors and shares. The periods after which remittances of earnings on foreign investments were permitted were fixed by regulation. The central bank scrutinized such remittances with a view to encouraging investing institutions to avoid disturbances in the foreign exchange market.

The focus of regulations in the ***Republic of Korea*** concerning inward foreign investment was primarily local ownership and control of economic activity. Foreign portfolio investment in domestic equities had been possible since 1981 through unit trusts and offshore funds. At the beginning of 1992 these indirect vehicles ceased to be the only available way for foreigners of investing in the equity market, direct purchases of shares being authorized within limits based on a categorization of Korean industries into "limited" (for example, public utilities, defence, shipping, transportation, finance and communications) and "non-limited". Foreign investors were permitted to invest up to 10 per cent of the market capitalization of companies in "non-limited" industries and up to 8 per cent of that in "limited" industries. Moreover, there was a ceiling of 3 per cent on the investment in any company by a particular foreign investor. Investment in the shares of two major enterprises, POSCO (Pohang Iron & Steel) and KEPCO (Korea Electric Power Company), were off limits for foreigners. Repatriation by foreigners of investment income and capital was freely allowed. Overseas investments and loans by residents required official approval. The principal method of attempting to distinguish between current and capital transactions under the regulations concerning exchange control was through the specification of maximum amounts of foreign exchange available for various purposes. Moreover, the export of currency notes above a certain ceiling was permitted only with official authorization.

The regime for international portfolio investment in ***India*** was restrictive and characterized by a considerable measure of administrative discretion (though a process of liberalization for FDI began in 1991). Repatriation of both investment income and capital was subject to controls. Until mid-1991 non-resident portfolio investors in ***Brazil*** were restricted to certain specified investment companies or funds. In July 1991 institutional investors were permitted to set up "omnibus accounts" (portfolios of Brazilian shares held in local custody and administered by local financial institutions). Regulations concerning the repatriation of investment income and capital had recently been liberalized but capital outflows by residents were controlled.

Chile maintained a far-reaching regime for controlling foreign investment in the country and foreign borrowing by residents. Regulations concerning the former appear to have reflected objectives regarding ownership structures and the encouragement of long-term rather than short-term investment. Repatriation depended on the form taken by the foreign investment, and could be subject to restrictions regarding the period which had to elapse before it was permitted. Exchange control was clearly administered with the aim of segregating current from capital transactions by such techniques as ceilings on the amounts of exchange obtainable without restrictions and the requirement of the provision of justification for purchases.

The main objective of ***Mexico's*** regime for inflows of foreign investment was long concerned mainly with levels of foreign ownership. In sectors from which foreign investors were not excluded, the principal vehicle for conserving national control was the issue of shares in different categories, those conferring complete corporate rights on shareholders either being restricted to nationals or, in the case of those also available to foreigners, being limited to less than 50 per cent of the total. As a result of a liberalization of foreign investment in 1989 there was a relaxation of restrictions on foreign ownership, which was henceforth permitted up to a level of 100 per cent in some three quarters of 754 sectors. Repatriation of capital could be carried out freely, and there were no exchange control regulations designed to segregate current from capital transactions.

6. *Policy responses in some developing countries to recent increases in capital inflows*

At the beginning of the 1990s legal regimes for foreign portfolio investment in developing countries typically reflected principally longer-term objectives of the kind exemplified in the previous subsection. But as some countries in South and South-East Asia and in Latin America are increasingly incorporated into the global network of financial markets, they have experienced sharp increases in capital inflows, with the result that there have been shifts in the focus of concern among policy makers. On the scale recently witnessed such capital inflows can exercise significant upward pressure on the recipient country's exchange rate, with potentially unfavourable consequences for its competitiveness and ability to attract foreign direct investment in sectors producing tradable goods and services. The monetary authority may take offsetting action through purchases of foreign currency. But this will generally be accompanied either by a rise in the money supply or, if this is unwanted, by an increase in government debt, which will have an adverse impact on the country's fiscal balance to the extent that the interest payments on such debt exceed interest receipts on the additional foreign reserves. Moreover, policy makers are only too aware that to the extent that the capital inflows are in volatile forms, they are easily subject to reversal, which can substantially complicate macroeconomic management and at worst threaten economic stability.[217]

As a result, several of the recipient countries have had recourse to measures to restrict inflows, which have included various degrees of direct control as well as changes in incentives. For example, minimum conditions have been laid down for external bond and equity issues (Chile); limits have been placed on banks' liabilities in foreign currencies (Mexico) or on their short-term obligations to non-residents (Indonesia); and a queuing system has been implemented to slow external borrowing by private firms (Indonesia). Actions to reduce the profitability of foreign borrowing have comprised the imposition of special reserve requirements on almost all capital inflows (Chile); reductions in the availability, and increases in the cost, of swap facilities at the central bank (Chile, Indonesia); restriction to assets with a relatively low return of the positions which banks can finance with liabilities denominated in foreign currencies (Mexico); and the levying of a stamp tax on foreign credits (Chile). Financial outflows have been encouraged through the relaxation of restrictions on foreign investment by individuals and institutions such as pension funds, and on capital repatriation by foreign firms (Chile, Thailand).

[217] This and the following paragraph summarize the more extensive discussion in *TDR 1992*, Part Two, annex II, and *TDR 1993*, Part One, chap. III, sect. D, and Part Two, chap. III, sect. C.4. They also draw on S. Schadler, M. Carkovic, A. Bennett and R. Kahn, "Recent experiences with surges in capital inflows", *IMF Occasional Paper 108* (Washington, D.C.: IMF, December 1993), chap. IV.

Moreover, risks to foreign lenders and portfolio investors have been increased by a widening of the bands within which exchange rates are permitted to fluctuate (Chile, Mexico).

These measures are unlikely to presage an end to the long-term trend among developing countries towards greater financial openness instanced in the previous subsection. This trend reflects in most of these countries the results of a basic reassessment of policy in this area. Moreoever, it could be reinforced by new international agreements, such as that eventually reached at the Uruguay Round negotiations on financial services[218] or those resulting from a possible extension of NAFTA to other countries in Latin America.[219] But the counterpart of greater openness is likely to be frequent recourse to measures designed to restrain capital inflows - and not just, as in the past, to check capital outflows - when this is seen to be necessary for macroeconomic management or to avoid a loss of international competitiveness. In taking such measures developing countries would be following precedents set by OECD countries during the last 30 years as they progressively liberalized their regimes for international capital flows (see sections B.2 and C.3 above).

D. Some proposals concerning international capital movements

1. *Recent experience and the climate of debate*

The intensity of discussion concerning policy towards international capital movements tends to vary with the most recent experience of the size of the movements themselves, typically being greatest in the aftermath of periods of international monetary turbulence. For instance, there have been the sharpened awareness in some developing countries of the problems which can be caused by such movements, and the resulting policy responses that were described in section C.6. There has also been a revival of debate about international action. This is associated more with the continuing volatility in the markets for OECD currencies, especially those of EU countries, a phenomenon which is none the less also important to developing countries for various reasons. Macroeconomic policy responses to international capital movements on the part of OECD countries have repercussions for developing ones. Moreover, as the global network of financial markets expands, any internationally agreed measures to deal with capital movements will be effective only if they also include some developing countries in their scope.

The debate about control has been accompanied by few ripples in the overall trend of policy in OECD countries which, as described in sections C.3 and C.4, is still in the direction of liberalization. In the EU the monetary turmoil in the autumn of 1992 did lead to the temporary imposition of controls by Spain. These initially (on 24 September) took the form of the introduction of compensatory one-year, non-interest-bearing deposits at the Bank of Spain against increments in open positions in foreign currencies and in peseta-denominated lending to non-residents, and of a rise to 100 per cent in the reserve-requirement ratio for increases in the peseta-denominated liabilities of resident financial institutions vis-à-vis their branches, subsidiaries or parent companies abroad. These measures were revoked shortly thereafter (on 5 October) and replaced by the imposition of compulsory non-interest-bearing deposits against increases in peseta lending to non-residents through foreign exchange swaps. Elsewhere in the EU there was a tightening of the administration of the existing controls on

218 That part of these negotiations involving agreement by countries on their commitments with regard to their markets in financial services has not yet been completed and is currently scheduled to end in 1995.

219 The provisions of NAFTA include the progressive removal of restrictions on market access for foreign financial institutions. Subject to limited qualifications, they also eliminate restrictions on capital transfers (thus going beyond obligations under IMF article VIII). While the latter provisions do not involve additional obligations for Mexico, the former will lead to an opening up of the country's financial sector. But for possible future members of an extended NAFTA analogous provisions might require liberalization of their existing regimes in both areas.

capital movements in Ireland and Portugal. However, the Spanish controls were abolished on 24 November, and remaining exchange controls in Ireland and Portugal were removed in December.

Another period of speculative pressures in the currency markets during the summer of 1993 led to a decision by EU finance ministers to increase the bands for currency fluctuations in the Exchange Rate Mechanism (ERM) to plus or minus 15 per cent around the central rate. (Implicit in this decision was rejection of recourse to measures controlling capital movements more directly.) However, the countries still belonging to the ERM have made at most limited use of the greater freedom for monetary policy provided by the widened bands and appear to be continuing to treat Germany as the point of reference in this regard.[220] Moreover, the provisions of the Maastricht Treaty concerning both capital movements and monetary union remain in place.

Recent debate has been concerned both with the narrower issue of the regime for exchange rates within the EU during the interim before monetary union and with arrangements that would reduce the effects of speculative pressures on the currencies of other OECD countries. While monetary union itself would serve the purpose of eliminating problems due to the volatility of the relative exchange rates of participant countries' currencies, whether transition to it can be successfully managed without measures designed to control capital movements directly remains open to question. For the OECD as a whole, not to mention non-OECD countries, monetary union is not a feasible solution to problems caused by international capital movements. Some of the policy options discussed in this context would entail improved policy coordination or policy convergence. Others (which are the principal subject of the remainder of this annex) would involve more direct intervention in the operations of actors in the currency markets. The latter proposals reflect belief that the benefits of considerable freedom for capital movements overall can be maintained in a system where the disincentives to speculation are increased.

2. *Monetary union*

Countries can avoid the problems caused by international capital markets by forming a monetary union, thus fixing their mutual exchange rates for good. As already indicated, this is the solution to which the EU remains committed under the Maastricht Treaty, although the recent monetary turbulence is likely to push back the timetable for its implementation[221] The establishment of the union will not eliminate capital movements among its member countries, but thereafter unfavourable consequences will have to be handled by means of policy instruments analogous to those available to national Governments for offsetting the undesired effects of monetary movements between the constituent regions of their countries. The single currency of the monetary union can be expected to become one of the world's major currencies, and the union will incorporate a number of major financial centres. Thus, periodic pressures on the single currency are likely as a result of capital movements between the union and third countries. As noted in section C.4, this possibility is acknowledged in the text of the Maastricht Treaty, which provides that safeguard measures (of a rather limited character) may be taken in circumstances where such capital movements are a source of serious difficulties for the operation of the union. This possibility also means that measures to restrain international capital movements will still be of interest to policy makers in EU countries of an eventual monetary union after it is in place.

As also described in section C.4, during the transition to monetary union the Maastricht Treaty provides member countries of the EU with rather greater latitude for action to deal with disruptive capital movements. But it is questionable whether the criteria of eco-

[220] As Sir Leon Brittan, EU Trade Commissioner, put it ("A Europe that deserves support", *Financial Times*, 29 March 1994), "Far from exploiting their monetary freedom after the crisis, most EU countries have followed fiscal and monetary policies consistent with the approach laid down in Maastricht. In fact they have not used the greater freedom given to them by the wider band in the revised ERM". Comparison of figures for the average values of ERM currencies in terms of the Deutsche mark during periods before and after the widening of currency bands at the beginning of August 1993 are instructive as to the effects of these self-imposed limitations. On average between the periods January-July 1993 and August 1993-January 1994 the French franc depreciated 2.4 per cent and the Belgian and Luxembourg franc 3.1 per cent, while the Netherlands guilder actually appreciated 0.1 per cent. The Irish pound was devalued within ERM in January 1993, and on average between February-July 1993 and August 1993-January 1994 it depreciated 1.8 per cent. The Spanish peseta and the Portuguese escudo were devalued in the ERM in May 1993, and on average between June-July 1993 and August 1993-January 1994 depreciated 4.8 per cent and 6.1 per cent, respectively. (The series for ERM exchange rates are from Deutsche Bundesbank, *Monthly Report*, February 1994, p. 92).

[221] Under article 109j of the Maastricht Treaty a decision on the establishment of monetary union may be taken as early as the end of 1996. The latest date envisaged for its establishment is the beginning of 1999.

nomic convergence, which must be met if countries are to qualify as members of the union, can be attained in the face of destabilizing capital movements through sole recourse to the traditional instruments of macroeconomic policy. Three of the convergence criteria relate to the stability of exchange rates, the permissible deviation of interest rates from a benchmark, and the avoidance of excessive government deficits.[222] The condition for qualification regarding exchange rates is that a country must have respected the normal fluctuations margins of the ERM (i.e. those of plus or minus 2.25 per cent around central rates) without severe tensions for at least two years. Moreover, it must not have lowered its bilateral central rate against any other EU member country's currency on its own initiative during the same period. As to interest rates, the condition is that a country must have had an average nominal long-term rate not exceeding by more than two percentage points that of, at most, the three member countries of the EU with the best performance in terms of price stability. Regarding government deficits there are two conditions (subject to certain qualifications); firstly, that the ratio of the planned or actual government deficit to GDP at market prices should not exceed 3 per cent and, secondly, that the ratio of government debt to GDP at market prices should not exceed 60 per cent.[223]

In the event of severe downward pressure on its exchange rate these convergence criteria may present a member country with policy dilemmas. Its currency must be kept within the normal fluctuation margins, and a reduction of the central rate is excluded. However, raising short-term interest rates, a traditional policy response in such a situation, may result in failure to meet the exchange-rate convergence criterion if this step also leads to a sufficiently large rise in long-term interest rates. Moreover, the rise in interest rates, through the resulting increase in the government's debt service obligations and the deterioration in its fiscal balance due to deflation, may also threaten the country's ability to meet the convergence criterion regarding excessive deficits. On the other hand, repeated or extended recourse to article 109i of the Maastricht Treaty, which during the transition to monetary union allows for action limited in scope and time to safeguard a country's external payments position, might well be considered a failure to avoid severe exchange rate tensions and thus also to be contrary to the convergence criterion for the exchange rate. Thus, success in the qualification process for membership of the monetary union might be possible only if a country were permanently to maintain measures to restrain speculative capital movements during the transition. At a minimum such success could well be facilitated by measures of this kind.

3. Macroeconomic policies

Two much discussed approaches to reducing speculative international capital movements and the resulting disorder in currency markets rely largely on macroeconomic policies. One approach, which has been espoused by the UNCTAD secretariat, would achieve this objective as one consequence of policies designed to achieve better management of global macroeconomic interdependence.[224] These policies would aim not only at reducing the volatility of exchange and interest rates but also at achieving a sustainable pattern among countries of external payments positions and the avoidance of inflationary or deflationary bias in the combined impact of policy stances. This approach would entail a commitment by Governments to defend a publicly announced pattern of exchange rates which had been internationally agreed and which was compatible with high levels of activity and employment, together with strengthened multilateral surveillance of the policies of major OECD countries with the objective of ensuring their consistency with the targets set for major macroeconomic variables. The macroeconomic policies would be reinforced by tax and prudential measures intended to exert their influence at the level of transactions and the management of financial institutions (such as those discussed in the next section). This approach would entail more binding policy commitments and tighter surveillance than the series of agreements and declarations concerning policy coordination made by the major industrial countries in 1985-1987.[225] It would also require that more account be taken of the effects of policies on countries other than the major industrial ones, including developing ones.

222 See article 109j and also Protocol on the Convergence Criteria referred to in article 109j of the Treaty Establishing the European Community.

223 Article 104c and Protocol on the Excessive Deficit Procedure.

224 See *TDR 1990*, Part Two, chap. I, sect. D, and the relevant section of the Overview.

225 These included the Plaza Accord of September 1985, the Tokyo Economic Declaration of May 1986, the Louvre Accord of February 1987, and the Venice Economic Declaration of June 1987.

Another approach, recently articulated in studies of international macroeconomic developments by IMF and OECD,[226] would seek to attain currency stability primarily through convergence of macroeconomic policies and economic performance in major OECD countries. The advantage of this approach, according to its proponents, is that it does not require the extensive policy coordination which recent experience shows to be a difficult goal to achieve. Proponents of this second approach are primarily concerned with setting targets for price stability and fiscal deficits. As indicated in the previous subsection, thinking along these lines underlies the convergence criteria under the Maastricht Treaty, which EU countries must meet if they are to qualify for membership of the monetary union. The discussion in that subsection shed some doubt on whether attempts to achieve such convergence solely through reliance on the traditional instruments of macroeconomic policy are likely to succeed. Moreover, it is difficult to conceive extending to the United States, Japan and Canada agreement on convergence targets similar to those in the Maastricht Treaty. Especially in conditions such as the currently prevailing ones of continuing stagnation or low economic growth in the OECD area, efforts to attain convergence targets that emphasize low inflation and fiscal equilibrium can be expected to be a source of global deflationary pressure.

As mentioned earlier, the microeconomic measures for curbing currency speculation which are the subject of the remainder of this annex were proposed in outline by the UNCTAD secretariat in *TDR 1990* as the complement of the macroeconomic policies contained in its proposed package for better management of global interdependence. Consideration of the microeconomic measures in isolation should not be taken to imply that effects which they might have on speculation would not be greatly strengthened by appropriate macroeconomic action. Nor should it be assumed that international agreement on the transactions-tax component of these measures would necessarily be easier to achieve than on the macroeconomic constituents of the proposed package, though with respect to the regulations concerning banks' exposure to foreign exchange risk, as is discussed below, progress towards such agreement has already been made. However, as noted in section A above, much less attention has been paid to such microeconomic measures in debate concerning global monetary stability. Moreover, it can be argued that they would contribute to such stability under regimes for global macroeconomic policies different from that envisaged in the proposed UNCTAD package.

4. A tax on foreign exchange transactions

The proposal for a tax on foreign exchange transactions seems to draw its original inspiration from Keynes, who suggested that the relatively lesser importance of speculative transactions in stocks in London than New York was due to the greater costs in the former, made up of the jobber's "turn", high brokerage charges, and a heavy transfer tax. In this vein he went on to suggest that the "introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States".[227] Since the late 1970s there has been a revival of interest in such a tax on transactions not only in stocks but also in foreign exchange.[228] However, the detailed discussion has been concerned mainly with the version for stocks.

The underlying motivation for a tax on foreign exchange transactions is the same as in Keynes's proposal, namely reduction of incentives to speculation. Proponents also believe that if the profitability of currency trading were

226 See, for example, IMF, "World Economic Outlook Interim Assessment January 1993", *World Economic and Financial Surveys* (Washington, D.C.: IMF, 1993), pp. 19-27, and *OECD Economic Outlook*, No. 53 (Paris: OECD, June 1993), pp. 31-36.

227 J.M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1960), p. 160.

228 A tax on transactions in stocks is discussed in a series of articles in *Journal of Financial Services Research*, No. 3, 1989: R. Roll, "Price volatility, international market links, and their implications for regulatory policies", especially pp. 233-234; S.A. Ross, "Commentary: using tax policy to curb speculative short-term trading"; J.E. Stiglitz, "Using tax policy to curb speculative short-term trading"; and L.H. Summers and V.P. Summers, "When financial markets work too well: a cautious case for a securities transactions tax" (pp. 275-285 of which deal fairly extensively with problems of implementing such a tax in practice). Without going into much detail James Tobin proposed a tax on foreign exchange transactions in his paper, "A proposal for international monetary reform", *The Eastern Economic Journal*, July/October 1978, pp. 155-159. See also D. Felix, "Suggestions for international collaboration to reduce destabilizing effects of international capital mobility on the developing countries" in *International Monetary and Financial Issues for the 1990s. Research Papers for the Group of Twenty-Four*, Vol. III (UNCTAD/GID/G24/3), New York, pp. 56-58, which is primarily concerned with the benefits of a foreign exchange transactions tax for developing countries.

reduced by such a tax, the activity would be the focus of less innovativeness as to new techniques and contracts (innovativeness which, they argue, is of limited benefit to society as a whole as opposed to the financial sector) and would attract fewer well qualified people.[229] In the absence of experience as to the effectiveness of a transactions tax in restraining speculation in the markets for widely used currencies of OECD countries (in contrast to those of certain developing ones), the attention paid to the proposal is due to the lack of plausible alternative solutions to this problem which are not of an emergency character (once the reimposition of direct controls over capital movements is excluded).[230] However, even if adoption of the proposal led to a dampening of speculation, occasional periods of serious turbulence in currency markets could still be expected to occur, during which a transactions tax at the rate envisaged would not be effective in offsetting the short-term profits for traders successfully calling large movements in exchange rates.[231] During such periods recourse to more draconian measures would often continue to be necessary.

There are several problems regarding the design and implementation of a foreign exchange transactions tax. Perhaps most importantly, the tax would require agreement to impose it among all countries with significant financial centres, if foreign exchange business were not to be transferred to those where the tax did not apply.[232] Thus, the agreement would have to cover not only OECD countries but also offshore financial centres. Moreover, as new financial centres emerge in developing countries, these too would have to be brought on board.

A second problem is which agents and transactions should be subject to the tax. With regard to the coverage of agents it can be argued that a tax applying to banks as well as to non-financial actors in the currency markets would not only "throw sand in the wheels of speculation" but also increase the costs to banks of operations necessary to the provision of a service required for the non-financial, non-speculative business of international trade and investment. Typically, banks undertake a number of other foreign exchange transactions among themselves for every one with a non-financial customer as part of the process of laying off the risks of assuming an open position and of price discovery.[233] As to the coverage of transactions, the situation is complicated by the variety of different instruments available to economic actors for taking positions which involve current and future receipts and payments of foreign exchange.

Concerning arguments over the imposition of a foreign exchange transactions tax on banks various points should be considered. In the first place, the fact that banks do provide the foreign exchange service for international business is not a decisive argument in itself against subjecting them to a transactions tax. There is no a priori reason why any economic activity should be exempt from taxation in all circumstances, and postwar tariff-cutting exercises have greatly lowered taxes on international trade. Moreover, while non-banks have been a major source of speculative pressures in currency markets, banks also often assume open positions in these markets and their foreign exchange trading can be an important source of profits (and of losses). Nevertheless, there are other proposals for reducing foreign exchange speculation by banks, that are less open to the objection that they raise the costs of services required by non-financial activities. Such measures involve regulations regarding banks' operations and the management of their balance sheets, and are discussed in the next subsection. If banks were exempted from the transactions tax and subjected to some alter-

229 This point is made for financial markets more generally by James Tobin in his Fred Hirsch Memorial Lecture, "On the efficiency of the financial system", *Lloyds Bank Review*, No. 153, July 1984, pp. 14-15.

230 As two commentators on recent currency disorder in the EU put it, "These measures have disadvantages ... But it is not enough for critics to point to their disadvantages. They must offer an alternative. And they must show that their alternative is feasible ..." (B. Eichengreen and C. Wyplosz, "The unstable EMS", *Brookings Papers on Economic Activity*, No. 1, 1993, p. 121).

231 If transactions in such cases were undertaken in the expectation of profiting from a movement in exchange rates over the period of a month, for example, translation of the expected rate of profit to an annual basis would involve multiplication of the monthly figure by 12. Such a figure explains the exceptionally high interest rates, sometimes of several hundred per cent per annum, often used to defend currencies during exchange crises. Estimating the effect of the tax on the profitability of each such transaction would also require multiplication of the tax rate by 12. However, even so, a uniform tax of 1 per cent of the value of transactions (Tobin's proposal) would usually offset only part of the expected movements in currency prices in the sort of situation discussed here.

232 An analogous argument has proved a telling political weapon in the hands of opponents of a transactions tax applying to the Chicago markets for commodity futures and other derivative contracts. See D. Greising and L. Morse, *Brokers, Bagmen and Moles. Fraud and Corruption in the Chicago Futures Markets* (New York, etc.: John Wiley and Sons, 1991), pp. 65-66 and 141.

233 "Price discovery" refers to the process whereby the prices of foreign exchange (or of other contracts in the markets for financial instruments and commodities) transmit information concerning the current consensus of opinion as to the relative strengths of supply and demand.

native regime, it would be necessary to define the institutions to which this exemption would apply, a matter which takes on particular importance at a time when the distinction between banks in the traditional sense and other institutions providing various financial services is becoming less clear-cut. A solution to this problem would be to limit the number of institutions permitted under their charter to participate in the interbank market in foreign exchange, and to grant exemption from the tax only to institutions having such permission.

As to the question of the transactions to which the tax should apply, these should include not only spot and forward transactions and foreign exchange swaps (which combine the two) but also other contracts involving the obligation or right to exchange currencies at a future date. Thus, the tax should cover spot transactions, outright forwards, foreign exchange swaps, futures and options.[234] Each of the first four of these categories of transaction is obviously capable of moving spot or forward exchange rates. But it might be argued that trading foreign exchange options does not exert direct pressure in the currency markets, since the contracts in question only confer the right to buy or sell currencies at a pre-set exchange rate. However, if options were not covered by the tax, they could increasingly be used as a vehicle through which traders could put themselves in a position to make large speculative purchases and sales of currencies capable of causing significant movements of exchange rates.[235] Such considerations seem to argue for inclusion of options, when exercised, in the scope of the tax.

As already noted, positions in foreign exchange can be taken via several different financial instruments. However, even in the case of some not covered in the previous paragraph, the transactions which the instruments entail often require the exchange of currencies and would thus not escape the tax. For example, cross-currency swaps or cross-currency interest rate swaps[236] involve the swapping by two parties of streams of payments in different currencies. So long as such payments are not subject to complete netting (see footnote 238 below), each involves an exchange of currencies and would be covered by the tax. But coverage would not necessarily apply to all the instruments which can serve as vehicles for taking positions in foreign currencies. For example, back-to-back and parallel loans[237] have long been used by companies to get round impediments to their access to a currency or regulations increasing its cost. Under such arrangements one company lends its country's currency either to another company or to another company's subsidiary in return for an offsetting loan in the borrower's currency for itself or one of its own subsidiaries. Such transactions do not require an exchange of

234 In a spot transaction in foreign exchange the two parties agree to exchange two currencies within two business days. Forward transactions are of two kinds: outright forwards and swaps. An outright forward transaction involves an agreement by two parties to exchange two currencies more than two business days hence. Maturities can vary from a few days to several months (or even, much less frequently, to more than a year). Foreign exchange swaps have two separate legs, one consisting of the sale or purchase of a foreign currency and the other of a repurchase or resale of the currency at a future date (thus reversing the first leg). The initial leg is usually a spot sale or purchase but can also refer to a future date, in which case the transaction is called a forward/forward. Many outright forwards involve non-financial customers on one side of the transaction, while swap transactions take place mainly between banks. The two legs of a swap are part of a single agreement and are priced accordingly, transaction costs being lower than for the corresponding spot and forward purchases or sales undertaken separately. (Other categories of swap, some of them relevant in the context of the proposal for a tax on foreign exchange transactions, are described below.) Futures are exchange-traded contracts specifying delivery of currencies at a specified price at a future date. Both the amounts in the contract and the delivery dates are standardized. Options are contracts giving the purchaser the right (but without any obligation) to buy or sell a certain amount of currency in the future at a pre-set exchange rate. Options may be exchange-traded, in which case the contracts are standardized (as for futures); or they may be sold over-the-counter, in which case contracts can be customized. According to a recent survey of the Bank for International Settlements (*Central Bank Survey of Foreign Exchange Market Activity in April 1992* (Basle, March 1993), table V), spot transactions accounted for 47-49 per cent of activity in the foreign exchange market (the share varying according to the basis of measurement), outright forwards for 6-7 per cent, swaps for 39-40 per cent, futures for 1 per cent, and options for 4-6 per cent.

235 It is of some interest in this context that historically commodity options trading was on occasion accused of disrupting spot and futures markets in the same underlying product. This concern resulted in a ban on trading in several commodity options under the Commodity Exchange Act of 1936 in the United States. See, for example, the brief account in R.J. Teweles, C.V. Harlow and H.L. Stone, *The Commodity Futures Game. Who Wins? Who Loses? Why?* (New York, etc.: McGraw-Hill Book Company, 1974), pp. 228-229.

236 Terminology is not uniform with regard to different categories of swap transaction. Cross-currency swaps sometimes refer to agreements to exchange two currencies at the current exchange rate and to reverse the transaction at a future date. But sometimes the term is also used in the case of transactions involving the swapping of the interest payments as well as the principal of loans denominated in different currencies. The latter transactions are also denoted as cross-currency interest rate swaps.

237 Back-to-back and parallel loans were used, for example, by British and United States companies before 1979 to enable the former to avoid purchasing dollars for the financing of their United States subsidiaries at the less favourable exchange rate prevailing in the market for investment currency under the exchange controls of the United Kingdom.

currencies. However, they do not seem especially well suited to short-term speculation, in part because the agreements frequently contain topping-up clauses under which one party compensates the other for the effects of unfavourable movements in the exchange rate for the two currencies during the period of the loan.

The examples given here are far from exhaustive, and in the event that a tax on foreign exchange transactions were imposed, new instruments or contracts would be likely to be devised or existing ones to be adjusted with the objective of evading the tax or reducing the amounts paid. It would be difficult to design the tax in such a way that it contained safeguards against all such eventualities. A more reasonable approach would be to accept the need for alteration in the design of the tax if the new or adjusted instruments seriously threatened its effectiveness.

Other problems, which are beyond the scope of this the present discussion, relate to the modalities of the tax. For example, the design of the tax would need to take account of several features of interbank transactions if these were to be subject to it. (Indeed, the resulting complications constitute a further argument for exempting interbank transactions in foreign exchange from the tax.) Moreover, the modalities must include the valuation of different categories of transaction involving commitments to currency exchanges in the future as opposed to currently, and the timing of its payment in such cases - whether, for example, the payment of the tax should take place at the initial entry into the commitment or at maturity. Another question under this heading would be the treatment under the tax of netting arrangements which could be used to reduce the amount of currencies actually exchanged in the case of some transactions.[238]

5. *Bank regulation and currency trading*

One alternative to a foreign exchange transactions tax as a means of reducing banks' participation in currency speculation would be the requirement to make non-interest-bearing deposits corresponding to increases in open positions in foreign exchange. Such a measure (as noted in subsection 1), was deployed by the Spanish Government in the autumn of 1992. Since it applies to balance sheet positions, it can be imposed in such a way as to serve as a tax on speculation without being open to the objection that, through its incidence on individual interbank transactions, it raises banks' costs of providing a foreign exchange service for international trade and long-term international investment.

Another approach would be to impose capital charges on banks' open positions in foreign exchange. As in the case of the transactions tax, international agreement would be necessary on the adoption of the measure by all countries with significant banking centres, so as to avoid the danger that foreign exchange business would move to countries where the regulations did not apply. This approach has the advantage of relying on regulations analogous to those already proposed as part of the current initiative of the Basle Committee on Banking Supervision[239] concerning standards for the supervision of banks' market risks including those due to their positions in foreign exchange.[240] Although this initiative is more narrowly directed at objectives regarding the prudential supervision of banks, it would none the less cover the very transactions through which banks can engage in currency speculation.

The regulation of banks' foreign exchange exposure in the major OECD countries is far from uniform. The specification of the contents of such regulation in banking law is much more detailed in some of these countries than in others. However, even in the latter the supervisory authorities can generally be expected to subject banks' management of their foreign exchange exposure to careful scrutiny, whilst in the former supervision in practice may also include matters not expressly mentioned in the relevant legislation. This variation is illustrated in a recent survey of banking regulation in seven OECD countries,[241] which shows that in four of them (Germany, France, United

238 Under such arrangements payments between parties are made only of sums due after a mutual offsetting of obligations.

239 The Basle Committee on Banking Supervision (originally named the Basle Committee on Banking Regulation and Supervisory Practices) was established in the mid-1970s to improve standards of supervision for international banks. Its member countries are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States. The work of the Committee between its inception and mid-1992 is surveyed in Andrew Cornford, "The role of the Basle Committee on Banking Supervision in the regulation of international banking", *UNCTAD Discussion Paper No. 68* (September 1993).

240 The guidelines under discussion are set out in the paper, "The supervisory treatment of market risks. Consultative proposal by the Basle Committee on Banking Supervision" (Basle, April 1993).

241 I. Swary and B. Topf, *Global Financial Deregulation. Commercial Banking at the Crossroads* (Cambridge,

Kingdom and Japan), for example, explicit provisions of regulations as to foreign exchange exposure emphasize levels of capital required in relation to open positions, while in another (Canada) they specify the minimum ratio of liabilities to assets in terms of the national currency for the subsidiaries of foreign banks.

Formal regulations concerning foreign exchange exposure are frequently of a fairly aggregate character. Within the limits laid down therein banks may thus be permitted to assume substantial net open positions for different currencies or for different maturities in a given currency. For example, a small net overall open position for a currency is compatible with much larger net open long and short positions for individual current and future months.[242] Thus, a bank with a small net overall open position might none the less be susceptible to significant profits and losses in response to changes in relative forward exchange rates. Consequently, many banks adopt mismatch limits for internal use going beyond those specified in their countries' regulatory regimes.

The initiative of the Basle Committee is a response to this lack of uniformity. As in other areas of its work, the Committee's objectives are the establishment of minimum supervisory standards both for prudential reasons and to eliminate the unfair competitive advantages that may accrue to banks subject to laxer regulatory regimes. The emphasis of the Basle Committee on capital requirements against positions involving market risk rather than the prescription of limits on such positions reflects its preference for enabling banks to retain flexibility in their financial management by giving them the opportunity to allocate their capital amongst different activities on the basis of their assessment of profiles of risk and return. In the Committee's view this approach also gives banks' additional incentives to use hedging techniques, while providing "a prudent capital cushion" for possible losses. However, the Committee supports the use by supervisory authorities of limits as well as capital requirements in banks' treatment of market risk if they consider that such additional controls are necessary.

The Basle Committee's proposal begins with a specification of methods for measuring banks' exposure due to different categories of currency transaction (as well as to transactions in precious metals, which it regards as closely related to those in foreign exchange). The actual capital requirements would be based on either of two alternative approaches. Under the first, "the shorthand method", the requirement would be 8 per cent of a net open position consisting of the greater of the sum of short or long positions in different currencies plus the total of each net position (short or long) in precious metals, regardless of sign.[243] Under the second approach, "the simulation method", the capital requirement would be set in relation to the worst or near-to-the worst loss which, it is estimated according to a simulation based on the behaviour of exchange rates during some past period, could result from a bank's foreign exchange exposure. The Committee proposes that the capital requirements should apply as at the close of each business day.[244]

This would still leave banks some leeway for speculation, and in the aftermath of the recent currency crises more stringent measures have been proposed. One idea is that the capital requirements should apply not just at the end of business days but also continuously throughout them.[245] In view of the difficulty

Massachusetts, etc.: Blackwell Publishers, 1992), which includes country surveys of Canada, France, Germany, Japan, Switzerland, the United Kingdom and the United States.

242 This would be reflected in a bank's exchange ladder, a management tool which shows receipts and sales of a currency for the current and future months resulting from spot and future purchases and sales. Large net open long or short positions for particular months, resulting from the excess of receipts over outgoings of the currency or vice versa, can to a significant extent offset each other across different maturities, thus giving a relatively small overall net open position. Profits and losses in response to movements of exchange rates are calculated by multiplying the net open position for each maturity by the appropriate new exchange rate. The detailed arithmetic is discussed, for example, in J. Walmsley, *The Foreign Exchange and Money Markets Guide* (New York, etc.: John Wiley and Sons, 1992), pp. 439-442.

243 The same approach to the management of foreign exchange risk is included in the proposed Directive on capital adequacy for member countries of EU. For the 1992 version of this proposed Directive see "Amended proposal for a Council Directive on capital adequacy of investment firms and credit institutions" (92/C50/05), reproduced in the *Official Journal of the European Communities*, Vol. 35, 25 February 1992.

244 The Basle Committee draws attention, in the consultative document referred to in footnote 240, to the opportunities for banks with entities in different time zones to engage in intra-group transactions designed to evade regulations limiting open positions in foreign exchange at the close of business (para. 24). Such opportunities accentuate the need for international agreement among countries with financial centres on the application of capital requirements against open foreign exchange positions. (Examples of the exploitation of such opportunities by a major international bank are given in R. Dale, *The Regulation of International Banking* (Cambridge: Woodhead-Faulkner, 1984), appendix 2.)

245 This proposal is attributed to Javier Alonso, an official of the Bank of Spain, in D. Shirreff, "Can anyone tame the currency market", *Euromoney*, September 1993, p. 60.

of controlling exposure precisely from moment to moment this proposal would mean that in practice banks would need to maintain levels of capital against their foreign exchange positions significantly in excess of prescribed minima.[246]

Continuously applied capital requirements would raise the cost to banks of functioning throughout the business day as market makers in foreign exchange. Market makers are willing to buy and sell at quoted prices (a bid price for buying and an offer or asked price for selling), if necessary taking net long or short positions in a currency since orders to buy and sell are not continuously balancing. This function is generally credited with contributing to the smooth functioning of the currency markets, in particular by reducing the volatility of prices. If performance of the function were to become more costly as a result of continuously applied capital requirements, banks could be expected to increase their spreads between bid and offer prices, thus raising the costs of interbank foreign exchange transactions (and by extension those of providing foreign exchange services to the non-financial sector). Without pertinent experience the size of the latter increase is difficult to forecast but could be expected to be small in comparison to that which would result from the application of a transactions tax to interbank foreign exchange transactions as well as to those between banks and non-bank entities.

Other proposals intermediate between that of the Basle Committee, and continuously applied capital requirements can also be envisaged. For example, banks could assume open positions within specified limits without becoming subject to such requirements. But agreement would probably be difficult on limits which provided banks with the desired degree of flexibility in their foreign exchange operations while also effectively reducing speculation. Alternatively, it might be argued that consultations on the Basle Committee's initiative have their own momentum and would be greatly complicated by attempts to extend it so as to become a more stringent restraint on currency speculation. Then, if after eventual experience of the application of the Basle Committee's initiative in practice such restraint still seemed necessary, continuously applied capital requirements might contribute to achieving it.

6. Proposals and existing regimes

The account in section C pointed to significant differences among countries in the obligations they have undertaken regarding freedom of international capital movements. For developing countries the main regime for international payments to which the great majority is subject is that of IMF. As described in section C.2, IMF's Articles of Agreement are concerned primarily with payments for current transactions, leaving Governments great latitude regarding the regulation of international capital transactions. Thus, measures such as those recently taken by developing countries and described above in section C.6 are not in conflict with their international obligations, and this would equally be true of recourse by such countries to taxes or other measures for the purpose of restraining capital movements on a permanent or quasi-permanent basis rather than as a shorter-term response to external payments pressures.[247]

The obligations of OECD countries in this area are more constraining. The OECD Code of Liberalization of Capital Movements is incompatible with direct limitation or restriction of international capital movements except in circumstances covered by its provisions for derogations. Nevertheless, the Code seems compatible with measures designed to restrain capital transactions by broad, non-discriminatory increases in costs to those engaging in them. This would appear to be true of both the transactions tax and the capital requirements against net open foreign exchange positions for banks described in subsections 4 and 5. But the compatibility of the transactions tax with the obligations of EU countries under relevant Directives and the Maastricht Treaty is less assured. These obligations permit protective measures of a short-term nature in response to the disruptive effects of international capital movements in certain circumstances. But a transactions tax adopted on a more permanent basis, even though its incidence was non-discriminatory, might not be acceptable. As for capital requirements for banks' net open positions in foreign exchange, these are actually part of the Union's own programme for the

246 The capital requirements for securities firms in the United States which apply on a continuous basis have this effect. For example, at the end of 1986 16 such firms reported average net capital 7.3 times larger than minimum legal requirements. (G. Haberman, "Capital requirements of commercial and investment banks: contrasts in regulation", *Federal Reserve Bank of New York Quarterly Review*, Autumn 1987, p. 6.)

247 Some of this freedom may be lost by Latin American countries which are covered by any eventually expanded version of NAFTA. See footnote 219 above.

harmonization of banking regulations in its member countries. Thus, it seems reasonable also to assume that any eventual recourse to a more stringent version of such requirements to restrain currency speculation would be consistent with obligations under the 1988 Directive on capital movements and the Maastricht Treaty. ■

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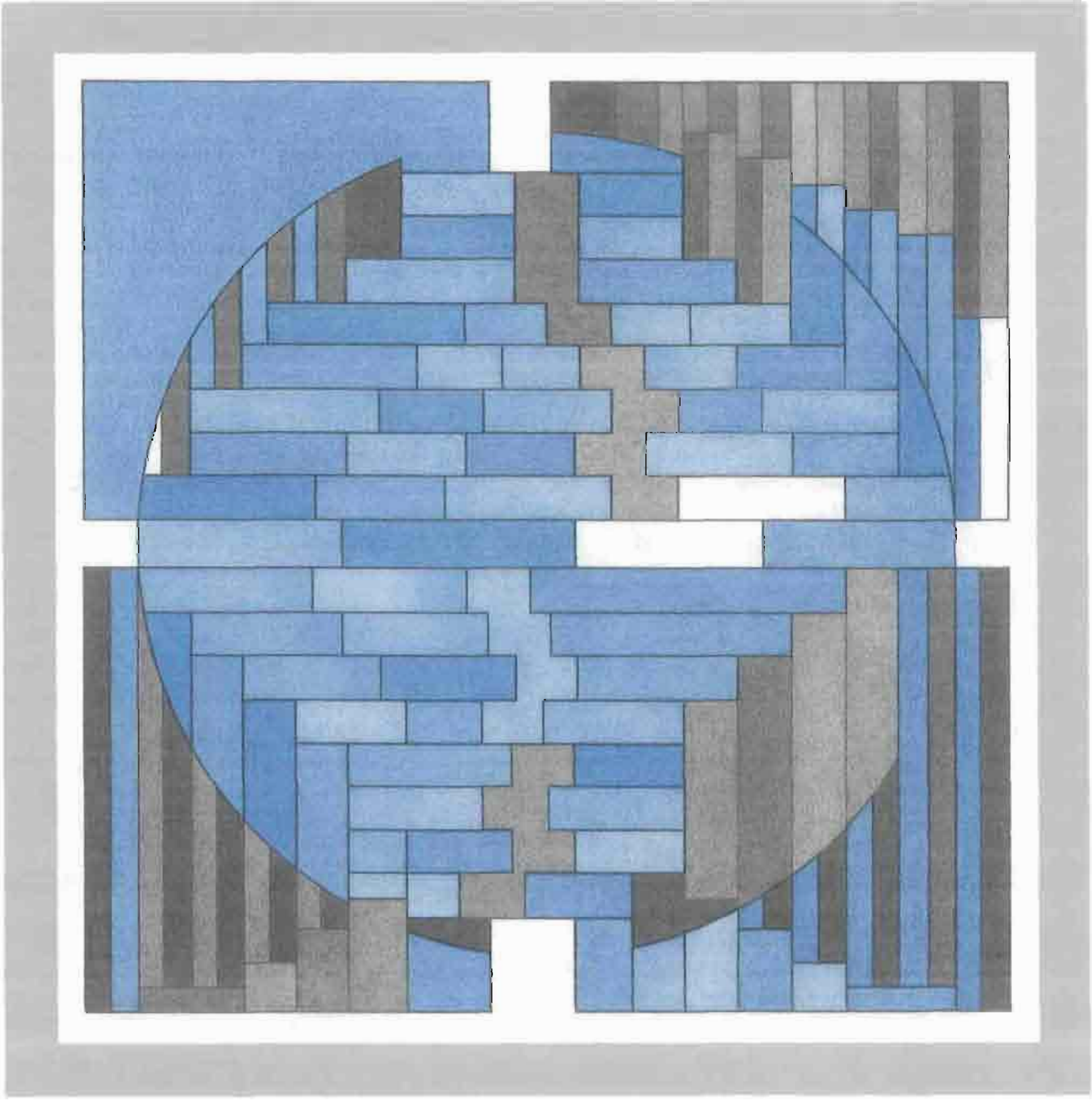
THE URUGUAY ROUND: AN INITIAL ASSESSMENT



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Introduction

The Cartagena Commitment, in its paragraph 144, requested the Trade and Development Board to analyse and assess the outcome of the Uruguay Round, in particular in areas of concern to developing countries, and its impact on the international trading system. This analysis, supported by documentation prepared by the Secretary-General of UNCTAD, should also provide the basis for an identification of the problems and opportunities facing developing countries and countries in transition to a market economy in increasing their participation in international trade in goods and services in the 1990s. This part of the present Report constitutes an initial contribution to this assessment. It should be read in conjunction with the supporting papers, dealing more fully with particular aspects, which will also be before the Board at its forty-first session.[248] The assessment is initial in the sense that there has not been sufficient time since the submission of the final tariff concessions, and of other concessions, notably in agriculture, for an in-depth evaluation of their content or their potential impact on trade flows even for the major trading countries, and the analysis of developing countries' concessions is only beginning. Furthermore, the legislative process has not proceeded far enough in the major trading countries to enable a detailed analysis to be made of the possible impact of the changes in domestic laws and regulations that will be required to implement the Agreements reached in the Round.

The Uruguay Round was officially launched on 20 September 1986 with the adoption of the Ministerial Declaration on the Uruguay Round (generally referred to as the Punta del Este Declaration), but the negotiating process can be considered to have begun as far back as in early 1982 in the preparatory work for the GATT Ministerial Session of November of that year, which established the work programme that provided the elements for the Uruguay Round negotiating agenda. Prior to its final meeting in Marrakesh, Morocco, the Trade Negotiations Committee (TNC), set up at Punta del Este, had met twice at Ministerial level, at the Mid-term Review at Montreal in December 1988, and at Brussels in December 1990.

The Trade Negotiations Committee concluded the Uruguay Round in Marrakesh, on 15 April 1994, with the signing of the Final Act and opening for signature of the Agreement Establishing the World Trade Organization (WTO). Of the 125 countries which formally participated in the Round, 111 signed the Final Act and 104 signed the WTO Agreement, in many cases with the indication that their acceptance was subject to ratification. Seven countries were unable to sign the WTO Agreement because of domestic legislative impediments.[249] In addition, a number of Decisions and Declarations were adopted, including (i) the Marrakesh Declaration containing schedules of concessions on goods; (ii) Decision on the Establishment of the Preparatory Committee for the WTO; (iii) Decision on Acceptance of and Accession to the Agreement Establishing the World Trade Organization; (iv) Decision on Trade and Environment; (v) Decision on Trade in Services and the Environment; (vi) Declaration on the Relationship of the World Trade Organization with the International Monetary Fund; and (vii) Decision on Organizational and Financial Consequences flowing from Implementation of the Agreement Establishing the World Trade Organization (see box 4). The WTO Preparatory Committee will address, among other matters, administrative procedural and legal issues to ensure the effective entry into force of the WTO Agreement, if possible as early as 1 January 1995.

The successful conclusion of the Uruguay Round should result in a substantial strengthening of the multilateral trading system, essentially by: (i) providing much more detailed rules to govern the application of a variety of trade policy measures, particularly those where weak or unclear disciplines had consistently been a source of trade tensions and the subject of trade disputes; (ii) devising new multilateral trade rules to cover intellectual property and trade in services; (iii) achieving a substantial degree of tariff liberalization so as to maintain the momentum towards ever freer multilateral trade; (iv) reducing the discriminatory aspects of regional trade agreements; (v) effectively raising the multilateral obligations of all countries to

[248] *Trade and Development Report, 1994: Supporting Papers* (UNCTAD/TDR/14/Supplement), United Nations publication, Sales No. E.94.II.D.28.

[249] Australia, Botswana, Burundi, India, Japan, Republic of Korea, United States.

Box 4

LIST OF AGREEMENTS CONCLUDED AT THE URUGUAY ROUND (MARRAKESH, 15 APRIL 1994) AND OF RELATED DECISIONS AND DECLARATIONS

I. AGREEMENTS

AGREEMENT ESTABLISHING THE WORLD TRADE ORGANIZATION (to which the following agreements and other texts are annexed):

ANNEX 1

ANNEX 1A: MULTILATERAL AGREEMENTS ON TRADE IN GOODS

General Agreement on Tariffs and Trade 1994

Understanding on the Interpretation of Article II:1(b) of the General Agreement on Tariffs and Trade 1994
Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994
Understanding on Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994
Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994
Understanding in Respect of Waivers of Obligations under the General Agreement on Tariffs and Trade 1994
Understanding on the Interpretation of Article XXVIII of the General Agreement on Tariffs and Trade 1994
Marrakesh Protocol to the General Agreement on Tariffs and Trade 1994

Agreement on Agriculture
Agreement on the Application of Sanitary and Phytosanitary Measures
Agreement on Textiles and Clothing
Agreement on Technical Barriers to Trade
Agreement on Trade-Related Investment Measures
Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994
Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994
Agreement on Preshipment Inspection
Agreement on Rules of Origin
Agreement on Import Licensing Procedures
Agreement on Subsidies and Countervailing Measures
Agreement on Safeguards

ANNEX 1B: GENERAL AGREEMENT ON TRADE IN SERVICES

ANNEX 1C: AGREEMENT ON TRADE-RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS

ANNEX 2: UNDERSTANDING ON RULES AND PROCEDURES GOVERNING THE THE SETTLEMENT OF DISPUTES

ANNEX 3: TRADE POLICY REVIEW MECHANISM

ANNEX 4: PLURILATERAL TRADE AGREEMENTS

Agreement on Trade in Civil Aircraft
Agreement on Government Procurement
International Dairy Agreement
International Bovine Meat Agreement

Box 4 (concluded)

II. MINISTERIAL DECLARATIONS AND DECISIONS

Decision on Measures in Favour of Least Developed Countries
Declaration on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking
Decision on Notification Procedures
Declaration on the Relationship of the World Trade Organization with the International Monetary Fund
Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least Developed and Net Food-Importing Developing Countries
Decision on Notification of First Integration under Article 2.6 of the Agreement on Textiles and Clothing
Decisions Relating to the Agreement on Technical Barriers to Trade
- Decision on Proposed Understanding on WTO-ISO Standards Information System
- Decision on Review of the ISO/IEC Information Centre Publication

Decisions and Declaration Relating to the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994
- Decision on Anti-Circumvention
- Decision on Review of Article 17.6 of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994
- Declaration on Dispute Settlement Pursuant to the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 or Part V of the Agreement on Subsidies and Countervailing Measures

Decisions Relating to the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994
- Decision Regarding Cases where Customs Administrations Have Reasons to Doubt the Truth or Accuracy of the Declared Value
- Decision on Texts Relating to Minimum Values and Imports by Sole Agents, Sole Distributors and Sole Concessionaires

Decisions Relating to the General Agreement on Trade in Services
- Decision on Institutional Arrangements for the General Agreement on Trade in Services
- Decision on Certain Dispute Settlement Procedures for the General Agreement on Trade in Services
- Decision on Trade in Services and the Environment
- Decision on Negotiations on Movement of Natural Persons
- Decisions on Financial Services
- Decision on Negotiations on Maritime Transport Services
- Decision on Negotiations on Basic Telecommunications
- Decision on Professional Services

Decision on Accession to the Agreement on Government Procurement
Decision on the Application and Review of the Understanding on Rules and Procedures Governing the Settlement of Disputes

III. UNDERSTANDING ON COMMITMENTS IN FINANCIAL SERVICES

broadly comparable levels, with differential and more favourable treatment for developing countries being delineated in a more specific, contractual manner; and (vi) linking together the various agreements concluded within a formal, institutional framework (i.e. WTO), subject to an integrated dispute settlement mechanism. A major result has been that a range of measures previously viewed as falling within the scope of domestic policy has been brought under multilateral discipline, and linked to the rights and obligations governing international trade and access to markets.

The detailed elaboration and tightening of multilateral disciplines, the introduction of new concepts and detailed criteria for their application and the improvement of the dispute settlement mechanism provide new scope for action against trade-restrictive measures. This can be expected to encourage countries to initiate litigation to assert and clarify these rights and obligations. In many cases, such obligations codify current practices, sometimes so as to legitimize measures that had been the subject of controversy and might have been successfully challenged if countries had had more confidence in the GATT system. Many of the Agreements negotiated provide technical solutions to practical problems that have arisen over recent years, particularly as between the European Union and the United States; other solutions reached often represent an alignment with the existing practices of one or the other party, and derive from national jurisprudence. In many cases, such alignment has taken place on those national provisions which involve a relatively higher level of discipline; in other cases, however, it has resulted in obligations of less stringency than in current practice. However, certain provisions may still lend themselves to abuse by providing openings for discriminatory measures and trade harassment. In specific cases, decisions by national authorities are relatively shielded from aspects of the dispute settlement process. In summary, WTO members will only be able to derive and maximize the anticipated benefits from the post-Uruguay Round system through active assertion and pursuit of their rights. ■

THE WORLD TRADE ORGANIZATION

According to the Punta del Esta Declaration, the Uruguay Round represented a single undertaking, in the sense that partial results limited to certain issues or sectors would not be an acceptable outcome, the intention being to prevent the continued neglect of sectors such as agriculture and textiles in the process of trade liberalization. However, the possible institutional outcome was not addressed. The idea that the Uruguay Round would result in a new international organization was not foreseen in the Punta del Este Declaration; the first proposals to this effect emerged in 1990, several months before the initial date set for the completion of the Round. The original proponents of a new organization, Canada and EC, presented it as a mechanism for implementing the results within a common institutional framework and for imposing more stringent disciplines to preclude unilateral trade measures. The latter aspect, in particular, led to its endorsement in the final period of the Uruguay Round by most developing countries. However, the United States continued to advocate an alternative solution, which would not have entailed the creation of a new institution, until the very last moment.

The main functions of WTO, as defined in article III of the Agreement, are to facilitate the implementation, administration and operation of the Uruguay Round Agreements, and to provide a forum for negotiations among members concerning their mutlilateral trade relations. The Agreements in question, which are administered within a single contractual framework and are subject to an integrated dispute settlement mechanism, consist of: (a) the General Agreement on Tariffs and Trade 1994,[250] which includes the present General Agreement, with its related legal instruments (termed "GATT 1947"), the series of Understandings reached in the Uruguay Round to interpret several GATT articles, and the Marrakesh Protocol to GATT 1994 (i.e. the results of the tariff negotiations and other concessions on goods);[251] (b) twelve Multilateral Agreements on Trade in Goods (MTAs) - annex 1A to the Final Act; (c) the General Agreement on Trade in Services (GATS) - annex 1B; (d) the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) - annex 1C; (e) the Understanding on Rules and Procedures Governing the Settlement of Disputes - annex 2; (f) an agreement on a Trade Policy Review Mechanism - annex 3; and (g) four Plurilateral Trade Agreements - annex 4, accession to which by a WTO member is optional. Although the WTO Agreement (which has been described as a "mini-charter") is strictly institutional and procedural in character, and has no substantive rules or principles other than those which are included in these annexed Agreements, it commits its members to ensure conformity of their laws, regulations and administrative procedures with the obligations in the Agreements. It also abolishes the "grandfather rights" of the Protocol of Provisional Application which enabled countries to maintain mandatory legislation otherwise inconsistent with their GATT obligations which predated their accession to GATT.[252] The new Organization, which may enter into force as early as 1 January 1995, is to be guided by the decisions, procedures and customary practices of GATT. It provides the framework for the implementation of the results of negotiations, either multilateral or plurilateral, on any issue in the area of multilateral trade relations, and for the linking of such agreements to the overall system of multilateral trade rights and obligations.

The WTO Agreement stipulates that GATT 1994 and GATT 1947 are two "legally distinct" agreements, although GATT 1994 consists of the text of GATT 1947 and its legal instruments, as well as of several Understandings on interpretations and modifications

250 Referred to in the Final Act (and hereinafter) as "GATT 1994".

251 E.g. commitments with respect to subsidies on agricultural products.

252 There is one exception: GATT 1994 provides legal cover for the United States "Jones Act".

of GATT articles and the Marrakesh Protocol containing schedules of concessions on goods. There was not sufficient time for participants in the Uruguay Round to accomplish the delicate legal task of appropriate redrafting of provisions of GATT 1947 that were superseded by those of the WTO Agreement. The pragmatic solution found was to incorporate GATT 1947 by reference, through insertion of an incorporation clause in Annex 1A of that Agreement.

The WTO organizational structure, which is open to all WTO members, consists of a Ministerial Conference, meeting at least once every two years, and a General Council, meeting as appropriate. The General Council will also carry out the functions of a Dispute Settlement Body and a Trade Policy Review Body. Other bodies include a Council for Trade in Goods, a Council for Trade in Services, and a Council for Trade-Related Aspects of Intellectual Property Rights (TRIPs). A Committee on Budget, Finance and Administration, a Committee on Trade and Development, and a Committee on Balance-of-Payments Restrictions will be established by the Ministerial Conference. The Council for Trade in Goods, the Council for Trade in Services, and the Council for TRIPs will establish their respective rules of procedure subject to the approval of the General Council, and any subsidiary bodies they may set up will establish their own rules of procedure subject to the approval of their respective Councils. The Council for Trade in Goods will oversee the functioning of the Multilateral Trade Agreements (MTAs) as set out in Annex 1A, while the Council for Trade in Services will oversee the functioning of the General Agreement on Trade in Services as set out in Annex 1B, and the Council for TRIPs will oversee the functioning of the Agreement on TRIPs, including Trade in Counterfeit Goods, as set out in Annex 1C.

WTO will cooperate with IMF and the World Bank with a view to achieving greater coherence in global economic policy making. The General Council of WTO will make arrangements with other intergovernmental organizations that have related responsibilities to provide for effective cooperation, as well as with non-governmental organizations for consultation and cooperation on matters related to those of WTO. There will be a secretariat of WTO headed by a Director-General.

The WTO Agreement stipulates that "the contracting parties to GATT 1947 as of the date of entry into force of this Agreement, and the European Communities which accept this Agreement and the Multilateral Trade Agreements" and which have submitted their Schedules of Concessions in goods (annexed to GATT 1994) and services (annexed to GATS) "shall become original members of the WTO".[253] There is an exemption from that basic requirement in respect of the least developed countries, which will only be required to undertake commitments and concessions to the extent consistent with their individual development, financial and trade needs or their administrative and institutional capabilities. Countries that become WTO members will retain their status as contracting parties to GATT 1947 (and thus bound by the two legally distinct sets of multilateral obligations) if they do not withdraw simultaneously from the latter.

The Preparatory Committee for the WTO, which was established at the Marrakesh Ministerial Meeting, is mandated to facilitate maximum possible participation in WTO and entry into force of the WTO Agreement as early as possible in 1995 and to ensure that WTO and all its bodies are fully operational from the first day of entry into force of the Agreement. To this end, the Preparatory Committee has established four subcommittees (on Trade and Environment; on Services; on Budget, Finance and Administration; and on Institutional, Procedural and Legal Matters). Their substantive work began in June 1994.

The establishment of WTO will introduce substantial modifications of relevance for the overall system of rights and obligations in international trade. Thus, contracting parties to GATT 1947 wishing to become "original members" of WTO will be required to accept all 12 MTAs, incorporated into the Agreement, without any exceptions or reservations, as well as to submit their schedules of tariff concessions and of specific sectoral and subsectoral concessions with respect to market access and national treatment for trade in services. This will lead to a substantial increase in the scope of obligations for all GATT contracting parties. However, developing countries, in particular, will be faced with a dramatic increase in the level of their obligations as most have emerged from the Round with a much higher level - in some cases across-the-board - of tariff bindings, particularly in agriculture; they have also accepted new obligations flowing from the revised

253 The European Community is not a contracting party to GATT 1947. Article IX:1 of the WTO Agreement states that "Where the European Communities exercise their right to vote, they shall have a number of votes equal to the number of their member States".

Tokyo Round Codes[254] which previously had been accepted by a minority of developing countries only, as well as new obligations with respect to the broad scope of measures covered by the General Agreement on Trade in Services and particularly stringent obligations in the area of intellectual property rights. The Agreement will substantially reduce the flexibility which developing countries have enjoyed under the multilateral trading system with respect to their trade policies and in certain areas previously considered to fall in the domestic policy sphere. These obligations are somewhat mitigated, however, by the provisions on differential and more favourable treatment, which offer a more substantial degree of flexibility to the least developed countries in particular.

Various views have been expressed as to the role that WTO will play in the "new world order". Several of the Ministerial statements at Marrakesh portrayed it as finally taking the place of the stillborn International Trade Organization (ITO) of the Havana Charter and constituting the "missing pillar" of the postwar world economic system - the third "Bretton Woods" institution.[255] However, in discussions in the national legislative context of the implications of the conversion of GATT into WTO views have been expressed that that the new Organization "would not be different in character from the existing GATT secretariat... nor is it expected to be a larger, more costly Organization"[256] and that "the WTO has no more real power than that which existed for the GATT under the previous agreements" and is a "mini-charter" rather than the ITO of the Havana Charter.[257] These differing views naturally reflect the particular political context in which they have been expressed.

The relationship of WTO with the United Nations system and other international organizations remains to be defined. The General Assembly, which has been considering for the last few years issues related to the strengthening of international organizations in the area of multilateral trade, and is expected to pay special attention to this matter at its forthcoming forty-ninth session,[258] could be viewed as the appropriate forum for defining actions needed to ensure the effective cooperation and complementary roles of these organizations.

[254] As of May 1994, 15 developing countries were parties to the Agreement on Technical Barriers to Trade; 2 to the Agreement on Government Procurement; 13 to the Subsidies Code; 11 to the Anti-Dumping Code; 12 to the Customs Valuation Code; 12 to the Agreement on Import Licensing Procedures; 2 to the Agreement on Trade in Civil Aircraft; 10 to the Arrangement Regarding Bovine Meat and 4 to the International Dairy Arrangement.

[255] Address by Peter D. Sutherland, Director-General of GATT, to the World Economic Forum, Davos, Switzerland, 28 January 1994 (*News of the Uruguay Round of Multilateral Trade Negotiations* (NUR 082), p.6.

[256] Submission to Congress by President Clinton, 15 December 1993 (see *International Trade Reporter*, vol. 10 (22 December 1993), p. 2164).

[257] Testimony prepared by Professor John Jackson (University of Michigan) for the hearing of 14 June 1994 of the United States Senate Committee on Foreign Relations. See also *International Trade Reporter*, vol. 11 (13 April 1994), p. 596.

[258] See General Assembly resolutions 45/201, 46/207, 47/184 and 48/54.

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THE KEY AGREEMENTS

The main achievement of the Uruguay Round was in effectively addressing those areas where the absence of international consensus and workable rules and procedures had given rise to frequent trade tensions and disputes which threatened to erode the multilateral system. Failure to reach agreement in these areas would have greatly exacerbated current trade disputes, almost certainly leading to a situation of "trade war", and thus would have seriously jeopardized the stability of the multilateral trading system. The most important results in this context were the Agreements reached on safeguards, subsidies and countervailing measures, anti-dumping, agriculture, and textiles and clothing.

These Agreements reassert, interpret and expand GATT rules in considerable, even minute, detail, and often address a series of technical issues which have given rise to misunderstandings and disputes in the past. In many cases precision has been provided by setting out multilateral disciplines in terms of economic concepts (e.g. "specificity" for subsidies and the Aggregate Measure of Support (AMS) for calculating subsidy commitments on agriculture). This definition of obligations in relation to specific economic criteria, often expressed in precise numerical terms or based on detailed coefficients and formulae, represents a major innovation in GATT practice, where disciplines previously depended upon the interpretation of rules and principles defined in normative terms (e.g. "equitable share", "reasonable expectations"). As noted above, the new approach was particularly useful as a means of giving precision to disciplines in areas such as agriculture and subsidies, and in defining differential and more favourable treatment for developing countries. However, some of these agreements also contain special safeguard clauses, and transitional periods are provided for to lessen the immediate economic impact. For example, the special safeguard measures established in the agreements on agriculture and on textiles and clothing provide mechanisms for shielding domestic producers from the need to adjust to import competition for an extended period.

A. Safeguards

Article XIX is one of a number of GATT provisions which enable countries, subject to specific requirements, to take trade-restrictive actions that would otherwise be prohibited to prevent injury to domestic industries. The article deals with serious injury or the threat thereof caused by increases in imports arising from GATT commitments; it does not address unfair trade practices. The use of article XIX has been declining as more "safeguard" actions have been taken without reference to GATT rules (frequently, in fact, in contravention of them), or under other GATT provisions directed at "unfair" practices, e.g. article VI. An important reason for evasion of article XIX has been the requirement that safeguard action should comply with the most-favoured-nation obligation of GATT, which precluded discrimination among different sources of imports and thus could result in requests for compensation or possible retaliatory action by major trading partners. Another reason, in some countries, was that higher standards of "injury" had been set for this action than for action to combat against allegedly "unfair" practices. The proponents of "selectivity", particularly the

European Community, considered that a solution would be for article XIX to allow Governments to take action in a discriminatory fashion against imports from particular sources on the grounds that "injury" was often caused by the rapid expansion of imports from only one or a few sources, and that only those particular imports need be restrained. The opposition of a majority of contracting parties, particularly developing countries, to any departure from the MFN clause led to the failure to reach agreement on this issue in the Tokyo Round. These two positions continued to dominate the negotiations in the Uruguay Round.

One of the alternative means of obtaining protection against allegedly injurious imports has been the negotiation of voluntary export restraints with individual supplying countries (a measure which had been legitimized for textiles and clothing in the Multi-Fibre Arrangement (MFA) but which spread to many other sectors). The proliferation of these so-called "grey area" measures was regarded as one of the major factors undermining the credibility of the GATT.

For these reasons, agreement on an effective and efficient multilateral safeguard system for the application of GATT article XIX was of paramount importance in improving security of access to markets, particularly for smaller trading countries, and thus for reestablishing the credibility of multilateral disciplines. The Agreement on Safeguards has largely responded to these requirements in that it has clarified and reinforced the disciplines for the application of safeguard measures, in particular by reaffirming the MFN clause and by a clear obligation prohibiting and eliminating voluntary export restraints, orderly marketing agreements and similar measures, which are to be phased out over a four-year period.[259] In addition, the Agreement establishes procedurally fair and transparent investigatory procedures; defines more precisely the criteria for determining serious injury; sets time-limits for the application of such measures; establishes a Committee on Safeguards to monitor and review the operation of the Agreement, and provides for differential and more favourable treatment to developing countries in the form of longer time-periods for maintenance of measures and specific thresholds under which safeguard actions will not be applied against their trade. It rewards countries for their adherence to these disciplines by waiving the requirement for a country taking safeguard action to compensate the countries affected by safeguard measures during the first three years after the action is taken, if the country in question has followed the rules and procedures to the letter. These improvements are designed to enhance security of access and predictability for the international trading community as a whole, particularly developing countries, and to prevent stronger partners from imposing restrictions on weaker partners outside the disciplines of GATT.

However, some serious qualifications exist in this respect. The possibility for the negotiation of quotas with the supplying countries, as well as provisions permitting countries to deviate from strict MFN treatment where there has been a "disproportionate increase" of imports from certain supplying countries (the so-called "quota modulation" provisions), both contained in article 5:2 of the Agreement, could well lend themselves to abuse. Without close monitoring of the implementing legislation and administrative practice of major trading countries and effective surveillance by the Committee on Safeguards, to which such measures must be justified, "quota modulation" could become the rule rather than the exception. These provisions seem inherently skewed against new entrants, in that a situation where imports would increase from a large variety of sources would be rather unlikely, and there is a risk that the "quota modulation" provisions would provide a mechanism for dealing with increases of imports from "troublesome" new entrants without affecting the trade of traditional suppliers. The solution, which reaffirms the MFN principle in one article of the Agreement and qualifies it in another, may be open to different interpretations, so that the effective operation of the Committee on Safeguards will be crucial in this respect.

Furthermore, the very attributes of the Agreement, such as the stringency of the injury test, the intensive multilateral surveillance and limited phase-out periods, could lead countries to make less use of its provisions and encourage importing countries to resort to other protective devices, where the disciplines governing such "trade remedy" provisions are more flexible. Anti-dumping action might be viewed as an alternative in this context.

The Agreement on Safeguards has not yet brought all sectors of interest to developing countries under its auspices. As noted below, the textiles and clothing sector will continue to be subject to a separate regime, with a built-in selective safeguard mechanism for the 10-year transitional period of its integration into the

[259] Each member may claim one specific, mutually agreed, exception, which may be maintained up to 1999.

GATT. Much of the agricultural sector[260] will also be subject to a different safeguards regime, which provides for special safeguard actions in the form of additional duties calculated on the basis of trigger volumes or trigger prices throughout the duration of the reform process, for which no precise termination date has been fixed.

B. Textiles and clothing

Textiles and clothing, the industrial sector of greatest interest to developing countries, has been governed by a special discriminatory trade regime. When developing countries and Japan began to penetrate the world market for cotton textiles in the early 1960s, the United States, followed by other developed countries, sought an arrangement that would permit them to escape certain GATT obligations and to negotiate quantitative restraint arrangements on a discriminatory basis, grounded in the concept of "market disruption", whereby imports from "low-cost" suppliers which were considered likely to cause damage to their domestic industries could be restricted.

Since the inception of the cotton textile agreement, successive negotiations have continually increased its product and country coverage, and intensified its discriminatory character. The regime began with restraints on trade in cotton textiles and eventually extended its coverage to synthetic fibres and wool, thus being appropriately termed the Multi-Fibre Arrangement (formally the Arrangement Regarding International Trade in Textiles). Its renewal in 1986 extended its application to all vegetable fibres and silk blends. Consequently, all fibres, with a few exceptions, are now covered by the MFA. The Arrangement not only restricted export opportunities for developing countries, but has also had adverse effects on consumer prices and costs in the developed countries. Furthermore, it represented a major contradiction to the basic principles of GATT and a threat to the credibility of the system as the mechanisms used to restrict textiles and clothing trade spread to other sectors.

Owing to the strong protectionist lobbies from domestic industries in the developed countries, the previous GATT rounds of multilateral trade negotiations had achieved little in terms of liberalizing trade in the textiles and clothing sector. While each round brought about trade liberalization in products of major export interest to the developed countries, trade in textiles and clothing evolved in an opposite direction. During the Kennedy and Tokyo Rounds, while developing countries pressed hard for the removal or reduction of such barriers in this sector of particular export interest to them, political pressures built up in the United States and the European Community against any dismantling of the protective regime directed against developing countries. In fact, in the Tokyo Round, the European Community obtained MFN tariff concessions from the United States on the understanding that these would be withdrawn ("snap back") if the MFA was not renewed. The phase-out of this discriminatory regime became the main objective of a large number of developing countries in the Uruguay Round.

The Agreement on Textiles and Clothing provides a legal framework for the phasing out of the MFA, leading to the "integration" of this sector into GATT at the end of a 10-year transition period, when the same rules will apply to trade in textiles and clothing as to trade in other goods. All WTO members are required to phase out their existing restrictions during the specified 10-year period. This phasing-out process comprises two aspects: the integration of products into the GATT, through the elimination of restrictions on products currently covered by the bilateral agreements negotiated under the MFA (as existing on 1 October 1994), to be accomplished in four stages leading to their complete removal at the end of 10 years; and an increase in the quotas of the products remaining under restriction, over the 10-year period, according to a fixed growth rate. Restrictions not covered by the MFA will have to be either brought into conformity with GATT 1994 within one year or phased out according to a programme to be presented to the Textiles Monitoring Body (which replaces the Textiles Surveillance Body of the MFA).

260 I.e. for those tariff items where "tariffication" has been applied and which have been specifically indicated in the Schedules as subject to this provision.

The "integration" of products into the GATT (or out of the MFA) is to be accomplished in four stages, with fixed percentages of products to be "integrated" - i.e. MFA restrictions can no longer be applied. On the date of entry into force of the WTO Agreement, each Member shall indicate those product categories which it will immediately "integrate" into the GATT, which should account for no less than 16 per cent of its total volume of 1990 imports of textile and clothing products as defined in the Annex to the Agreement. A further 17 per cent will be integrated on the first day of the 37th month, another 18 per cent on the first day of the 85th month and the rest (i.e. 49 per cent) at the end of the 10-year transition period. The Agreement states in unequivocal terms that all restrictions shall be terminated on the first day of the 121st month that the WTO Agreement is in effect, and "there shall be no extension of the Agreement".

Apart from the criterion that each phase-in has to encompass products from each of the four groups of tops and yarns, fabrics, made-up textile products and clothing, the selection of products is left to the importing countries. It could be expected that the products that had never been subject to restriction would be "integrated" first, while the integration of more sensitive products in each category would be postponed as long as possible. The growth rates which apply to the products remaining under quota during the transition period (in steps of 16 per cent, 25 per cent and 27 per cent), given that they are calculated as percentages of percentages, will be meaningful to the extent that significant growth rates are provided in the bilateral agreements existing at the date of entry into force of the WTO Agreement. It seems likely that the decisions relating to the choice of products to be integrated will involve an element of negotiation with the interested exporting countries. There is a risk that article 7 of the Agreement, which vaguely links the integration process to other Uruguay Round commitments, including tariff concessions, will be used to justify delays in the implementation programme or as a basis for selecting products for "integration" in the light of further negotiations with exporting countries. Developing countries have firmly resisted any suggestion that they should be asked to "pay" for the abolition of what constitutes a derogation from GATT obligations.

Furthermore, the "end-loading" of the integration process, which postpones the integration of 49 per cent of each country's textile imports to the last day of the transitional period, has given rise to concern in that it is felt that protectionist forces will make use of this time to attempt to build up sufficient political pressure to achieve a postponement of the final stage. The growth rates applied to the restrictions maintained throughout the transitional period will have little mitigating effect with respect to product categories where the initial negotiated growth rates are low, as is likely to be the case for sensitive product categories, where integration will be postponed to the end of the 10-year period.

During that period new restrictions can be negotiated or imposed under a "transitional safeguard mechanism" (article 6), on a discriminatory basis, when importing countries determine that imports of textile and clothing products are causing "serious damage" to their domestic industries. Such safeguards cannot, however, be applied to those products that have been "integrated" into the GATT - i.e. removed from the coverage of the bilateral agreements as part of the above-mentioned process. They may, however, be applied against imports from countries that had never participated in the MFA, as well as from those that never restricted imports under the MFA (including those that were not signatories), if the countries applying them notify their intention to make use of this clause. It should be noted that the MFA was applicable only among its signatories, whereas the Agreement on Textiles and Clothing and its various procedures and mechanisms apply to all members of WTO. The Agreement also includes special provisions to deal with problems of "circumvention" such as by transshipment, rerouting, false declarations of country of origin and falsification of official documents.

This Agreement is particularly important in that, in the case of previous GATT Rounds, the granting of authority to the executive branch to participate in negotiations by the legislature was made conditional upon guarantees that the discriminatory regime for textiles and clothing would be maintained and extended. It was actually a condition for the executive branch (particularly in the United States) to obtain the necessary negotiating authority to participate in the Kennedy and Tokyo Rounds.[261] The agreement to phase out the MFA, despite the length of the transitional period, represents a serious setback for protectionist interests, not only in the developed "importing " countries, but also for the "quota farmers" in the exporting countries who also benefited from the economic rents.

261 The negotiation of the Long-term Cotton Textiles Agreement and the MFA can be viewed as conditions for the United States Executive Branch to participate in the Kennedy and Tokyo Rounds, respectively.

C. Subsidies and countervailing measures

Throughout the history of GATT, subsidies have been one of the main causes of trade tensions and disputes, mainly because no international consensus existed as to the appropriate role of Governments in supporting investment, production and trade. The main constraint on subsidized exports was not the provisions dealing with the use of subsidies *per se* in GATT article XVI, but the recourse to countervailing duties by a limited number of countries in order to prevent "material injury" to domestic industries under article VI. Developed countries accepted not to grant export subsidies on non-primary products and agreed on a list of export subsidies which would be prohibited. These became an important element of the Subsidies and Countervailing Duties Code negotiated in the Tokyo Round, in which the United States renounced the cover of the Protocol of Provisional Application (i.e. the "grandfather" clause of GATT), so as to apply the test of material injury to those countries that accepted the Code, including a number of developing countries which agreed to enter into commitments to phase out their export subsidies.

The Agreement on Subsidies and Countervailing Measures reached in the Uruguay Round differs considerably from the Tokyo Round Code in its approach and, like all the Multilateral Trade Agreements in the Final Act, will apply to all WTO members. For the first time it contains an agreement on the definition of a subsidy. A subsidy is defined as involving "a financial contribution by a Government or any public body" and "a benefit is thereby conferred". The financial contribution may involve a direct transfer of funds, potential direct transfers (such as loan guarantees), the forgoing of revenue by the Government, or the public provision of goods or services, other than infrastructure, or the government purchase of goods; or any form of income or price support. The Agreement also establishes the legality of subsidies, identifying those which are to be prohibited, permitted (i.e. "non-actionable" - in not being exposed to the possibility of remedial action), or applied only if they do not adversely affect the trade interests of other countries. Subsidies contingent upon export performance or upon the use of domestic in preference to imported goods are prohibited.

"Specificity", a concept derived from United States practice, is a central concept in the Agreement. Remedies provided against "prohibited" or "actionable" subsidies can only be applied if a subsidy is "specific" to an enterprise or industry or group of enterprises or industries. Subsidies which are not "specific" (i.e. where access is generally available or granted on the basis of objective criteria or conditions, and not limited to certain enterprises or industries) are not actionable unless it can be demonstrated that they are specific in practice.[262] Furthermore, article 8:2 provides that specific subsidies for industrial research and pre-competitive development activities (subject to precise conditions and tests), subsidies to disadvantaged regions within a country, and subsidies to adapt existing facilities to new environmental requirements are "non-actionable".

Other subsidies are "actionable", either in the form of countervailing duties, if they cause material injury to domestic producers, or through remedial action, if they nullify GATT benefits or if they cause serious prejudice to the interests of other members by displacing or impeding imports into the national market or displacing exports to third-country markets, by resulting in significant price undercutting, or by permitting an increase in the world market share of a primary product or commodity. The Agreement also contains clearer rules for recourse against trade-distorting subsidies; some subsidies are deemed *prima facie* to cause serious prejudice to other countries' trade interests, including those where ad valorem subsidization exceeds 5 per cent and those aimed at covering operating losses of enterprises or the direct forgiveness of debt. The thrust of these provisions is to provide countries with effective recourse against subsidies which displace their exports abroad. The Agreement also provides more specific rules governing the initiation of countervailing duty investigations, an improved causal link between subsidization and injury, as well as a

262 For example, the granting of disproportionately large amounts to certain enterprises.

"sunset clause" provision, which will correct situations where countervailing duties were imposed for lengthy periods even after the removal of the subsidy which had provoked them. Such provisions are aimed at reducing the scope for countervailing duties to be used as a "trade remedy" device for harassing imports. However, the Agreement codifies the practice of cumulation of injury, a matter of particular concern to developing countries, which will facilitate injury finding in investigations involving several countries, including small suppliers.

It should be noted that the three specific categories of "non-actionable" subsidies serve to exempt from the disciplines of the Agreement key subsidy programmes of certain developed countries (e.g. EU, Canada). However, in order to retain their "non-actionable" status, notification of such subsidy programmes must be made to the Committee on Subsidies and Countervailing Measures; if not, they would lose this status and be exposed to possible countervailing duties. In fact, the provisions on non-actionable subsidies run for five years only, and are to be reviewed six months before the end of that period. Pressures to eliminate this status are already in evidence.

In recognition that subsidies may play an important role in the economic development programmes of developing countries, the Agreement, in article 27, contains specific and rather complex provisions for differential and more favourable treatment for developing countries, particularly with respect to subsidies that would otherwise be prohibited, laying out a set of "graduation"criteria. Special exemptions are provided for least developed countries and for a specific list of developing countries, which will benefit from these exceptions so long as their per capita income remains at less than $1,000 per annum (the so-called "Annex VII countries").[263] Other developing countries are to phase out their export subsidies over a 10-year period. When a developing country becomes "competitive" in a given product, defined as reaching 3.2 per cent of world trade in the product for two consecutive years, it must eliminate export subsidies on that product over two years (for Annex VII countries the period is eight years). In the case of actionable subsidies, developing countries are exempted from the assumption of prejudice and benefit from *de minimis* thresholds in the application of countervailing duties. The Agreement also contains provisions which recognize the importance of subsidies in the transition process to a market-based economy, providing such countries with important exceptions from the prohibition on export subsidies for a seven-year period, which can be extended.

In addition, subsidies on agricultural products are generally excluded from the disciplines of the Agreement (as they are covered by the Agreement on Agriculture). In anticipation of the negotiation of specific rules on subsidies in the context of the revision of the Agreement on Trade in Civil Aircraft, certain provisions of the Agreement, e.g. ceilings for research and development grants, do not apply to that sector. Furthermore, it is expected that the Multilateral Steel Agreement currently under negotiation will also include special rules on subsidies.

D. Agriculture

Trade in agriculture has been traditionally characterized by a considerably lower degree of multilateral discipline and market access commitments than those governing trade in industrial products. While the original GATT provisions provided for some exceptions for agricultural products subject to price supports, the major trading countries succeeded, through waivers, unbinding of duties, etc., in effectively evading obligations that would restrict their freedom to protect and subsidize domestic agricultural production and exports. This led to a situation of overproduction, border protection and export subsidy competition, which was the cause of an almost continuous series of trade disputes, and had a major adverse effect on developing country exporters of agricultural products.

263 Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe.

Attempts in previous rounds of multilateral negotiations to impose tighter disciplines on agricultural trade policies were unsuccessful, but from the beginning of the Uruguay Round it became evident that there could be no final agreement without a major agricultural package. The Cairns Group of exporting countries, which included both developing and developed countries,[264] was a major force in the earlier stages of the negotiations. This group, or at least some of its members from Latin America, consistently refused to accept decisions that would have implied a minimalist approach to agricultural trade liberalization, as manifested in their rejection of the deals reached among developed countries at the Montreal and Brussels Ministerial Meetings of the Trade Negotiations Committee. Another group of developing countries, net importers of foodstuffs, perceived that the proposed solutions with respect to agricultural subsidization would result in increases in the cost of their food imports, and adopted a coordinated approach to seek a solution that would mitigate the difficulties they would face.[265] Their efforts resulted in the Ministerial Decision described below.

In the latter stages of the negotiations, agriculture tended to be dealt with on a bilateral basis between the European Community and the United States. When the text included in the 1991 draft Final Act (the "Dunkel text") was not found acceptable as a basis for negotiation by EC, it subsequently conducted bilateral negotiations with the United States, reaching the preliminary "Blair House" agreement in late 1992, and obtaining further modifications to this text in the final weeks of the Round.

The Agreement on Agriculture takes what may be described as the first step towards stability and predictability in trade in agricultural products, and provides a framework for further negotiations aimed at more meaningful liberalization.[266] It represents what could be described as a binding "standstill and rollback" of protectionist measures in this sector. However, so long as Governments operate within the "frontiers" established in numerical terms in the Agreement, they are free to apply a wide range of policy options, in most cases without being exposed to challenge under the WTO provisions.

The first major element of this framework is tariffication: all measures affecting imports of agricultural products will have to be converted into bound customs duties (including such measures as quantitative import restrictions, variable levies, minimum import prices, non-tariff measures maintained through state-trading enterprises, voluntary export restraints, etc). These tariff rates (which also include any pre-tariffication duties) are to be reduced by 24 per cent over a 10-year period by developing countries and by 36 per cent over a six-year period by developed countries. These reductions are calculated on a simple average basis, with a minimum rate of reduction of 10 per cent for each tariff line for developing countries and of 15 per cent for developed countries. In many important agricultural sectors, the tariffication process has resulted in the establishment of tariff rates that may prove to be as prohibitive as the non-tariff barriers they replaced, often reaching levels, in the major developed countries, in the range of 200-500 per cent ad valorem.[267] The reduction formula thus enables countries to confine their reduction on such tariffs to 15 per cent, while still conforming to the 36 per cent overall average by eliminating low tariffs on other products.

Special exceptions from immediate tariffication were provided to take into account the problems of Japan and the Republic of Korea in the rice sector, whose obligations were confined to minimum access opportunities for products meeting the criteria for "special treatment" specified in Annex 5 of the Agreement on Agriculture.[268]

In many sectors the tariffication process thus will not, in itself, provide any significant improvement in market access conditions. Where there were hitherto no significant imports, the only available access will be that provided by the minimum access commitment, under which countries are obliged to open a tariff quota equivalent to 3 per cent of domestic consumption, to be increased to 5 per cent over

264 The Cairns Group originally included Argentina, Australia, Brazil, New Zealand and Uruguay which were later joined by Canada, Chile, Colombia, Hungary, Indonesia, Philippines, Malaysia, Thailand and Fiji.

265 The initial group consisted of Egypt, Morocco, Jamaica and Peru, which were supported by other developing countries, particularly African countries.

266 The text of the Agreement should be read in parallel with the Note by the Chairman of the Market Access Group on Modalities for the Establishment of Specific Binding Commitments under the Reform Programme (MTN.GNG/MA/W/24, 20 December 1993).

267 This is sometimes the result of what has been termed "dirty tariffication" i.e. in excess of what would have been expected given the difference between prevailing world and domestic prices.

268 Under its Schedule of concessions Japan will provide a quota increasing from 379,000 to 758,000 tons over the six-year period, at rates ranging from zero to 25 per cent for various forms of rice.

six years. These tariff quotas will not necessarily provide duty-free access but should be at substantially reduced rates.[269] Where imports were hitherto globally or from specific countries, governed by quantitative restrictions, voluntary restraint arrangements or specific arrangements providing for reduced import levies, these suppliers will be allocated tariff quotas to preserve their "current access opportunities", which will also be enlarged over the six-year period. Many of the tariff quotas have thus been allocated to specific suppliers. Where imports already account for 5 per cent of consumption, the existing quota levels have usually been maintained without increase.

The second major element of the new disciplines on agriculture is the commitment to bind and reduce support to domestic producers of agricultural products. Unlike the general normative disciplines on subsidies, the solution has been aimed at specific results, i.e. a 20 per cent reduction of the "Aggregate Measure of Support" (AMS), rather than to discipline particular policy measures. Governments are thus left to choose from a variety of policy options in achieving these results. Exceptions from this requirement to reduce support include (i) subsidies deemed to have a minimum impact on trade or "decoupled" from domestic production, which are listed in Annex 2 to the Agreement (the "Green Box"), (ii) cases in which domestic support constitutes less than 10 per cent of the total value of production for developing countries, or 5 per cent for developed countries, on a general or product-specific basis where relevant, and (iii) direct payments under production-limiting programmes. Although phrased in generic language, this last provision is primarily intended to cover the EU "compensation payments" and the United States "deficiency payments"). In addition, developing countries are provided with exemptions with respect to investment subsidies, agricultural input subsidies, or those applied to encourage diversification out of illicit narcotic crops.

The domestic support reduction commitments are applied on an aggregate, as opposed to a product-specific, basis, usually consisting of one page in each country's Schedule.[270] Consequently, support to production may be shifted among commodities, thus achieving effective "rebalancing" among sectors and permitting the application of much lower reductions to targeted sectors. This provision, combined with the formula for tariff reductions described above, enables countries to retain high rates of protection and subsidization in selected product categories.

The third element is the bound reduction of export subsidies, which are defined in article 9:1 of the Agreement. These are to be reduced by 24 per cent in terms of value (budget outlays) and 14 per cent in volume over a 10 year-period by developing countries. For developed countries the corresponding figures are 36 per cent, 21 per cent and six years. Unlike the commitments on domestic subsidies, these commitments are laid out in detailed schedules, indicating the budget outlay and quantity commitments for each year of the implementation period on a sectoral basis. In addition to the different time-limits and levels of reduction, developing countries are provided with differential and more favourable treatment in the form of exemptions from commitments to reduce subsidies aimed at lowering the cost of marketing exports, including internal and international transportation and freight.

The liberalizing impact of the Agreement is affected by a special safeguard clause which permits members to impose an "additional duty" on imports of those items subject to tariffication, if the volume of imports of a given product exceeds a "trigger level" in terms of percentage of domestic consumption or when import prices fall below a"trigger price" based on a 1986-1988 reference price. The amount of the additional duty is a function of the difference between the import price and the trigger price (i.e. similar to a variable levy). Measures taken under this provision (article 5) are shielded from recourse by affected countries under the Agreement on Safeguards. This pre-eminence of the Agreement on Agriculture is futher confirmed by the "peace clause" (i.e. article 13, Due Restraint) which ensures that actions taken in "full conformity" with the provisions of the Agreement on Agriculture cannot be challenged under the related provisions in the Agreement on Subsidies and Countervailing Measures, nor even under certain aspects of the Dispute Settlement Understanding.

269 In the EU Schedule rates range from zero to 23 per cent and frequently involve specific duties. In the United States, tariff quotas generally take the form of positive, combined (i.e. ad valorem and specific) duties.

270 The United States has accepted a commitment to reduce its AMS from $23 billion to $19 billion; Japan from Y4,800 billion to Y3,900 billion; EU from ECU 73 billion to ECU 61 billion, accompanied by special commitments with respect to oilseeds.

E. Anti-dumping

Negotiations on the Agreement on Implementation of Article VI of GATT 1994 constituted the third attempt to clarify the GATT rules on Anti-Dumping Measures, the first Anti-Dumping Code having been negotiated in the Kennedy Round and the second in the Tokyo Round. Problems relating to the application and administration of anti-dumping systems, and the increased recourse to anti-dumping actions, became more pronounced before and during the Uruguay Round. In addition, developing countries which had adopted anti-dumping legislation in the context of the liberalization of their import regimes began to resort to such actions. In the period 1989-1993, the number of anti-dumping actions initiated almost tripled. Exporting countries, including many developing countries, alleged that the suppliers concerned either were not exporting at prices lower than those in their domestic markets or that their exports were in fact causing injury. Major importing countries were concerned that exporters were engaged in innovative practices to circumvent or to evade anti-dumping duties. Negotiations in this area were conducted in a very opaque manner; for example, no text was available until the draft Final Act was presented in December 1991.

The Agreement provides more detailed rules on the procedures for initiating investigations, rules governing the calculation of dumping margins, rules for the determination of injury or threat thereof, and requirements for the review of findings and understandings. These rules are aimed at introducing more transparency into domestic rules and procedures and provide for greater scrutiny by administrative officials of the information contained in complaints, a clear requirement that positive action must be taken to ascertain industry support for the complaint, a major reduction in the scope for a determination of dumping based on inappropriate methodology, and a requirement to review anti-dumping measures within a five-year period.

Negotiations in this area were characterized by the process of alignment with the practices of either the European Union or the United States, drawing on the experience acquired in the application of the Tokyo Round Code. In some instances, this process resulted in alignment with the more stringent regulations or practices, such as acceptance of the EU practices on calculation of sales below production costs. Other areas where more stringent disciplines were accepted include the treatment of exchange rate conversions and the adjustments for costs affected by "start-up operations". However, in other cases, such as the threshold for determining whether a "major proportion" of the industry supports an anti-dumping complaint, the opposite has occurred. In some cases, certain procedures codified in the Agreement, for example that of "cumulative injury assessment", had been the subject of complaints from developing countries

It would seem particularly important for developing countries to monitor closely the process of adoption of these requirements into domestic law by the main users of anti-dumping duties. Traditional complainants appear to be attempting to use the current process of the introduction of new anti-dumping legislation to include more restrictive rules (which would be permitted, but not required, by the Agreement). Even more than in other areas, unless the positive aspects of the Agreement are faithfully incorporated into domestic laws and procedures, the Agreement could result in a reinforcement of the ability of users of anti-dumping legislation to harass and limit trade.

Furthermore, article 17.6 of the Agreement, in deference to both United States and EU practice, subjects anti-dumping actions to a less stringent standard of review in dispute settlement procedures than that applied in the case of other Agreements, obliging panels to accord relatively greater deference to the decisions of the administering authorities, and to the provisions of the implementing legislation, and thus opening up possibilities for multiple interpretations of the Agreement. For these reasons, and in view of the relatively greater stringency introduced in the other Agreements discussed above, recourse to anti-dumping action may become even more the preferred "trade remedy" for protectionist interests.

The liberalization of import regimes resulting from the Uruguay Round and the increased stringency of other Agreements may make anti-dumping measures a relatively attractive tool for protection. Anti-dumping action can be described as a "rich man's trade remedy" in the sense that it requires adequate financial and human resources to carry out the investigations and other procedures required by the Agreement. Many developing countries are in the process of introducing anti-dumping legislation. Inability to observe basic procedural requirements might expose them to successful challenges by developed countries under the dispute settlement mechanism.

At the Marrakesh meeting, Ministers decided that the issue of circumvention would be remitted to the Committee on Anti-Dumping Practices, on account of the failure of negotiators to agree to a suitable provision. Provisions to address circumvention of anti-dumping measures already exist in several national legislations. There is a danger that, unless controlled by the institutional machinery of WTO, unilateral actions will threaten the stability and security of market access concessions.

F. Trade-related investment measures

The negotiations on trade-related investment measures (TRIMs) derived from the perception, particularly in the United States, that measures applied to regulate foreign investment had a distortive effect on trade. In the early 1980s the United States initiated a major dispute under GATT article XXIII with its largest trading partner, Canada, as a result of which it was established that certain of these measures did, in fact, contravene the GATT. This was an encouragement to pursue the issue in the Uruguay Round. However, during the first years of the Round some developed countries attempted to use the issue of TRIMs to negotiate multilateral obligations with respect to the treatment of investment *per se*, in pursuit of their longstanding objective of obtaining the multilateral acceptance of such principles as a "right of establishment" and "national treatment" for transnational enterprises, and to link such principles to the multilateral trading system. Due to the strong response of a group of developing countries, negotiations finally concentrated on compatibility with the GATT of measures which linked investment to trade in goods.

As a result, the Agreement on TRIMs does not introduce any new obligations, but merely prohibits those TRIMs that have been judged inconsistent with GATT obligations regarding National Treatment on Internal Taxation and Regulation (article III) and the General Elimination of Quantitative Restrictions (article XI). These include (a) local content requirements (inconsistent with the national treatment obligation), such as those which require the purchase or use by an enterprise of products of domestic origin in terms of the volume or value of products or in terms of a proportion of their domestic production, or that require an enterprise's purchases or use of imported products to be limited to an amount related to the volume or value of the local products that it exports, and (b) trade-balancing requirements (inconsistent with the obligation to eliminate quantitative restrictions), such as those which restrict the importation by an enterprise of products used in or related to its local production, generally or to an amount linked to its exports or to the foreign exchange inflows attributable to the enterprise, or that restrict exports in terms of volume or value of products or as a proportion of local production. These measures are included in an Illustrative List annexed to the Agreement. However, there would seem to be a "grey area" subject to interpretation, and a variety of investment measures may be challenged after the entry into force of the WTO Agreement.

Following the logic of the TRIMs Agreement, developing countries invoking the balance-of-payments provisions of GATT article XVIII:B are permitted to deviate from their obligations under the TRIMs Agreement to the extent that that article permits them to deviate from the GATT articles concerned. Furthermore, differential and more favourable treatment is provided in terms of the phase-out period, which is five years for developing countries and seven years for least developed countries (as opposed to two years for developed countries). This period may be extended for developing countries by the Council for Trade in Goods.

G. Other multilateral agreements on trade in goods

The Agreement on Technical Barriers to Trade (TBT Agreement) concluded at Tokyo was revised in the Uruguay Round to clarify the key concept of "unnecessary obstacle", providing that technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective, with due regard for the risks that non-fulfilment would create. Such risks can be assessed on the basis of scientific and technical information, related processing technology or intended end-uses of products. The Agreement was also strengthened so as to deal more effectively with standards and technical regulations of subnational entities (e.g. provinces). Perhaps the most important revision was the extension of the disciplines to cover technical regulations and standards for processes and production methods (the Tokyo Round Agreement having dealt only with "products"), which is particularly relevant in dealing with environmental considerations, notably in cases where the exported product may conform to environmental standards but the production method may be deemed not in conformity.

The Tokyo Round Codes on Customs Valuation and Import Licensing were also revised, but what is most importanct is that, like the Agreements discussed in the previous section, they have been converted into Multilateral Trade Agreements by which all WTO members will be bound. In addition, new multilateral instruments were negotiated on Rules of Origin, Sanitary and Phytosanitary Measures and Preshipment Inspection.

Owing to their weak administrative capacity, a number of developing countries have relied heavily on the services of preshipment inspection firms to deter fraudulent commercial practices such as over- and under-invoicing. Some developed countries considered that preshipment inspection (PSI) created difficulties for exporters, including unnecessary delays and inadequate protection of confidential business information. The Agreement on Preshipment Inspection provides for transparency in the operation of PSI regulations and of the entities involved, while recognizing the need for developing countries to verify the quality, quantity or price of imported goods.

The Agreement on Rules of Origin is a significant achievement of the Uruguay Round. Although the negotiations on this subject were in relatively low key, the Agreement equally fills a vacuum in the conduct of multilateral trade relations. Previous attempts to control the application of these origin rules were unsuccessful.

One aspect of the new rules which deserves to be highlighted is that the negotiations were triggered, to a large extent, by the dissatisfaction of a number of countries with the use of rules of origin by other major trading countries to deal with circumvention of anti-dumping duties through assembly in third countries. Some of the rules laid down by the Agreement are specifically designed to deal with problems which have actually arisen in this respect.[271]

The preamble to the Agreement refers to the desire to "increase the responsiveness of the GATT system to the evolving international economic environment". Apparently, participants foresaw that with the increasing globalization of production and trade it may no longer be a simple task to determine the origin of a good for purposes of the application of non-preferential commercial policy instruments under the General Agreement, such as: MFN treatment under articles I, II, III, XI and XIII of GATT 1994; anti-dumping and countervailing duties under article VI of GATT 1994; safeguard measures under article XIX of GATT 1994; origin marking requirements under article IX of GATT 1994; and any discriminatory quantitative restrictions or tariff quotas. The preamble also seems to indicate concern that rules of origin might be used for protective purposes. To preclude moves in this direction, there is provision for disciplines to govern the application of non-preferential rules of origin during a transition period. Coupled with arrangements for transparency, notification, consultations and dispute settlement, the Agreement launches a programme of work to harmonize rules of origin. (The Agreement

[271] For instance, the rule against negative origin tests is specifically designed to prevent repetition of an incident that occurred in connection with exports of photocopiers assembled in California, which were subjected to anti-dumping duties relating to photocopiers originating in Japan as a result of the application of a negative origin test.

deals only with non-preferential origin rules, although a Common Declaration with regard to Preferential Rules of Origin is attached thereto, in Annex II).

The impact of the disciplines during the transition period should not be underestimated. Indeed, depending on current rules and administrative practices of GATT contracting parties, the disciplines will already have a considerable impact upon entry into force of the Agreement. Thus, the clear definition of the applicable origin rules will instil considerable legal certainty into those jurisdictions where rules of origin have been vaguely defined for a large number of products. It will also render the retroactive application of rules of origin more difficult. Negative origin rules may only be used to clarify a positive standard or where such a standard is unnecessary. The Agreement imposes an obligation to issue, at the request of exporters, importers or other economic agents, binding rulings on the origin of a product. Such rulings shall be delivered even in cases where shipment has not yet been undertaken. Moreover, such rulings will have to be made publicly available. The obligation to define clearly the criteria to be met in order to determine origin will increase legal certainty and ensure greater predictability and objectivity. Moreover, the possibility accorded economic agents to request preliminary binding origin rulings should eliminate any doubts in borderline situations.

The Agreement on Sanitary and Phytosanitary Measures supplements the thrust of the Agreement on Agriculture by addressing another mechanism for protection in this sector, which has had a major negative impact on the trade of developing countries. It is intended to ensure that such measures will be applied only to the extent necessary to protect food safety, animal health and plant health and will be based as far as possible on analysis and evaluation of objective scientific data. Provision is made for technical assistance to developing countries, which is particularly necessary in the area covered by the Agreement.

H. Plurilateral trade agreements

One of the objectives of the proponents of the Uruguay Round was to correct the situation emerging from the Tokyo Round in 1979, where the nine codes on non-tariff measures and certain product sectors had been opened for acceptance on an optional basis but to which many GATT contracting parties, including most of the developing countries, had not subscribed.[272] A major result of the Uruguay Round has been the inclusion of modified versions of five of the codes in Annex 1A to the WTO Agreement, thus making them applicable to all WTO members. However, the remaining four, dealing with bovine meat, dairy products, civil aircraft and government procurement, and comprising Annex 4 of the Agreement, retain their "plurilateral" character. The Tokyo Agreement on Government Procurement was renegotiated in parallel to the Uruguay Round, and the renegotiation of the Agreement on Trade in Civil Aircraft is under way.

The Agreement on Government Procurement, as negotiated in the Tokyo Round, was applicable solely to signatories that accepted to apply national treatment and specified procedures governing the procurement practices of the government entities listed in annexes to the Agreement, which were subject to the disciplines imposed on them by the Agreement. The revised Agreement enlarges the number of entities subject to these disciplines, to include the entities of subnational (e.g. provincial) governments and certain public utilities, and extends the coverage of the Agreement to certain services purchased by these entities.[273] It also makes several procedural improvements, and includes a separate decision on procedures for WTO members to negotiate adherence to the Government Procurement Agreement. How-

272 The most "popular" of these Tokyo Round Agreements was that on Technical Barriers to Trade, subscribed to by 43 contracting parties, including 15 developing countries (as of 6 May 1994). The comparable figures for the Code on Customs Valuation were 32 and 12, and on Subsidies and Countervailing Duties 32 and 13 (GATT document L/6453/Add.23).

273 It has been estimated that in 1990 entities covered by the Agreement on Government Procurement awarded contracts totalling SDR 45 billion. The European Union has stated that its concessions under the 1994 Agreement will open up markets of ECU 350 billion to foreign suppliers and service providers.

ever, some of the concessions negotiated between the European Union and the United States are not extended to other signatories. This has created additional discrimination within an Agreement which itself is not applied on an MFN basis. Hong Kong, which had been an active participant in the renegotiations, refused to accept the Agreement for this reason. Membership in the Agreement, with two exceptions,[274] is now confined to OECD countries.

The WTO Agreement leaves open the possibility of negotiating additional plurilateral agreements which could be included in Annex 4 on the basis of consensus.[275] It also specifies that the plurilateral agreements may not create either obligations or rights for members that have not accepted them. It would appear that candidates for the status of a plurilateral agreement already exist. One is the Multilateral Steel Agreement, negotiation of which could not be completed before the end of the Uruguay Round and is still in progress. It has also been suggested that an agreement on competition policy (or an "anti-trust code") be negotiated as an Annex 4 agreement.[276] Annex 4 could be used to cover situations in which the results of multilateral negotiations on particular issues were acceptable only to a limited number of countries. Despite the consensus provisions, continued vigilance may be required to prevent the concept of the so-called "conditional MFN" from being legitimized in WTO.

I. Tariff negotiations

One of the achievements of the Uruguay Round in respect of market access was the significant reduction of the levels of tariffs which, according to analyses conducted to date, has surpassed the targets set at the Montreal Mid-Term Review of December 1988. Those targets included, *inter alia*, the average reduction of tariffs on industrial products by one third on a trade-weighted basis and, with regard to agricultural products, the tariffication of all non-tariff measures and the reduction of all tariffs, including those resulting from the tariffication process, by an average of 36 per cent, with a minimum cut of 15 per cent for each tariff line. For developing countries, the average tariff reduction was set at 24 per cent, with minimum reductions by line of 10 per cent. These impressive results were achieved despite the fact that, unlike the Kennedy and Tokyo Rounds, tariffs were not negotiated on the basis of an accross-the-board reduction formula.

With regard to industrial products, the main thrust for tariff reductions was provided by the "Quad" agreement among Canada, the European Union, Japan and the United States at the Tokyo Summit of July 1993. The Quad package agreed at the earlier stages of the negotiations involved the mutual elimination of tariffs (the "zero for zero" approach) in the sectors of pharmaceuticals, construction equipment, medical equipment, steel, pulp and paper, beer, furniture, farm equipment and distilled spirits. Greater-than-average reductions were agreed for electronics, scientific equipment, toys, wood products and certain non-ferrous metals. It was also agreed that tariffs on chemical products should be harmonized. The finally agreed tariff reductions will result in an overall reduction in developed countries of their MFN tariffs on industrial products (excluding fuel) by an average of 38 per cent on a trade-weighted basis, from 6.3 per cent to 3.9 per cent. For agricultural products the target set of a simple tariff average reduction of 36 per cent was generally met.[277]

Developing countries will benefit from these tariff reductions, which should improve their market access, in particular with regard to

[274] Israel and the Republic of Korea.

[275] The provision for adding new plurilateral agreements to Annex 4 exclusively on the basis of consensus among WTO members provides some assurance that the agreements will not be unduly discriminatory in character.

[276] An informal proposal to this effect has been made by the Max-Planck Institute for Foreign and International Patent, Copyright and Competition Law, Munich, Germany. ("Draft International Antitrust Code - as a GATT-MTO-Plurilateral Trade Agreement", 10 July 1993).

[277] GATT, *News of the Uruguay Round of Multilateral Trade Negotiations (Marrakesh, 1994)*, April 1994.

Table 25

QUAD COUNTRIES: DISTRIBUTION OF IMPORTS IN 1988 BY LEVEL OF MFN DUTY (AT PRE- AND POST-URUGUAY ROUND RATES)

(Percentage)

Importing market	Total imports			Imports from developing countries										
	Value ($mill)	Duty-free A	Duty-free B	Value ($mill)	Duty-free A	Duty-free B	10% and above A	10% and above B	10%-14.9% A	10%-14.9% B	15%-19.9% A	15%-19.9% B	20% or more A	20% or more B
							Agricultural products (non-tropical)							
Canada	4 548	44	47	521	55	56	37	12	24	8	6	1	7	2
European Union	29 205	48	53	12 120	47	49	40	37	5	9	11	11	24	17
Japan	20 978	43	44	3 732	36	37	42	30	10	13	11	2	21	15
United States	15 086	18	33	4 489	13	20	32	25	9	11	7	1	16	13
							Tropical agricultural products							
Canada	1 182	68	74	664	84	87	7	2	5	2	2	-	-	-
European Union	15 305	12	50	13 397	10	54	42	33	9	3	3	19	31	11
Japan	4 120	39	41	2 327	51	52	36	30	2	1	3	7	31	22
United States	7 081	58	73	6 205	62	77	5	4	2	3	3	-	-	-
							Other tropical products							
Canada	1 654	12	13	331	41	44	45	3	22	1	20	3	3	-
European Union	7 802	35	57	4 633	57	68	12	-	12	-	-	-	-	-
Japan	5 352	62	78	3 919	60	73	24	4	7	4	12	-	5	-
United States	8 361	18	53	4 146	31	71	2	-	1	-	1	-	-	-
							Natural resource-based products							
Canada	5 388	55	55	738	61	62	19	-	19	-	-	-	-	-
European Union	41 321	54	58	11 933	48	51	27	31	7	10	10	12	10	8
Japan	32 714	35	57	13 056	29	45	13	2	7	1	6	-	-	-
United States	30 113	60	67	9 399	44	51	3	3	3	3	-	-	-	-
							Textiles and clothing							
Canada	4 015	2	3	1 655	1	1	98	88	11	17	5	70	82	-
European Union	26 794	-	-	16 569	-	-	80	69	80	69	-	-	-	-
Japan	10 190	3	4	5 334	2	2	75	33	55	32	20	-	-	-
United States	28 780	-	3	20 076	-	1	75	71	7	7	27	37	42	27
							Leather and footwear							
Canada	933	1	3	417	-	-	99	78	21	14	-	63	78	1
European Union	5 088	10	11	3 583	8	8	24	24	-	-	-	24	24	-
Japan	1 472	10	14	1 007	10	13	84	28	57	2	1	1	26	25
United States	9 525	1	7	6 789	1	6	42	41	36	35	-	-	6	6
							Other industrial products [a]							
Canada	86 626	23	40	6 450	29	54	31	3	26	2	4	1	1	-
European Union	295 474	28	45	72 385	50	57	10	5	9	5	1	-	-	-
Japan	110 072	29	66	47 828	9	44	4	3	3	2	-	-	2	2
United States	350 222	11	38	109 946	6	32	3	2	2	1	-	1	1	-
							All products [a]							
Canada	104 607	23	38	10 162	26	43	45	20	23	5	4	15	18	-
European Union	379 671	24	40	106 626	24	36	33	26	22	17	3	5	8	4
Japan	159 400	36	62	53 675	25	48	22	11	12	6	5	1	5	4
United States	413 065	15	40	132 937	12	37	18	15	5	4	5	6	8	5

Source: Calculations by the UNCTAD secretariat, based on data in its Trade Control Measures Information System.

Note: A = Pre-Uruguay Round, B = Post-Uruguay Round.

a Excluding fuels.

products not covered by, and to countries excluded from, preferential import schemes of developed countries. The reduction of MFN tariff levels in the Quad countries for instance, will considerably increase duty-free access for developing countries.

The UNCTAD secretariat has calculated what would have been (other things being equal) the structure of Quad markets' imports from developing countries (in terms of tariff levels) on the assumption that the reduced tariff levels agreed in the Uruguay Round were in force at that time (i.e. 1988). The results are shown in table 25. It can be seen that, on this basis, duty-free access for developing countries will increase, once the concessions are implemented, from 12 per cent to 37 per cent of United States imports (excluding fuels), and from 24 per cent to 36 per cent of those of European Union, 26 per cent to 43 per cent in Canada and 25 per cent to 48 per cent in Japan. However, these increased shares for developing countries remain in general lower than the post-Uruguay Round shares of imports from all sources, although, except for imports by the European Union, the increase in the developing countries' share is relatively greater. These figures mainly reflect the increase in the proportion of duty-free imports of "other industrial products", which include products for which Quad countries agreed to eliminate tariffs. While the proportion of MFN duty-free imports by Quad countries in 1988, from developing countries, of products included in most of the sectors shown was already substantial, and will be further increased (often more than for imports from all sources), the proportion of duty-free imports of textiles, clothing, leather and footwear into these markets remains very low.[278]

The agreed concessions on tariffs will lead to a general reduction of the share of imports facing tariffs of 10 per cent or more. Nevertheless, while developing countries benefit from liberalization in all sectors, the proportion of imports attracting duties of 10 per cent or above remains relatively high, in particular for imports from developing countries in product sectors of export interest to them, such as agricultural products (non-tropical), textiles and clothing, and leather and footwear. Moreover, while higher tariffs have been reduced, there are several instances where significant proportions of imports from developing countries would still be subject to MFN tariffs in the high-tariff range, especially for the sectors mentioned above.

Calculations by the UNCTAD secretariat show that, for imports from all sources, overall MFN tariffs will be reduced on a trade-weighted basis, as a result of the tariff concessions, by 33 per cent in Japan and the United States, 38 per cent in the European Union and 45 per cent in Canada (see part I of table 26, where again fuels are excluded). The reductions vary considerably among sectors and markets, ranging from 6 per cent for leather and footwear in the United States to 59 per cent for non-agricultural tropical products in Japan. In many instances, particularly in sectors of export interest to developing countries (such as agricultural products, textiles and clothing, leather and footwear), MFN tariff averages will be considerably higher than the average for all products after the implementation of the agreed reductions. Even if allowance is made for preferential imports from developing countries under the GSP, which considerably lowers the averages for developing countries for the sectors just mentioned, post-Uruguay Round tariffs remain higher than the overall tariff in each Quad market for imports from all sources. The same generally holds true at a higher level of product disaggregation (see parts II-IV of table 26). For instance, within the tropical agricultural products group, it is true for roots, rice, tobacco, nuts and fruits, particularly in Japan and the European Union. For other agricultural products, it is the case for dairy produce (in all four markets) and meat, cereals and fruit and vegetables (particularly in Japan and the European Union). For natural resource-based products it holds especially for fish and fishery products in the European Union. As for manufactures, while in this sector on the whole tariff reductions are greater than for other sectors, some products of particular export interest to developing countries will still face relatively high tariff barriers in Quad markets - not only textiles, clothing and footwear, as already mentioned, but also products such as travel goods (EU and North America), cork and wood products (Japan), automotive products (EU) and sanitary, plumbing, and heating appliances (United States).

Table 26 also shows that the trade-weighted average tariff reduction in Quad markets is often smaller when this average is calculated using imports from developing countries as weights than when using imports from all sources. This is because most of the products which developing countries successfully export face relatively high tariffs in developed country markets, and these tariffs

[278] This assessment takes into account tariff concessions by the Quad countries alone, for which data were available at the time of writing (June 1994). However, the Quad markets account for more than 90 per cent of developed countries' total imports.

Table 26

REDUCTION IN TRADE-WEIGHTED TARIFF AVERAGES FOR IMPORTS [a] BY QUAD COUNTRIES IN 1988

(Percentage)

I: Major product groups

Importing market	Total imports: Value ($million)	Total imports: MFN tariff average A	Total imports: MFN tariff average B	Total imports: Reduction [b] (%)	Imports from developing countries: Value ($million)	Imports from developing countries: MFN tariff average A	Imports from developing countries: MFN tariff average B	Imports from developing countries: Reduction [b] (%)	Imports from developing countries: MFN/GSP [c] tariff average A	Imports from developing countries: MFN/GSP [c] tariff average B	Imports from developing countries: Reduction [b] (%)
					Agricultural products (non-tropical)						
Canada	4 548	12.5	7.8	38.0	521	7.6	4.9	34.9	5.5	3.8	31.3
European Union	29 205	21.9	14.9	32.2	12 120	23.5	16.8	28.4	22.8	16.6	27.3
Japan	20 978	41.3	31.8	23.0	3 732	19.5	14.9	23.4	18.2	14.5	20.5
United States	15 086	6.9	5.3	24.1	4 489	9.1	7.0	23.5	6.0	4.9	19.2
					Tropical agricultural products						
Canada	1 182	2.2	1.2	43.5	664	1.2	0.6	45.5	0.6	0.3	-
European Union	15 305	17.8	10.5	41.0	13 391	17.4	10.0	42.6	15.2	9.4	37.9
Japan	4 120	16.1	11.2	30.6	2 311	17.4	10.9	37.2	9.9	8.4	15.6
United States	7 081	2.4	1.4	40.0	6 200	2.1	1.2	41.1	1.5	0.8	42.8
					Other tropical products						
Canada	1 654	10.1	5.9	41.4	331	7.2	3.6	50.1	4.7	3.5	25.5
European Union	7 802	4.0	1.9	52.3	4 633	3.0	1.5	48.6	-	-	-
Japan	5 352	3.8	1.6	59.1	3 919	4.5	1.9	57.1	3.0	1.5	48.7
United States	8 361	3.4	1.9	46.3	4 146	3.2	1.4	55.4	0.9	0.7	-
					Natural resource-based products						
Canada	5 388	3.3	1.8	45.4	738	3.3	1.9	41.8	2.4	1.7	29.2
European Union	41 321	4.2	3.3	21.8	11 933	6.0	4.8	18.9	3.4	3.2	6.7
Japan	32 714	3.0	1.7	44.1	13 056	3.8	2.2	43.1	2.3	1.6	29.8
United States	30 113	1.5	1.1	27.0	9 399	2.6	2.0	22.5	0.6	0.5	-
					Textiles and clothing						
Canada	4 015	20.8	13.9	33.2	1 655	22.1	15.6	29.6	21.4	15.4	28.1
European Union	26 794	11.3	9.4	17.4	16 569	11.9	10.1	14.9	-	-	-
Japan	10 190	11.5	7.8	32.6	5 334	11.7	7.9	32.3	5.2	5.0	3.5
United States	28 780	17.1	14.9	12.5	20 076	18.7	16.9	9.9	18.5	16.7	9.7
					Leather and footwear						
Canada	933	17.9	12.8	28.5	417	19.8	15.0	24.3	18.3	14.5	20.8
European Union	5 088	8.6	7.3	14.9	3 583	9.1	7.8	14.7	0.2	0.1	-
Japan	1 472	14.8	13.0	12.4	1 007	13.3	11.5	13.3	8.4	7.5	10.2
United States	9 525	9.7	9.1	5.9	6 789	9.6	9.1	5.2	9.2	8.9	2.9
					Other industrial products (excluding fuels)						
Canada	86 626	7.2	3.7	48.2	6 450	6.8	3.1	54.9	4.0	2.7	33.1
European Union	295 474	4.7	2.5	47.4	72 385	3.5	2.0	41.7	0.3	0.2	-
Japan	110 072	3.3	1.5	55.8	47 828	3.9	2.3	40.9	2.8	1.9	31.3
United States	350 222	3.8	2.3	41.9	109 946	3.3	1.7	48.5	1.5	0.8	42.9
					All imports (excluding fuels)						
Canada	104 607	8.0	4.4	45.3	10 162	12.4	7.4	40.5	7.5	5.3	29.3
European Union	379 671	7.5	4.6	38.2	106 626	9.8	6.9	29.8	5.1	3.5	30.3
Japan	159 400	9.3	6.2	33.3	53 675	7.4	4.7	36.5	4.3	3.4	22.6
United States	413 065	5.1	3.4	32.7	132 937	7.6	5.5	28.3	4.7	3.8	18.8

(For source and notes see end of table.)

Table 26 (continued)

REDUCTION IN TRADE-WEIGHTED TARIFF AVERAGES FOR IMPORTS [a] BY QUAD COUNTRIES IN 1988

(Percentage)

II: Non-tropical agricultural products

Importing market	Total imports: Value ($million)	MFN tariff average A	MFN tariff average B	Reduction [b] (%)	Imports from developing countries: Value ($million)	MFN tariff Average A	MFN tariff Average B	Reduction [b] (%)	MFN/GSP [c] tariff average A	MFN/GSP [c] tariff average B	Reduction [b] (%)
					Fruits and vegetables						
Canada	1 775	4 1	3 2	22 1	289	2.0	1 6	22 1	2 0	1.6	22 1
European Union	6 102	14.8	11 1	25 1	3 225	16.4	12 7	22 6	12 7	10.1	20 9
Japan	2 525	24 7	17 4	29 4	714	19.5	12 9	33 7	17 9	12.5	29 9
United States	3 020	12 0	9 5	20 9	2 077	14.2	11 4	19 5	10 8	8.8	18 1
					Cereals						
Canada	129	4 5	2 9	35 7	1	12.8	8 1	36 1	5 9	5.1	14 9
European Union	982	104 5	66 6	36 2	188	110.8	70 8	36 1	110 7	70.8	36 1
Japan	4 123	101 4	85 5	15 7	157	13.1	10 8	17 7	13 2	10.8	17 7
United States	493	2 0	1 3	32 7	74	1.1	0 5	53 2	0 1	-	-
					Meat and meat products						
Canada	512	30 1	15 3	49 1	33	22.1	8 7	60 5	22 1	8.7	60 6
European Union	2 785	75 2	47 7	36 5	1 091	83.7	53 4	36 2	81 0	53.3	34 2
Japan	3 969	34 9	20 4	41 4	927	10.8	8 0	25 7	10 8	8.0	25 5
United States	2 559	10 3	8 6	17 0	374	8.9	6 0	32 5	7 4	6.0	19.6
					Dairy products						
Canada	112	91 3	58 4	36.0	2	86.0	55 0	36 0	85 9	55 0	36 0
European Union	782	67 2	43 2	35.8	9	135.5	97 3	28 2	134 2	96 3	28 3
Japan	474	188 5	160 1	15.1	-	35.0	29 8	14 9	35 0	29 8	14 9
United States	403	28 0	24 1	13.9	20	32.2	27 7	14 0	32 2	27 7	14 0
					Oilseeds, fats and oils						
Canada	90	2 8	1.8	38.1	3	2.4	1 5	35 9	1 9	1 2	35 7
European Union	4 238	2 3	1.8	23.0	1 547	5.6	4 5	20 6	5 6	4 5	20 4
Japan	2 214	0 6	0 3	-	283	1.1	0 7	35 5	1 1	0.7	35 4
United States	465	3.6	2.6	29.7	72	2.1	1 7	18 0	1 8	1 5	14 6
					Other						
Canada	1 934	11 9	7 6	36.5	194	12.8	8 9	30 4	7 3	5 9	19 6
European Union	14 358	11 7	8 5	27.3	6 093	19 8	15 2	23 6	19 2	14 7	23 1
Japan	7 683	20 4	14 7	27.8	1 658	28 1	22 4	20 1	25 7	21 6	16 6
United States	8 155	3.5	2 1	38.4	1 878	3 8	2 4	37 0	0 7	0 4	-

(For source and notes see end of table.)

Table 26 (continued)

REDUCTION IN TRADE-WEIGHTED TARIFF AVERAGES FOR IMPORTS [a] BY QUAD COUNTRIES IN 1988

(Percentage)

III: Tropical products

Importing market	Total imports: Value ($million)	Total imports: MFN tariff average A	Total imports: MFN tariff average B	Total imports: Reduction [b] (%)	Imports from developing countries: Value ($million)	MFN tariff Average A	MFN tariff Average B	Reduction [b] (%)	MFN/GSP [c] tariff average A	MFN/GSP [c] tariff average B	Reduction [b] (%)
					Beverages						
Canada	507	0.7	0.2	-	381	0.4	0.1	-	0.2	-	-
European Union	6 376	4.7	0.4	90.5	6 291	4.8	0.4	90.9	3.8	0.4	88.6
Japan	1 157	4.5	2.9	36.2	1 013	3.2	2.0	37.2	1.6	1.1	26.6
United States	3 295	0.1	-	-	3 039	-	-	-	-	-	-
					Spices, flowers, plants, etc.						
Canada	205	5.7	3.3	42.2	52	6.5	3.6	43.9	4.8	3.3	31.4
European Union	1 643	6.9	2.7	61.6	1 061	7.0	2.3	67.5	3.8	2.3	48.2
Japan	946	4.7	2.4	49.5	597	5.0	2.3	53.5	1.2	0.8	34.0
United States	1 529	4.4	2.1	50.9	998	4.3	2.0	52.3	0.7	0.5	-
					Oilseeds, vegetable oils and oilcakes						
Canada	106	6.5	4.1	36.4	33	10.8	6.9	36.1	2.5	2.3	10.9
European Union	1 738	4.3	2.7	37.7	1 413	5.0	3.1	37.7	3.6	2.9	19.1
Japan	303	4.8	2.5	48.4	225	5.9	3.0	49.1	1.7	0.9	48.4
United States	435	2.2	0.6	71.2	365	1.8	0.3	85.6	1.3	0.1	88.6
					Roots, rice, tobacco						
Canada	77	3.1	2.0	37.1	19	2.9	1.8	37.2	0.3	0.2	-
European Union	2 915	58.8	37.1	36.8	2 181	65.1	40.2	38.2	57.9	37.5	35.3
Japan	1 182	24.5	20.8	14.9	145	74.5	63.3	15.0	74.5	63.3	15.1
United States	713	10.4	6.7	35.4	577	10.1	6.8	33.2	8.2	5.7	30.8
					Nuts and fruits						
Canada	344	2.1	1.1	46.8	194	0.4	0.2	-	0.3	0.2	-
European Union	3 210	17.1	13.0	23.7	2 714	17.8	13.7	23.1	16.2	13.1	19.5
Japan	1 002	29.3	16.6	43.5	654	36.5	19.6	46.3	14.6	12.9	11.9
United States	1 762	3.1	1.6	49.7	1 589	2.7	1.3	53.4	2.0	0.8	58.7
					Rubber and wood						
Canada	1 857	9.4	5.5	41.5	335	7.5	3.7	49.7	4.7	3.6	23.7
European Union	9 218	4.0	1.9	52.7	5 094	2.7	1.3	49.3	-	-	-
Japan	6 127	3.0	1.3	57.8	4 479	3.7	1.6	55.3	2.6	1.4	47.1
United States	8 967	3.4	1.9	45.5	4 206	3.3	1.6	50.5	1.0	0.8	23.0
					Jute and hard fibres						
Canada	38	8.7	5.6	35.5	20	4.1	2.7	35.4	1.2	1.1	11.5
European Union	402	7.1	4.0	43.1	335	6.7	3.4	49.0	-	-	-
Japan	207	10.0	3.9	61.2	115	9.9	3.4	65.6	3.0	0.1	95.3
United States	240	1.9	0.5	74.6	171	1.2	0.2	82.5	0.7	-	-

(For source and notes see end of table.)

Table 26 (continued)

REDUCTION IN TRADE-WEIGHTED TARIFF AVERAGES FOR IMPORTS [a] BY QUAD COUNTRIES IN 1988

(Percentage)

IV: Manufactures

Importing market	Total imports				Imports from developing countries						
	Value ($million)	MFN tariff average A	MFN tariff average B	Reduction [b] (%)	Value ($million)	MFN tariff Average A	MFN tariff Average B	Reduction [b] (%)	MFN/GSP [c] tariff average A	MFN/GSP [c] tariff average B	Reduction [b] (%)
					Leather and rubber						
Canada	1 393	10 4	6 8	34 2	150	10 4	6 4	38 7	6 1	5 7	7.8
European Union	4 202	4 7	3 4	27 5	1 954	4.5	3 5	22 8	0 3	0 2	-
Japan	818	3 8	2 0	46 4	184	6.5	2 5	61 0	2 7	1.4	50 0
United States	4 466	3 9	3 1	21.2	1 258	3.9	2 8	28 9	0 6	0 1	-
					Cork and wood						
Canada	335	7 6	4 5	40 2	87	8.3	5 0	39 5	4.9	4.7	4 3
European Union	3 174	8 3	4 7	43 2	1 195	8.2	4 5	44 9	-	-	-
Japan	1 082	12 9	6 0	53 4	876	14.3	6 7	53 1	11 9	5.8	51 6
United States	2 092	4 7	2 7	43 2	1 099	6.1	4 3	30 2	3.2	2.9	10.9
					Non-metallic mineral manufactures						
Canada	1666	7 2	2 6	64 0	114	9.2	4 2	54 0	3.9	2.7	29.7
European Union	11 114	1 8	1 2	33 4	2 814	1.8	1 3	27 8	-	-	-
Japan	4 104	2 8	0 5	84 0	1 764	2.7	0 4	83 6	1 8	-	100.0
United States	10 214	3 8	2 4	36 5	3 276	3.4	2 2	36 0	1 4	0.1	29.8
					Manufactures of metal						
Canada	2917	9 9	6 1	38 7	315	10.4	6 2	40 5	6.4	5.5	14.3
European Union	6 544	5 7	3 1	45 2	1 359	6.1	3 2	47 5	-	-	-
Japan	1 346	4 9	0 9	80 6	480	5.0	0 9	82 7	0 2	-	-
United States	8 873	4 7	2 7	41 9	3 344	4.9	3 1	36 8	1 1	0 8	30.4
					Office machines and telecommunications						
Canada	9 260	4 1	0.7	82 2	1 547	4.4	0.8	81 8	1.9	0.6	69.6
European Union	41 865	7 6	4.0	46 7	9 155	8.8	5.3	40 4	-	-	-
Japan	7 546	4 0	-	100 0	2 435	3.8	-	100 0	3.3	-	100.0
United States	61 009	4 3	1.0	76 7	26 513	4 3	1.0	77 1	2.5	0.5	80.7
					Other non-electrical machinery						
Canada	11 616	6 8	3.4	49 6	367	8.6	5.4	37 0	2 9	2.7	4.8
European Union	23 050	4 5	1.9	56 5	1 264	4 9	2.6	48 1	-	-	-
Japan	4 905	2 6	-	100 0	700	3 7	-	100 0	0 6	-	-
United States	32 012	3 3	1.5	55 0	4 161	3.5	1.9	47 0	0 3	0.2	-
					Electrical machinery						
Canada	4 281	9 3	4 6	51 1	424	8 7	3 9	55 2	5.1	3.4	33.9
European Union	12 750	5 5	2 9	46 2	2 197	5.5	3 3	40 2	-	-	-
Japan	2 877	2 6	0 3	88 9	821	3 3	0 4	87 7	2 2	-	100.0
United States	17 316	4 5	2 6	41 9	7 636	4.7	3 1	34 0	0 5	0.4	-
					Automotive products						
Canada	26 351	9 2	6 0	34 6	676	9.2	6 1	33 8	6 0	6.0	-
European Union	19 521	9 5	8 4	11 7	1 570	8.5	7 2	15 5	-	-	-
Japan	3 651	0 4	-	-	93	2.6	-	100 0	2 6	-	100.0
United States	76 452	5 0	4 8	3 8	6 719	3.1	2 9	7 8	2 0	2 0	-

(For source and notes see end of table.)

Table 26 (concluded)

REDUCTION IN TRADE-WEIGHTED TARIFF AVERAGES FOR IMPORTS [a] BY QUAD COUNTRIES IN 1988

(Percentage)

IV: Manufactures (continued)

Importing market	Total imports: Value ($million)	Total imports: MFN tariff average A	Total imports: MFN tariff average B	Total imports: Reduction [b] (%)	Imports from developing countries: Value ($million)	Imports from developing countries: MFN tariff Average A	Imports from developing countries: MFN tariff Average B	Imports from developing countries: Reduction [b] (%)	Imports from developing countries: MFN/GSP [c] tariff average A	Imports from developing countries: MFN/GSP [c] tariff average B	Imports from developing countries: Reduction [b] (%)
Textiles											
Canada	2 157	19 3	11 9	38 3	541	18 2	11 6	36 2	17.0	11.2	34 0
European Union	10 985	9 1	6 8	25 4	5 000	8 8	6 7	23 9	-	-	-
Japan	3 931	8 7	5 9	31 7	1 595	7 7	5 4	29 3	3.8	3.1	18 4
United States	6 056	10 5	7 4	29 2	2 543	9 9	7 9	20 7	9.3	7.5	19 6
Clothing											
Canada	1 916	23 4	16 7	28 5	1 237	23 6	16 9	28 2	22 4	16.8	25 1
European Union	16 761	12 7	10 9	14 0	12 877	12 7	10 9	14 2	-	-	-
Japan	6 809	14 3	10 0	29 8	4 258	14 3	10 1	29 2	6 5	6.3	3 8
United States	24 510	17 9	16.1	10 2	19 117	18 8	17 1	9 3	18 6	17.0	8 9
Sanitary, plumbing, heating, etc											
Canada	309	10 0	6 5	34 7	65	9.5	6 2	35 1	5 8	5 6	2.1
European Union	800	6 5	3 8	40 6	199	6.9	4 4	36 0	-	-	-
Japan	196	4 4	0 1	96 8	72	4.7	0 3	93 6	-	-	-
United States	1 155	6 9	5 3	23 4	817	7.0	5 5	21 4	-	-	-
Furniture											
Canada	735	13 8	5 5	60 1	109	14 6	5 8	60 1	9 8	5 8	41.0
European Union	2 389	5 6	0 8	86 0	569	5 7	0 7	87 1	-	-	-
Japan	1 019	5 1	0 8	83 9	620	5 1	0 7	87 2	-	-	-
United States	4 885	3 6	0 1	97 6	2 307	3 8	0 1	97 7	-	-	9.6
Travel goods, handbags, etc.											
Canada	177	15 5	9 7	37 1	95	15.7	9 9	37 2	10 2	9 6	3.8
European Union	1 361	6 1	4 0	34 0	860	6.0	3 9	34 6	-	-	-
Japan	778	10 8	8 6	20.1	326	10.3	8 2	20 1	5 1	5 1	-
United States	2 075	15 0	13 6	9 1	1 207	15.5	14 0	9 3	14 7	13 3	9.7
Footwear											
Canada	614	22 1	16 1	27 1	331	22.2	17 1	23 1	21 4	16 7	22.2
European Union	2 988	11 7	10 2	12 8	2 155	12.4	10 7	13 3	-	-	-
Japan	1 158	17 0	15 3	10 3	844	14.9	13 2	11 0	9 4	8 7	8.0
United States	8 380	10 5	10 0	4 9	6 165	10.3	9 8	4 5	10 1	9 8	2.9
Professional, scientific, etc. instruments											
Canada	1 850	4 6	1 2	73 2	43	6.5	2 3	64 8	4 1	1 8	56.4
European Union	7 596	6 3	1 9	70 6	411	6 3	2 2	64 9	-	-	-
Japan	2 478	1 6	-	100 0	107	2.0	-	100 0	0 9	-	-
United States	5 435	5 2	1 6	69 4	1 122	5.5	1 4	74 8	0 2	-	-

Source: As for table 25.

Note: A = Pre-Uruguay Round; B = Post-Uruguay Round.

a Including duty-free imports.

b For reasons of statistical significance, average reductions from pre-Uruguay Round tariffs that were below 1 per cent ad valorem have not been calculated.

c Calculated by applying GSP tariff rates, where applicable, instead of MFN rates, to the entire imports of the item from the preference-receiving countries concerned.

consequently are given a relatively greater weight. This is true not only for their exports as a whole (except to Japan) but also within most of the major product groups distinguished in the table.

It has also to be borne in mind that using import values as weights for calculating average tariffs underestimates the effect of very high tariffs. Because the tariff was so high, imports of affected products were minimal or zero, and hence bring down the tariff average. The effect is similar where significant non-tariff barriers inhibited or severely limited imports. Furthermore, while tariffication has been taken into account as much as possible in this assessment, the tables do not clearly identify the tariffs which resulted from the tariffication process provided for in the Agreement on Agriculture. These tariffied rates may be very high owing, for instance, to the choice of the base years 1986-1988, which was a period when world prices for many products were exceptionally low. There could consequently be an increase in border protection following tariffication which would, however, be reduced subsequently. A detailed examination of the schedules of Quad countries' commitments in agriculture shows that such very high initial tariffs are to be applied, *inter alia*, to imports of certain meat and meat preparations, dairy products, food preparations and wines. Items which will be affected in the European Union include meat products, dairy products, cereals, bananas, citrus fruit and sugars; in Japan, dried leguminous vegetables, cereals and preparations of cereal flour, etc.; and in the United States, dairy products, sugars, and edible preparations. However, tariff quotas have been opened under the "minimum access" and "current market opportunities" provisions of the Agreement, corresponding to at least 5 per cent of domestic consumption, at ad valorem rates generally ranging from zero to 30 per cent (many rates being specific). In many cases these tariff quotas have been allocated among specific countries.

High MFN tariffs have been a matter of traditional concern to developing countries, an important factor restricting their access to industrial markets. In previous negotiations, developed countries benefited from tariff cuts on industrial products traded among themselves, while many products of export interest to developing countries were exempted from accross-the-board commitments. Items so affected were "sensitive" products in sectors where developing countries are important suppliers, such as textiles, clothing, footwear and steel. In the Uruguay Round, as discussed above, while tariffs in all ranges were reduced considerably, the proportion of imports facing tariffs in the high-tariff ranges will still be significant in a number of cases. As may be seen from table 27, MFN tariff averages for the Quad countries which will result from the Uruguay Round are also high on an unweighted basis in various instances. The table also shows that, in addition to the very high rates remaining on imports of agricultural products, tariff peaks will still affect products in other sectors where rates deviate significantly from the (unweighted) average. There has been some progress in reducing escalation for some products of export interest to developing countries,[279] although escalating tariffs at higher stages of processing may still discourage exports from developing countries of products with greater value added.

It would seem, from the foregoing, that WTO should preserve the momentum built up in the Uruguay Round by providing for a continuation of tariff negotiations, given that these are foreseen for 1999 in the Agreement on Agriculture. Pending such multilateral action, autonomous improvement of the GSP could be considered.

As for the developing countries' participation in the Round, it is undeniable that their contribution to the successful outcome of the negotiations was of capital importance. Most developing countries made substantial commitments on market access, consolidating the results of their liberalization programmes undertaken unilaterally. In many instances concessions were made even before the conclusion of the negotiatons (since, as noted above, many developing countries acceded to GATT during the Uruguay Round). With respect to tariffs, they made impressive concessions either for reducing their tariffs or for binding them at ceiling levels (and sometimes for both). For several developing countries the average MFN tariff reduction on industrial products was comparable to or greater than that of OECD countries (e.g. for India, Republic of Korea, Venezuela and Brazil). For others the reduction was proportionately smaller, but from a level that was in general higher than in developed countries. A number of developing countries emerged from the Round with their entire tariff schedule bound, either as a result of the tariff negotiations themselves (e.g. Argentina, Brazil), of across-the-board tariffication and binding of the resultant rates

[279] See "A preliminary analysis of the results of the Uruguay Round and their effects on the trading prospects of developing countries", report by the UNCTAD secretariat (TD/B/WG.4/13), para. 46.

Table 27

QUAD COUNTRIES: PRE- AND POST-URUGUAY ROUND MFN TARIFF PROFILES

(Percentage ad valorem)

Importing market	Unweighted MFN tariff average: Pre-UR	Unweighted MFN tariff average: Post-UR	Maximum MFN rate: Pre-UR	Maximum MFN rate: Post-UR
		Agricultural products (non-tropical)		
Canada	13.4	8.6	266.6	170.6
European Union	32.2	21.4	438.0	280.4
Japan	31.4	23.1	650.0	552.5
United States	10.3	7.2	999.8	449.9
		Tropical agricultural products		
Canada	4.9	2.5	30.1	19.3
European Union	17.3	11.1	162.4	104.0
Japan	14.2	9.0	589.0	500.7
United States	9.5	6.5	536.9	429.5
		Other tropical products		
Canada	8.0	4.8	25.0	15.7
European Union	4.3	1.9	25.0	12.0
Japan	5.4	1.7	23.4	10.0
United States	3.7	1.7	25.0	18.0
		Natural resource-based products		
Canada	5.5	2.7	17.5	11.3
European Union	8.1	6.3	30.0	26.0
Japan	5.8	3.4	20.0	15.0
United States	3.5	2.3	35.0	35.0
		Textiles and clothing		
Canada	19.6	12.7	30.0	18.0
European Union	10.5	8.2	17.0	12.0
Japan	10.7	6.9	22.4	16.0
United States	12.8	9.1	42.4	32.0
		Leather and footwear		
Canada	13.3	9.6	25.0	20.0
European Union	8.3	6.9	20.0	17.0
Japan	29.8	23.4	84.0	75.2
United States	14.0	11.8	61.8	61.8
		Other industrial products [a]		
Canada	8.1	3.9	30.3	25.0
European Union	5.7	2.8	98.2	78.6
Japan	4.1	1.2	43.5	43.5
United States	5.2	2.6	151.2	121.4
		All products [a]		
Canada	9.9	5.5	266.6	170.6
European Union	10.4	6.6	438.0	280.4
Japan	9.7	5.9	650.0	552.5
United States	7.0	4.3	999.8	449.9

Source: As for table 25.
a Excluding fuels.

in the agricultural sector, or of the negotiation of their accession to GATT during or immediately before the Round (e.g. Venezuela and Mexico, respectively).

In this context the Understanding on the Interpretation of Article XXVIII of GATT 1994 responds to the concerns of developing countries in establishing that, in tariff renegotiations, the country having the highest export concentration in the product concerned, regardless of the absolute level of imports, is considered to possess principal supplier rights in such negotiations. On the other hand, the Understanding on the Interpretation of Article II:1(b) obliges developing countries to include charges and fees levied for fiscal purposes in their bound tariff rates. Any such charge which has not been included in their Schedules may not be added subsequently.■

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Chapter III

EXPANSION OF THE COVERAGE OF MULTILATERAL DISCIPLINES

A major outcome of the Uruguay Round has been to devise new multilateral disciplines in the areas of intellectual property and trade in services, and to link them to the GATT rights and obligations through the institutional "umbrella" of WTO and its integrated dispute settlement mechanism. This extension of multilateral trade obligations and the attempts to use the mandate on trade-related investment measures (TRIMs) to negotiate rules on investment should be viewed in the context of a persistent theme in international economic debate, that of establishing multilateral rules for the protection of property rights. Since the beginning of this century, the countries which have been the sources of foreign direct investment and the home of transnational corporations (TNCs) have sought to establish multilateral rules and principles to govern the treatment of foreign investors similar to those found in bilateral investment treaties ("national treatment" and "right of establishment"). In the present, "globalized" world economy, these initiatives have been broadened to address the whole spectrum of impediments faced by TNCs which restrict their competitiveness in worldwide operations, i.e. including such additional matters as access to telecommunications networks, the physical movement of executives and specialists, and the avoidance of conditions on investment that inhibit the execution of a global production strategy. The international convergence of technological capacities and the gradual erosion of competitiveness in the traditional areas of production of a number of developed countries made intellectual property a key element in comparative advantage; differences in the level of protection of intellectual property rights were leading to increasing trade tensions, and the universal protection of such rights became a major priority.

The Havana Charter (in article 12) contained multilateral rights and obligations on investment. This objective was pursued by the developing countries under the auspices of the United Nations, through the negotiation of a code of conduct for TNCs that would set out a balance of rights and obligations as between the home and host countries with respect to the treatment of such enterprises. Furthermore, negotiation of a code of conduct on the transfer of technology that would facilitate the flow of technology to developing countries was undertaken in UNCTAD. After two decades these negotiations have been all but abandoned.

A. Trade in services

The United States was the main proponent of the inclusion of trade in services in the Uruguay Round. The proposal met with resistance from the developing countries, which were concerned that the discussion of services in a GATT context could create a basic assumption that GATT principles, such as national treatment, should apply automatically to services and that they would be open to retaliation on trade in goods if they did not apply such principles. They ultimately agreed to conduct negotiations on trade in services once it was settled that such negotiations would be conducted within an *ad hoc* juridical frame of reference outside GATT, and that the promotion of the economic growth of all trading partners and the development of the developing countries through the expansion of trade in services under conditions of transparency and progressive liberalization would be their main aim.

The General Agreement on Trade in Services (GATS) establishes an entirely new contractual framework to govern trade in services, containing new concepts, such as that of "trade in services" itself,[280] which has been defined to include four "modes of supply": supply through cross-border movement, the movement of consumers, commercial presence, and the presence of natural persons. It also draws upon GATT principles such as national treatment, but places them in a different context. The Agreement consists of: (i) a general framework; (ii) sectoral annexes; and (iii) national schedules containing commitments on market access and national treatment and additional commitments in specific service sectors or subsectors. It establishes a series of general obligations, including unconditional MFN treatment for all measures affecting "trade in services", with the exception of specific derogations which have to be notified by countries wishing to claim them when accepting the Agreement. (In the early stages of the negotiations, the possibility emerged that there might be only "conditional" MFN treatment; this risk still exists for certain sectors where extensive resort to MFN derogations is being threatened.) National treatment and market access commitments, however, are confined to those relating to the sectors, subsectors and modes of supply specifically included in the individual Schedules of Commitments of each member. The promotion of development is an inherent objective of the Agreement and is not stated in terms of "special" treatment. For example, developing countries may liberalize to a lesser degree and may make market access conditional upon measures to assist them in strengthening their services sectors, for example through access to information networks and distribution channels or access to technology on a commercial basis.

The various annexes are an integral part of GATS and may be divided into four categories: (i) annex on MFN exemptions, enabling a member to add exemptions to article II prior to the entry into force of the Agreement; (ii) annexes covering specific sectors, notably air transport and financial services; (iii) annexes defining in more precise terms the concepts of or provisions relating to telecommunications and the movement of natural persons; and (iv) annexes providing the modalities for continuation of negotiations on financial services, basic telecommunication services and maritime transport services. The universal coverage of GATS could be circumvented through the possibility to seek such exemptions under the Annex on Article II exemptions, which specifies the conditions under which a member, at the entry into force of the Agreement, is exempted from its MFN obligations. This possibility is, however, limited in as much as the annex relates to existing measures only, although some of the exemptions scheduled appear to provide for the possibility of future measures. As the negotiations have not been concluded in three major sectors and one mode of supply, the Ministerial Decisions on Financial Services, Negotiations on Basic Telecommunications and Negotiations on Maritime Transport Services provide that MFN exemptions could be made in these sectors until the conclusion of the negotiations, the target date for which is six months after the entry into force of the WTO Agreement for Financial Services and Basic Telecommunications and June 1996 for Maritime Services. The Council for Trade in Services will review all exemptions granted for a period of more than five years, and in so doing will examine whether the conditions which created the need for the exemptions still prevail and determine the date of any further review. In principle, exemptions should not exceed a period of 10 years. In any event, they will be subject to negotiation in subsequent trade-liberalizing rounds. The language indicates that the 10-year period is not definitive and could be extended. Moreover, the annex does not lay down criteria or conditions for the inclusion of exemptions, and most of those scheduled in the MFN exemption lists are for an indefinite period. Many exemptions may well have been put forward with a view to gaining advantages in the future negotiations.

There are 96 Schedules of specific commitments. Most (61) of the offers are accompanied by an MFN exemption list and vary widely in their coverage of sectors and modes of supply, as well as in the extent of limitations of market access and national treatment. The degree of development of the services sector is reflected in the coverage of the sectors offered. It is difficult to establish criteria and parameters for an evaluation of the "value" of concessions and an estimation of their "trade impact", or of the impact of liberalization in the services

280 The term "trade" in services appears to have been specifically devised for the purpose and includes what had been previously termed "invisible transactions" in GATT. The definition of what constitutes such trade (which includes factor movements) had to be worked out during the negotiations. This has led to certain incongruities between the definition of trade in goods and that of trade in services. See, for example, the background note by the UNCTAD secretariat, "The concept of services trade statistics" (UNCTAD/SDD/SER/1), 15 September 1993.

sector. The impact of the specific commitments on market access and national treatment will be a function of the extent to which: (i) services sectors and subsectors have been included in individual Schedules; (ii) the four modes of supply are included; (iii) terms of market access and national treatment in the transactions listed are limited or qualified; (iv) requirements for an "economic needs test" are included without specifying objective criteria; and (v) the number of MFN exemptions. The impact of the commitments has to be viewed in the context of the existing domestic regulatory framework, taking into account whether the country concerned has introduced legislative changes to implement the commitments it has undertaken. A meaningful assessment would also require appropriate disaggregated statistical data on trade in services through all modes of supply and a study of the impact of the barriers to entry.

The most impressive feature of GATS is not the degree of liberalization that it has achieved, as for many developed countries this represents no more than a limited binding of the status quo which has not been deemed to require any particular implementing legislation. It is rather the extension of the scope of multilateral trade rights and obligations to cover measures affecting such diverse aspects as foreign direct investment, professional qualifications and the movement of persons and electronic data across national frontiers, thus making them legitimate subject matter for inclusion in the negotiation of future trade commitments under GATS, as well as under other Agreements. The Annex on Telecommunications incorporates a new "users'" right which ensures that enterprises benefiting from market access commitments have the right to "plug in" to national telecommunications systems. Another major achievement is that, despite strong lobbying efforts by protectionist interests, the Agreement covers all service sectors (only air traffic rights, covered by ICAO, being excluded). There is, however, a considerable imbalance concerning the extent to which different sectors or modes of supply have been made subject to specific commitments in the Schedules. Sectors with a high degree of coverage in the Schedules include tourism, business services, value added communication services and financial services; further liberalization of the latter sector is provided in the Understanding on Commitments on Financial Services, subscribed to by OECD countries but applied on an unconditional MFN basis. The majority of commitments involve the "commercial presence" mode of supply, reflecting the desire of countries to attract investment rather than have services supplied from abroad. The commitments with regard to the movement of natural persons have almost invariably been made on a "horizontal" basis, i.e. relating to the position of an individual person within a firm (such as executives and expert technicians) and not to specific sectors, which makes it difficult to assess the value of such commitments for developing countries.

The oft-mentioned "strategic" character of many services gave rise to difficulties in reaching agreement on the scope and depth of commitments in certain key sectors. The unwillingness of the United States to accept a "cultural exception" for audiovisual services led the EU (and other countries) to withdraw their offers in this sector. Offers on space-launching services had been withdrawn earlier. The perception by the United States, in particular, that other countries had made inadequate offers in the financial sector, and that in most countries basic telecommunications were still controlled by state entities, led it to seek generalized MFN exemptions in these sectors. In order that such disagreements on sectoral issues should not affect the acceptance of GATS itself, it was agreed to continue negotiations, under the auspices of the Preparatory Committee for the WTO, on the Schedules of Commitments with respect to movement of natural persons and the sectors of maritime transport, financial services and basic telecommunications. The main objective of these negotiations is to reach a solution that would enable certain countries to minimize the scope of MFN derogations in these sectors and increase the depth of the offers.

One of the main concerns of developing countries during the earlier stages of the Uruguay Round was that the negotiations on TRIMs and on trade in services could be used to link trade and investment issues in such a way that national treatment and right of establishment for investors would somehow become incorporated in the GATT system. As noted above, the TRIMs Agreement does no more than restate GATT rules which have been interpreted to prohibit those TRIMs that contravene GATT articles III and XI but which do not deal with the rights of investors *per se*.[281] These areas are addressed rather in GATS, which clearly provides that neither "establishment" nor "national treatment" are "rights", but can be the subject of qualified concessions exchanged on a reciprocal basis

281 However, the possibility that the TRIMs Agreement could be "complemented" by provisions on investment policy is foreseen in its article 9.

(including concessions in other modes of supply such as the temporary movement of persons) with respect to specific sectors or subsectors within the framework of the Schedules of Commitments. GATS does, however, implicitly recognize the right of home countries to defend the interests of the foreign affiliates of their enterprises within the dispute settlement provisions. Extension of the GATS approach of sector-by-sector negotiations on commercial presence in exchange for benefits with respect to other modes of supply or other service or goods sectors might provide a technique for bringing investment within the purview of WTO in a future round of negotiations.

GATS also contains a built-in programme of future work that will have considerable impact on its scope. This programme includes negotiations on emergency safeguard measures, government procurement, subsidies, and domestic regulations concerning professional qualifications. The Agreement further provides a framework for future rounds of negotiations aimed at the progressive liberalization of trade in services, to begin within five years from the entry into force of the WTO Agreement.

B. Trade-related Intellectual Property Rights

The scope and intensity of the obligations contained in the Agreement on Trade-Related Intellectual Property Rights (TRIPs) go far beyond what had been envisaged at the beginning of the negotiations. As a result, the essential provisions of the international conventions governing intellectual property protection, administered under WIPO auspices, have been made universally applicable on an MFN basis, given a binding character and incorporated as inherent rights of the multilateral trading system, through the WTO Agreement with its common dispute settlement mechanism. The TRIPs Agreement establishes disciplines for copyright, trade marks, geographical indications, industrial designs, patents, layout designs of integrated circuits, and protection of undisclosed information, and builds upon, in certain instances going beyond, the provisions of existing WIPO instruments, notably the Paris, Berne and Rome Conventions. It provides new rules with respect to issues which had not been resolved in WIPO forums, the most important of which was acceptance that all products or processes in all fields of technology will be patentable. Other key aspects in this regard relate to copyright protection for computer software, protection for data banks and phonogram producers, the term of patent protection, the protection of undisclosed information, and civil litigation procedures.

With the exception of certain commitments to encourage technology transfer to the least developed countries, there are no special provisions to facilitate the transfer of technology to developing countries. Differential and more favourable treatment is confined to extended time-limits for the implementation of some of the provisions of the Agreement, which can be up to 10 years for sectors where patent protection was not previously available (although even these temporary exemptions are qualified in the case of pharmaceutical and agricultural chemicals). There are certain general provisions regarding the protection of public health and nutrition and the possibility of compulsory licensing of patents to achieve specific objectives (including the prevention of anti-competitive practices in contractual licences) which provide possibilities for developing countries to deal with some of the abuses they had been seeking to control under the negotiations in UNCTAD on an international code of conduct on the transfer of technology.

The TRIPs Agreement does not cover all aspects of intellectual property rights owing to the different national attitudes and approaches that exist, notably with respect to bio- technology and the concepts of abuse and exhaustion of intellectual property rights. The Agreement will reduce the possibility that intellectual property rights legislation will become another trade remedy in the protectionist arsenal. For example, it will constrain the field of application by the United States of its "Special" 301 legislation (described in chapter V, section A). Much will depend upon how the Agreement is implemented in practice, and it is to be expected that countries will be active in challenging measures under the dispute settlement mechanism in order to "test" the scope of the obligations.

Costs will be incurred by developing countries from the application of this stronger regime for intellectual property protection. These will be related to the increases in royalty payments to foreigners and the increase in prices of products manufactured under licence or imported. In addition, significant administrative costs will be incurred; developing countries will have the obligation to substantially improve and enlarge their judicial, administrative and enforcement frameworks, including the setting up of customs control machinery, and to mobilize and develop the necessary human resources, which merits international support. In the longer run, however, a possible consequence of the TRIPs Agreement could be a greater incentive for enterprises to invest in developing countries and to license patented inventions to entrepreneurs in those countries.

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Chapter IV

THE DEVELOPMENT DIMENSION

A. Towards a development-oriented system

Over the last three decades, the international trade debate has been strongly influenced by the efforts of developing countries to reform the international trading system so as to make it more responsive to their needs and aspirations. Those efforts reflected their perception that they had inherited a system in the design of which they had played little or no part, and which was intrinsically biased against their interests. The major policy thrust, embodied in the establishment of UNCTAD, was the realization of the need for and the possibility of achieving reform of the system through coordinated negotiating initiatives and solidarity. In the trade field it was envisaged that such corrective action should take the form of actions by developed countries to grant generalized preferential, non-reciprocal and non-discriminatory treatment to developing countries in those areas of international economic cooperation where it might be feasible. The first major achievement in this regard was the generalized system of preferences (GSP), negotiated in UNCTAD and implemented in 1971. The Tokyo Declaration of 1973 recognized the principles of differential and more favourable treatment in favour of developing countries, and provisions to this effect were incorporated in several of the instruments emerging from the Tokyo Round, including the "Enabling Clause" which legitimized such deviations from MFN treatment in the GATT context. The Punta del Este Declaration reaffirmed the principle of differential and more favourable treatment in respect of the Uruguay Round.

However, it became increasingly evident that a parallel process was under way under which developing countries, rather than receiving more favourable treatment, were encountering increasing discrimination against their trade, evidenced in such measures as: (a) voluntary export restraints and other "grey area" measures directed against their most competitive exports; (b) bilateral pressures by major importing countries aimed at obtaining trade concessions through the threat of trade sanctions rather than the offer of reciprocal benefits; (c) the extension of free-trade agreements and customs unions among developed countries; (d) higher MFN tariffs on products of export interest to developing countries compared to those of interest to developed countries after seven rounds of multilateral trade negotiations; (e) the proliferation of restraints on textiles and clothing exports under the Multi-Fibre Arrangement; and (f) the diminishing effectiveness of any GATT disciplines governing trade in agricultural products. In addition, the GSP was beginning to be applied in a conditional and discriminatory fashion, being used more frequently by some preference-giving countries as a means of leverage to obtain other benefits, including concessions outside the area of trade. The Tokyo Round codes, with their limited membership, appeared to represent a major step towards the "GATT plus" approach, advocated in developed country circles in the early 1970s, according to which those countries would create an inner system of rights and obligations encompassing areas of mutual interest among themselves. These approaches not only tended to introduce fragmentation into the system of multilateral rights and obligations but also led to active consideration of the resurrection of the so-called "conditional" MFN clause, which constituted a major impediment to past efforts at multilateral trade liberalization. In addition, as the system evolved, differential and more favourable treatment came to be reflected in greater degrees of flexibility for developing countries in the application of trade measures, rather than any binding commitments by developed countries in favour of their exports.

As a consequence, the thrust of the developing countries' initiatives shifted in that, while seeking to preserve the commitments made in their favour, they began to concentrate on defending the integrity of the unconditional MFN clause, obtaining MFN tariff reductions, and strengthening the disciplines of GATT (particularly in the product sectors mentioned above) so as to prevent the restriction and harassment of their trade. Particular emphasize was laid on the dispute settlement mechanism, as a means of defence against bilateral pressures from their major trading partners. At UNCTAD VI (Belgrade, 1983), all countries recognized the need to strengthen the international trading system based on the MFN principle.[282] Meanwhile, in the early 1980s the acceptance by many developing countries of IMF structural adjustment programmes led to their adoption of an export-oriented development model and unilateral trade liberalization through the elimination of quantitative import restrictions and reduction of tariffs. This stimulated an enhanced interest by developing countries in export markets. The Uruguay Round was consequently viewed as a means of obtaining improved and more secure access for their exports, consolidating the liberalization undertaken unilaterally and demanding "negotiating credit" from the countries that were benefitting from this unilateral liberalization. The Uruguay Round (unlike the Tokyo Round) was open only to GATT contracting parties or to countries that committed themselves to negotiate accession to GATT during the Round; a large number of developing countries followed this course of action. Many of the developing countries which acceded to GATT either immediately before or during the Round accepted to bind up to 100 per cent of items in their tariff schedules. The drastic reduction in tariffs and quantitative restrictions by developing countries created a need for the adoption of new legislation to protect them against unfair trading practices, for example on anti-dumping measures, which had been unnecessary under more restrictive import regimes. This stimulated an interest on the part of their trading partners in subjecting such legislation and procedures to the type of discipline that had been accepted in the Tokyo Round codes.

B. The scope of policy options

As a result of their major contribution to the Uruguay Round, developing countries will have significantly less flexibility in their use of both trade and domestic policy instruments. The outcome of the tariff negotiations, including by those developing countries which had been contracting parties for many decades, has been an extensive binding of tariffs, which has served to consolidate the tariff reductions undertaken by developing countries as part of their autonomous trade liberalization measures under their economic reform programmes and the "entry fee" paid by those countries that acceded to the GATT during the Uruguay Round. Furthermore, the incorporation of the revised Tokyo Round codes (which had previously been accepted by a limited number of developing countries) into the Final Act of the Uruguay Round has resulted in a major increase in the level of multilateral obligations for most developing countries, although, as noted below, such disciplines were often mitigated by provisions for differential and more favourable treatment. While the balance-of-payments

282 For example, in resolution 159 (VI), para. 14.

provisions of GATT article XVIII have not been substantially modified by the Understanding on that article, many developing countries had disinvoked article XVIII:B during the negotiations.

The extension of multilateral disciplines into areas traditionally viewed as pertaining to domestic policy has also limited developing countries' options with respect to policy measures aimed at increasing the competitiveness of their exports or achieving other development goals. In recent decades, a number of developing countries have successfully deployed a wide range of policy measures to strengthen their international competitiveness and export performance, enabling them to "catch up" with developed countries. The multilateral disciplines emerging from the Uruguay Round, which reflect the evolution of legislation and trade and economic policy in the developed countries, reduce the scope of available policy options in this regard. Thus, the disciplines of the Uruguay Round Agreements may deprive latecomers (including countries in transition) of the opportunity of emulating the successful strategies of those countries and cause them to turn to different development strategies, the success of which will depend largely on the more secure and liberal market access achieved in the Uruguay Round, and on continuation of the momentum to further multilateral liberalization.

Before the Uruguay Round, differential and more favourable treatment had been embodied mostly in instruments of an autonomous nature, such as the GSP, or in the form of "best endeavour" clauses, time-bound exceptions for obligations and longer periods for implementing them, flexibility in procedures and access to technical assistance and advice. Such provisions exist in many Agreements. However, in certain Agreements, differential and more favourable treatment has been given a contractual character, particularly in the form of numerical thresholds for undertaking certain commitments.

For the first time, differential and more favourable treatment is provided for in the form of contractual commitments affording improved security of market access with respect to the application of specific measures. Thus, there is a clearer definition of the beneficiaries of such treatment (for example, under the Agreement on Subsidies and Countervailing Measures they are the least developed countries and those developing countries where per capita income remains below $1,000), and numerical thresholds included in various agreements (such as the Agreement on Safeguards) stipulate that safeguard measures shall not be applied against a product originating in a developing country member as long as its share of the imports of the product concerned in the importing member does not exceed 3 per cent (provided that developing country members with a smaller share collectively account for not more than 9 per cent of total imports of the product concerned). A similar dual threshold applies in the case of countervailing duties. It will clearly be necessary to establish a consensus on which countries qualify as "developing" countries if these thresholds are to be effectively respected in practice.

During the Uruguay Round, effective joint action by developing countries took the form of common proposals on specific issues, supported by groups of like-minded developing countries, often widely dispersed geographically. The impact of these joint initiatives, which in most cases were not confined to seeking the inclusion of provisions on differential and more favourable treatment, can be witnessed in many provisions of the Agreements. At the beginning of the Round, it appeared that the traditional developing country coordination mechanism might well be sidetracked in favour of mixed groups of like-minded developed and developing countries, such as the Cairns group of agricultural exporters. However, as the negotiations progressed on some crucial issues the developing countries as a whole were able to formulate and pursue proposals that were eventually incorporated into the final results. Areas of particular concentration by developing countries in this respect included trade in services (movement of persons, telecommunications, the structure of GATS), TRIMs, TRIPs and textiles and clothing (where the International Textiles and Clothing Bureau played a major role) and the impact of the Round on net food-importing countries.[283] In addition, the Informal Group of Developing Countries met throughout the Round and the developing countries spoke with a common voice on key issues at crucial points.

283 These positions evolved in meetings held in the permanent missions of developing countries at Geneva and in meetings held in the Geneva area and in various developing countries. Technical support from the UNCTAD/UNDP Programme (see box 5) was often requested in this process.

Box 5

UNCTAD TECHNICAL ASSISTANCE ACTIVITIES IN RELATION TO THE URUGUAY ROUND

The Secretary-General of UNCTAD was requested, in paragraph 105(9) of the Final Act of UNCTAD VII (Geneva, 1987), to "provide technical assistance to developing countries, on request, in connection with the Uruguay Round of multilateral trade negotiations so as to facilitate their effective participation in these negotiations". UNDP was invited "to consider favourably the requests for the provision of adequate financial resources to UNCTAD and to individual countries for this purpose."

In response to this request, UNCTAD has provided such assistance through UNDP-financed projects, consisting of an interregional project and three regional projects (for Africa, Asia and the Pacific and Latin America and the Caribbean), complemented by a subregional project for the Central American countries. The UNCTAD/UNDP Technical Assistance Programme aimed at establishing, developing and strengthening the national negotiating capabilities of developing countries with regard to the Uruguay Round, and at assisting them in identifying their trade interests with respect to the various issues under negotiation, and in pursuing these interests by means of concrete proposals and counterproposals.

The Cartagena Commitment undertaken at UNCTAD VIII (1992) acknowledged the appreciation expressed by recipient countries for the support provided by UNDP through UNCTAD to facilitate the effective participation of developing countries in the Uruguay Round and called upon the UNCTAD secretariat to strengthen its technical cooperation activities, which should encompass, *inter alia*, trade negotiations, market access, and assessment and implementation of the results of the Uruguay Round.

The Fifth Programming Cycle of UNDP, which began in 1992, required modifications in related UNCTAD technical assistance activities. Consequently, two of the above regional projects (for the Asia/Pacific and Latin America/Caribbean regions) have been succeeded by new comprehensive programmes of technical cooperation, covering a considerably wider range of issues. For Asia and the Pacific, a new Project on "Institutional Capacities for Multilateral Trade" provided technical support to developing countries in the region during the latter phase of the Uruguay Round and will continue to assist these countries in the implementation of the Round's results, including through assistance in the adaptation of national laws and regulations and strengthening of human resources, as well as with respect to trade in services, trade and environment and competition policies, as well as the identification and analysis of possible issues for future trade negotiations. LATINTRADE emerged as an initiative embodying the concerted efforts of UNDP and UNCTAD with the participation of regional and subregional institutions, including, in particular, the Latin American Economic System (SELA), as well as the Inter-American Development Bank and ECLAC. Its objective is to enhance and strengthen the national negotiating capacities of these countries to enable them to more effectively participate in the new multilateral trade agreements; it will include post-Uruguay Round implementation issues, trade and environment, trade in services, the regional trade information infrastructure, and development of human resources.

In Africa, UNDP is in the process of assessing the priorities for a comparable new programme, and UNCTAD is attempting to obtain funds from various sources so that similar assistance, tailored to the particular needs of the African countries, can be provided.

Recently, a new project has been established to provide assistance to Arab countries in the post-Uruguay Round trading system, which takes into account the fact that some Arab countries have only very recently become contracting parties to GATT or are still in the process of accession. UNCTAD is executing projects for individual countries, such as China and the Russian Federation, to deal with matters linked to their participation in the international trading system. After the Marrakesh Ministerial Meeting the Trade and Development Board, in paragraph 11(e) of its agreed conclusions 410 (XL), agreed that UNCTAD should "refocus and intensify, where necessary, its technical assistance in the light of the Uruguay Round agreements aiming to increase the capacities of developing countries, especially the least developed among them, as well as to the economies in transition concerned, for their effective participation in the international trading system, and to ensure an efficient cooperation with relevant international organizations, in particular with the WTO and ITC."

C. The least developed countries

In launching the Uruguay Round, the Punta del Este Ministerial Declaration recognized the need for "positive measures to facilitate the expansion of trading opportunities" for the least developed countries. At Marrakesh, Ministers adopted a Decision on Measures in Favour of Least Developed Countries which, in the main, exhorts members to give prompt effect to the provisions in favour of these countries contained in the various Agreements. These provisions include advance implementation of MFN concessions on tariff and non-tariff measures for products of export interest to the least developed countries (LDCs). Apart from these provisions, participants in the Round gave an undertaking to consider further improving their GSP and other schemes in respect of products of interest to LDCs. In addition, there is a recognition of the weak export base and undiversified nature of their exports and thus a commitment to substantially increase technical assistance in the development, strengthening and diversification of their production and export bases, including those of services. The realization of these measures and their positive impact on the ability of LDCs to benefit from trade liberalization remain to be seen. It should be noted that where the various Agreements provide for differential and more favourable treatment for developing countries, the treatment extended to the LDCs is more favourable than for other developing countries, generally according them longer periods for compliance with and implementation of obligations. In some instances the LDCs have been exempted from certain obligations either indefinitely (e.g. concerning agricultural subsidies and export subsidies on industrial products) or for extended periods (e.g. TRIMs); in others they are required to assume the same level of obligation as all other countries within a relatively short transitional period (e.g. in the TRIPs Agreement). They have been given one additional year to meet the requirement of article XI of the WTO Agreement concerning the submission of Schedules on goods and services.

The LDCs and net food-importing countries were successful in negotiating a Ministerial Decision intended primarily as a political message to mobilize the support of Governments, through technical and financial assistance for food aid, as well as of the multilateral financial institutions, to take action to mitigate the impact of the higher food prices that were expected to result from the new multilateral disciplines on agricultural export subsidies. It is important, as emphasized by those countries, that any such assistance ensures for them the maintenance of acceptable levels of food imports if world food prices rise as a consequence of the Uruguay Round, and that the assistance be combined with adequate resources for increasing agricultural output and productivity, in order to reduce their high dependence on imports for their basic food needs. Also, it is necessary to improve market access conditions for these countries.

Conflicting views have been put forward on whether, and how far, any country or group of countries can be said to have emerged as "losers" from the Uruguay Round. In the long run, all countries stand to gain from trade liberalization and the acceptance of more stringent multilateral disciplines by the major trading countries. For the immediate future, however, it is clear that the poorer developing countries including the LDCs and other developing countries in Africa, will face additional difficulties due to the erosion of the preferential margins they enjoyed, particularly under the Lomé Convention, the expected increase in the cost of imported technology and in the price of imported foodstuffs, and the much higher level of both legal and procedural obligations that they will have to assume. The African countries, in particular, appear to have obtained recognition from the international community of the problems which they will confront in this new situation. However, this recognition needs to be translated into concrete action, including measures to provide them with alternative market access opportunities (e.g. through enlargement of GSP benefits), but also to assist them to take maximum advantage of the differential treatment they have been accorded. In particular these countries will require assistance in the areas of external finance, infrastructure, institution building and human resource development. ■

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Chapter V

THE REVIVAL OF MULTILATERALISM

A. Enforcement of multilateral disciplines

The Uruguay Round involved a major attempt to halt the erosion of the multilateral system caused by the proliferation of "grey area" measures, such as voluntary export restraints and the threat of unilateral action to attain national trade objectives. The first problem has been addressed by the Agreement on Safeguards, which abolishes voluntary export restraints, and the Agreement on Textiles and Clothing, which phases out the MFA.

The second problem relates primarily to actions taken under section 301 of the United States Trade Act of 1974 as amended. Originally intended to provide the Executive Branch with authority to raise tariffs as part of the normal GATT provisions for compensatory withdrawal of concessions, or in the context of article XXVIII renegotiations on tariff rates, this provision has changed character in subsequent legislation (i.e. in 1984 and 1988) to become an instrument for pursuing changes in other countries' trade practices, without first establishing whether or not such practices are in conflict with multilateral obligations. In particular, the "Super" 301 provision was added to address the broader aspects of countries' trade regimes, while "Special" 301 focused on intellectual property rights and was seen as a means of convincing countries of the need for bringing intellectual property within the scope of multilateral trading rights and obligations. While countries obviously require legislation to enable them to implement the decisions and recommendations of the Dispute Settlement Body when compensatory withdrawals of concessions are authorized, the problem with section 301 was that the countermeasures threatened were contrary to multilateral commitments.

The expansion of the scope of multilateral trade obligations means that a wider range of practices will be covered by the dispute settlement mechanism of WTO. Furthermore, the rights and obligations of members are more clearly defined than under GATT 1947 and have been extended to lay out precise obligations with respect to TRIPs and trade in services (e.g. the access obligations on trade in services are confined to those specified in the Schedules of Commitments). While this should prevent section 301 and similar legislation from being used in a manner inconsistent with multilateral rules, much will depend upon the determination of members to make full use of the dispute settlement mechanism when faced with such bilateral pressures with respect to measures which they maintain in full conformity with their multilateral obligations.

In this context, it should be noted that the Understanding on Rules and Procedures Governing the Settlement of Disputes substantially strengthens the dispute settlement mechanism by introducing a series of features lacking in the existing GATT mechanism. It sets up a unified system for goods, services and intellectual property rights. It ensures a complainant the right to the establishment of a panel and, once the panel is established, it proceeds through pre-determined successive stages in terms of a clearly specified timetable. Once a dispute is initiated, no member will be able to delay, postpone or block a decision. Panel reports are approved by the dispute settlement body unless there is a consensus to reject them, which is highly improbable. Recourse to a new appellate procedure is available for parties that wish to dispute a panel's conclusions and recommendations, and it can be expected that such recourse will be frequent, at least until the precise role of the Dispute Settlement Body (DSB) is established in practice.

Furthermore, members are committed not to make a determination to the effect that a violation of obligations or other nullification or impairment of benefits has occurred except through recourse to this mechanism. There are more effective surveillance and monitoring procedures to ensure compliance with recommendations. If a member does not comply with the recommendations or rulings of the Dispute Settlement Body, the ultimate recourse remains of compensation or the suspension of concessions, which must be authorized by the DSB. Where it is not practical or effective to suspend concessions with respect to the same sectors or agreements, "cross-sectoral" retaliation, i.e. as between goods, services and intellectual property, will be authorized. The concept of cross-sectoral retaliation was strongly opposed by many developing countries at earlier stages of the negotiations before the structures of the Agreements, including the Understanding on dispute settlement, had evolved. It appears to some, however, that cross-retaliation could actually strengthen the position of developing countries, in that retaliation in the area of intellectual property rights or in certain service sectors would be taken seriously by the major trading countries.

Some of the Uruguay Round Agreements contain additional dispute settlement rules and procedures (e.g. those on anti-dumping, subsidies and countervailing measures, and services). In addition, all these instruments contain mechanisms for surveillance of their implementation and review of their operation. The Uruguay Round has resulted in the setting up of a large number of councils, committees, monitoring bodies, working parties, expert groups, etc. The Decision on Notification Procedures contains an indicative list of notifiable measures and provides for a central registry of notifications. A considerably higher level of transparency has been achieved, as domestic procedures come under more strict multilateral surveillance. In addition, Annex 3 of the WTO Agreement confirms the establishment of the Trade Policy Review Mechanism that had been introduced on a provisional basis at the Mid-Term Review in 1988. It provides for the regular collective appreciation and evaluation of the full range of individual members' trade policies and practices and their impact on the functioning of the multilateral trading system.

B. Regional agreements

In parallel to their participation in the Uruguay Round, certain major trading countries also engaged in negotiations aimed at enlarging existing regional trading arrangements or establishing new ones (including arrangements among countries which had traditionally been staunch supporters of multilateral approaches). These countries appeared motivated by the perception that their mutual trade and economic relations had already become so extensive that more detailed obligations were required to govern their mutual trade relations covering a wider range of issues than had seemed possible when GATT was originally negotiated. Agreements to that end were perceived as providing better security of access and more efficient measures for the conciliation of disputes than those provided by GATT. Accordingly, regional agreements, particularly those involving major trading powers, were viewed as an "insurance policy" against a breakdown of the multilateral system. These perceptions may have been reinforced by the slow progress in negotiations in the GATT framework, the increasing recourse by major trading countries to unilateral measures and the apparent unwieldiness of the GATT dispute settlement mechanism. Access to regional "economic spaces" was seen as a means for enterprises to adjust to a more competitive situation and be better equipped to compete on a global scale. In developing countries, the widespread adoption of export-oriented development strategies and liberal import regimes provided a stimulus for the reinvigoration of regional and subregional agreements which had become moribund. In addition, the countries in transition in Central and Eastern Europe adopted an active approach to regional cooperation, both among themselves and with Western European countries.

The expansion and proliferation of regional agreements gave rise to the concern that the multilateral trading system would be further eroded and that it would degenerate into competing and mutually antagonistic "regional blocs" and a return to the policies of "spheres of influence" of the major powers, particularly if the Uruguay Round did not succeed. The final outcome of the Round, however, has served to ease the pressure on the countries concerned to lessen the forces of regionalism by "dissolving" many of the discriminatory aspects of regional agreements. Thus, tariff preferences for regional partners have been multilaterally reduced, including through the "zero-zero" arrangements in a number of sectors (e.g. construction, medical and agricultural equipment, steel, beer, distilled spirits, paper, furniture). Some idea of the impact of the MFN tariff reductions on the NAFTA and EEA tariff margins can be gained from the discussion above related to table 25. Furthermore, the Uruguay Round has established multilateral disciplines of equal or greater stringency than those in the regional agreements. For example, the disciplines of the Agreement on Agriculture and on Subsidies and Countervailing Measures go beyond the corresponding provisions of EEA and NAFTA respectively. Other Agreements, such as those on TRIPs, Technical Barriers to Trade and Sanitary and Phytosanitary Measures, effectively "multilateralize" the treatment of these issues in regional groupings (notably NAFTA). The TRIMs Agreement provides a shorter phase-out period for local content requirements in the automotive sector. The restrictions on textiles and clothing, which were generally not applied against partners in regional agreements, will be phased out, although tariff margins will remain. On the other hand, the safeguard provisions in NAFTA appear to have anticipated the quota modulation provisions of the Agreement on Safeguards so as to generally exclude regional partners from safeguard action. The partners to regional agreements in some cases have accepted additional commitments in areas that are not covered by the WTO Agreement, notably with respect to the treatment of foreign investors, labour rights and environmental measures (in NAFTA). EEA members have accepted the competition policy rules of the European Union. Discrimination in favour of regional partners has also been reduced or removed for those sectors and subsectors included in the Schedules of Commitments annexed to GATS.

One of the major concerns motivating smaller countries to pursue regional approaches is their impression that such agreements provide greater security of market access than GATT. However, the intensification of multilateral disciplines and the Understanding on Rules and Procedures Governing the Settlement of Disputes, described above, may mitigate this perception. The experience of the Canada/United States Free Trade Area Agreement has demonstrated that regional partners may seek to resolve bilateral disputes in the multilateral context. Both that Agreement and NAFTA contain *GATT aquis* provisions (i.e. all GATT rights are preserved). ■

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Chapter VI

IMPLEMENTATION AND CONTINUED NEGOTIATION

A. The built-in work programme

Most of the Agreements concluded in the Uruguay Round provide for regular reviews of their operation. In addition, special reviews of work programmes are provided for to introduce further improvements or verify the practical implementation of the substantive provisions in several of the Agreements, including the Agreement establishing the WTO, the Understanding on the interpretation of GATT article XVII, and the Agreements on sanitary and phytosanitary measures, subsidies and countervailing measures, technical barriers to trade, TRIMs, anti-dumping, preshipment inspection, rules of origin, and TRIPs. GATS also provides for a review of trade in services prior to future negotiations and special working parties in such areas as professional qualifications. As already noted, renegotiation of certain existing plurilateral agreements that will be covered by Annex 4 of the WTO Agreement (e.g. on Civil Aircraft) is currently under way, as is the negotiation of a multilateral steel agreement, for possible inclusion in Annex 4.

Furthermore, some Agreements specifically provide for future multilateral negotiations. The most specific provision relates to trade in services, where separate decisions envisage the continuation of negotiations on commitments relating to basic telecommunications, financial services, movement of natural persons and maritime transport services under the auspices of the Preparatory Committee for the WTO. GATS itself provides that members will enter into successive rounds of negotiations, beginning not later than five years from the date of entry into force of the WTO Agreement, with a view to increasing the general level of the specific commitments contained in the Schedules. It also provides for negotiations to establish disciplines with respect to emergency safeguard measures and subsidies, as well as negotiations on government procurement. The Agreement on Agriculture provides for a continuation of the reform process, to fulfil the long-term objective of substantial progressive reductions in support and protection. Negotiations for continuing this process will be initiated one year before the end of the implementation period. The Agreement on TRIMs is due for a review not later than five years after the WTO Agreement enters into force to examine the possibility of incorporating provisions on investment and competition policy. These provisions for reviews and future negotiations constitute what may be considered a built-in future work programme for WTO, which implies a situation of permanent negotiation. On the assumption that the new Organization will come into being at some time during 1995, most of these reviews and further negotiations will be initiated in 1999-2000, and could provide the basis for a further round of multilateral trade negotiations, potentially in a single package, at that time. When they become full members of WTO (see below) China, the Russian Federation and Taiwan province of China could be full participants in such tariff negotiations.[284]

The WTO Agreements provide a mechanism for countries to effectively defend and

[284] China has applied to resume its status as a contracting party to GATT, which would qualify it for original membership in WTO, subject to the conditions of article XI of that Agreement. The Russian Federation has observer status in GATT and its application for accession is under consideration (see also section B below, in particular box 3). The application of Taiwan province of China is under consideration by a Working Party of GATT, where it is designated as "Chinese Taipei", to be known in full as the "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu". See *Focus. GATT Newsletter*, No. 94, October 1992.

pursue their interests if they have the requisite resources. In particular, it can be expected that the major trading countries will initiate a series of actions to define the scope of the new obligations emerging from the Round, and developing country practices will inevitably constitute the targets of some of these challenges. However, many developing countries will be faced with serious challenges with respect to institutional capacity, human resource development and information management. Effective utilization of the Agreements would seem to require strong, coordinated governmental machinery on trade matters. There will be a need to monitor how the new rules are complied with by trading partners with respect to national trade interests, as well as to implement the multilateral rules in national legislation, and to establish the institutional mechanisms for the purpose. For most developing countries, their ability to cope successfully with this complex system may be a cause of concern, and many may find themselves having to accept more onerous multilateral obligations under close surveillance from trading partners, without being able to benefit from the expanded trading opportunities. Technical assistance programmes designed to assist developing countries to respond to these challenges, and to utilize the opportunities offered by the implementation of the Uruguay Round results, would seem necessary.

B. Accession to GATT/WTO

As noted above, many developing countries followed the timetable and procedure established in the Punta del Este Declaration for the participation and accession of countries that were not contracting parties to GATT in September 1986. At the final stages of the Round, when it was established that only contracting parties to GATT 1947 could become original members of WTO, a wave of accessions occurred, under article XXVI of GATT, by developing countries which had been applying the General Agreement on a *de facto* basis (see box 6).

In this process, China, which had participated in the Uruguay Round while negotiating its resumption of contracting party status, has been an exception. The negotiations are still continuing with a view to China's becoming an original member of WTO, but they have been slowed down by several factors. The most important of these have been the preoccupation with the perceived lack of transparency and continued state enterprise domination of the Chinese import regime, combined with the persistent efforts of major trading countries to impose special conditions on China, such as a selective safeguard clause, which would nullify China's rights under the WTO. China has become the world's fastest-growing major importer and is seen as the "locomotive" of the growth of world trade in the next decade. If the multilateral disciplines of WTO were not to cover trade relations with China, the credibility of the institution would undoubtedly suffer.[285] Certain countries may have been reluctant to make substantial tariff concessions on items of interest to many developing countries where China is the principal supplier, in anticipation of future tariff negotiations with that country.

The dissolution of the USSR and the adoption of market-oriented economic systems by the newly independent republics, as well as by other countries in Central and Eastern Europe which had been contracting parties for several decades, took place while the Uruguay Round was under way. In the later stages of the negotiations additions were made to several Agreements which recognized the specific problems faced by the economies in transition. Thus, the Agreement on Subsidies and Countervailing Measures (article 29) introduces special transitional arrangements for such countries, permitting them to apply, under certain conditions, subsidy programmes necessary for economic reforms, including otherwise prohibited subsidies, during a seven-year period from the date of entry into force of the WTO Agreement. During the same period, their actionable subsidies will not be subject to remedies under the Agreement. Likewise, article 65 of the Agreement on TRIPs foresees the same transitional arrangements for the economies in transition as for developing countries, i.e. they are entitled to delay, with some ex-

285 For a review of developments in China in the context of growth and integration of the industrializing East see *TDR 1993*, Part II, chap. IV.

Box 6

COUNTRIES AND CUSTOMS TERRITORIES THAT ARE NON-CONTRACTING PARTIES TO GATT 1947 COVERED BY THE MINISTERIAL DECISION ON ACCEPTANCE OF AND ACCESSION TO THE WTO AGREEMENT (AS OF 1 JULY 1994)

Countries which participated in the Uruguay Round under Part I(F) of the Punta del Este Declaration

China - applied for resumption of GATT contractual status in July 1986; Working Party established in March 1987.

Algeria - Working Party on Accession established in June 1987.

Countries and customs territories in accession to GATT 1947 which were associated with the Uruguay Round under the TNC decision of 28 July 1993

	Working Party on Accession established in:
Bulgaria	November 1986
Nepal	June 1989
Mongolia	October 1991
Panama	October 1991
Slovenia	July 1992[1]
Ecuador	September 1992
Taiwan province of China	September 1992
Albania	December 1992
Russian Federation	June 1993
Saudi Arabia	July 1993
Belarus	October 1993
Croatia	October 1993
Armenia	December 1993
Latvia	December 1993
Moldova	December 1993
Ukraine	December 1993
Jordan	January 1994
Lithuania	February 1994
Estonia	March 1994

Countries applying GATT 1947 on a de facto basis (as of 1 July 1994)

Cambodia	Sao Tome and Principe
Algeria	Papua New Guinea
Yemen	Seychelles
Equatorial Guinea	Djibouti
Tonga	Solomon Islands
Bahamas	Tuvalu
Cape Verde	Kiribati

Source: GATT (press releases and documents).

[1] The Working Party concluded its work in June 1992.

ceptions, the application of the Agreement for a period of five years following the date of entry into force of the WTO Agreement. GATS (article XII) allows countries in the process of economic transition, like developing countries, to adopt or maintain restrictions on trade in services with regard to which they have undertaken specific commitments in the event of serious balance of payments and external financial difficulties or the threat thereof.

Most of the economies in transition concerned, notably the Russian Federation, have initiated procedures for accession to GATT. While these countries have been able to enter into trade agreements with, and even obtain preferential treatment from, several developed countries, the latter have retained, in their import regime applied to the countries in transition, certain discriminatory aspects of their trade legislation, including such provisions as selective safeguard clauses and special anti-dumping criteria and mechanisms, which had originally been designed as a response to the economic and political system previously existing. Any such discriminatory legislation would have to be eliminated in respect of any transition economy that becomes a member of WTO.

There are indications that issues which are not directly related to GATT obligations may arise in the accession negotiations of these countries. Ownership, in particular, has become the key issue in the working parties on negotiation of accession. Some countries have been seeking commitments concerning privatization programmes in general, as well as the specific aspects of transparency and monitoring, specific timetables, percentages and other numerical goals of privatization. While these relate in particular to foreign trade enterprises, they also concern agriculture, industry, and services such as banking. Other members of the working parties, however, have opposed this kind of commitment on the grounds that there is no provision in either GATT 1947 or GATT 1994 that would require contracting parties to privatize economic activities to any particular degree, and that certain types of business transactions, such as barter trade, are not inconsistent with the provisions of GATT 1994.

The Understanding on the Interpretation of Article XVII of GATT 1994, which introduces a considerably greater degree of surveillance and transparency with respect to the operations of state-trading enterprises, seems to have been drawn up in anticipation of the accession of countries in transition. That article provides for obligations only in respect of the activities of state-trading enterprises, which are defined as including any enterprise to which a contracting party grants formally, or in effect, exclusive or special privileges in carrying out sales or purchases involving either exports or imports. The ownership of these enterprises is not specified. The Understanding contains a "working definition" of state-trading enterprises which identifies as falling within its scope, "governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their practices or sales the level or direction of imports or exports".

The effective revision of the non-application provisions of GATT article XXXV, incorporated in the WTO Agreement, creates a further disadvantage for acceding countries by enabling members to use the threat of its invocation to obtain concessions in the accession negotiations, including tariff negotiations, a situation which article XXXV was intended to prevent.

C. The future agenda

During the final stages of the Uruguay Round it became apparent that, unlike the case of previous Rounds,[286] decisions relating to a future work programme could well constitute an inherent part of the final package. The understanding that no country would raise new matters that would complicate the consecration of the results at Marrakesh was not respected, and initiatives were taken to make acceptance of the results conditional upon decisions to place certain new issues on the work programme of the WTO Preparatory Committee. The measures which had received the most active support from certain developed countries were (a) links between trade rights and environmental measures, (b) multilateral rules on competition policy, and (c) links between trade and labour rights. The latter issue attracted the

286 It should be recalled that at the final meeting of the Tokyo Round, the United States chief negotiator made a statement to the effect that the Tokyo Round would be the last negotiation of the twentieth century. Two years later, at the 1981 session of the GATT Contracting Parties, initiatives were taken to establish a work programme that led to the Uruguay Round.

Box 7

POSSIBLE ADDITIONAL ITEMS TO THE WTO WORK PROGRAMME[1]

In the statements which they made in the course of this meeting, Ministers representing a number of participating delegations stressed the importance they attach to their requests for an examination of the relationship between the trading system and internationally recognized labour standards, the relationship between immigration policies and international trade, trade and competition policy, including rules on export financing and restrictive business practices, trade and investment, regionalism, the interaction between trade policies and policies relating to financial and monetary matters, including debt, and commodity markets, international trade and company law; the establishment of a mechanism for compensation for the erosion of preferences, the link between trade, development, political stability and the alleviation of poverty, and unilateral or extraterritorial trade measures.

1 Concluding remarks by the Minister of Foreign Affairs of Uruguay, Chairman of TNC, Marrakesh, 15 April 1994 (MTN.TNC/MIN(94)/6).

most fervent support and opposition. However, delegations arrived in Marrakesh armed with their own proposals, with the result that all such ideas have been listed in a paragraph of the Chairman's Concluding Remarks (see box 7).

A decision was taken to establish a Sub-Committee on Trade and Environment.[287] As noted above, some of the Uruguay Round Agreements, notably those on subsidies and countervailing duties, technical barriers to trade and sanitary and phytosanitary measures, contain provisions which are relevant to countries' ability to take measures to protect the environment. The concerns that the trade-environment link could be used to promote protectionist interests derive essentially from three situations. The first, and more traditional, relates to technical regulations to ensure that imported products conform to domestic environmental regulations. This is essentially the situation foreseen in the Agreement on Technical Barriers to Trade, which would provide the mechanism for addressing trade problems arising in this context. The second situation corresponds to the issues raised in the dispute over the United States restrictions on imports of tuna - i.e. where a country imposes restrictions on a product that in itself is not dangerous to the environment but for which the method of production or extraction is deemed to be so. The solution to such problems relates to the existence of international environmental agreements and to the possiblity of establishing links beween these agreements and the multilateral trade obligations of WTO in a manner similar to that established for intellectual property rights under the TRIPs Agreement. The third situation derives from the "level playing field" argument: lower environmental standards among countries will affect international competition and investment decisions, in as much as cost cutting as a result of the lowering of standards can be considered as dumping or subsidization. There are already instances of this argument being used to justify anti-dumping duties against non-GATT countries and the current debate on the internalization of environmental costs could provide more arguments for protectionist interests.

At Marrakesh, some Ministers made strong statements in favour of the negotiation of multilateral competition rules in the WTO context. It should be recalled that the issue of restrictive business practices was among the issues dealt with in the Havana Charter that was not taken up in GATT (despite attempts to do so), but was addressed in the United Nations, ultimately becoming the non-binding Set of Mutually Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, negotiated in UNCTAD. A number of Uruguay Round Agreements touch upon RBPs, notably those on TRIMs, anti-dumping, subsidies and countervailing measures, safeguards, trade in services and TRIPs. In partic-

287 For its part, the Trade and Development Board established in May 1994 a number of new bodies, two of which will deal with matters directly related to the outcome of the Uruguay Round (see box 8).

Box 8

THE URUGUAY ROUND IN THE MID-TERM REVIEW OF THE CARTAGENA COMMITMENT OF UNCTAD VIII

In May 1994, the Trade and Development Board conducted a Mid-Term Review of the work programme of UNCTAD's intergovernmental machinery. As a result, the Board decided to establish new working groups, two of which have a direct relevance to the Uruguay Round results. In addition, the Board agreed to the holding of a seminar on regional economic arrangements and their relationship with the multilateral trading system.

Ad Hoc Working Group on Trading Opportunities in the New International Trading Context

The terms of reference of the Group provide for the following activities:

- Identifying new trading opportunities arising from the implementation of the Uruguay Round agreements, in particular sectors and markets, with a view to enhancing the ability of developing countries, in particular the least developed countries, and countries in transition concerned to take full advantage of such opportunities.
- Enhancing the understanding of the implications of the new rules deriving from the Uruguay Round agreements and their follow-up, and identifying where and how developing countries and economies in transition concerned could be assisted to: (a) make use of the special clauses providing differential and more favourable treatment; and (b) implement and benefit from the commitments undertaken.
- Analyzing the modalities to give effect to the decision on special provisions for least developed countries and identifying areas in which technical cooperation should be strengthened.

Ad Hoc Working Group on Trade, Environment and Development

The Group will:

- Examine the effects of environmental policies, standards and regulations on market access and competitiveness, in particular of the developing countries, especially the least developed among them, and countries in transition, taking into account the financial and technological implications;
- Identify and analyse emerging environmental policy instruments with a trade impact;
- Explore the market opportunities and implications for exporters which may flow from the demand for "environmentally friendly" products;
- Study eco-labelling and eco-certification schemes, and possibilities for international cooperation in this field. The work of the Group will initially focus on: (a) a comparative analysis of current and planned schemes, and (b) an examination of the possibilities for taking into account the interests of developing countries in the elaboration of eco-labelling criteria.

ular, there is concern that the strict prohibition of voluntary export restraints (VERs) (or "orderly marketing arrangements") may result in such measures "going underground" and being applied through industry-to-industry understandings, despite the clear obligation on Governments in the Agreement on Safeguards not to encourage or support such measures. VERs could also be replaced by frequent recourse to anti-dumping actions, as certain elements of the Agreement on Anti-Dumping (including the "standards of review" clause) appear to impose relatively less discipline on this technique of protection. In fact, anti-dumping measures, in particular price undertakings, can be used to perpetuate anti-competitive situations. On the other hand, in the context of the TRIMs and TRIPs Agreements, there is concern that the disciplines may be interpreted in such a way as to prevent members, particularly developing countries, from taking effective measures to combat restrictive business practices by TNCs. Proponents of the negotiation of multilateral rules on competition (or anti-trust regulations) have cited these examples in stressing that such rules are required to ensure the effective implementation of the Uruguay Round Agreements.[288]

[288] Article 9 of the TRIMs Agreement provides for consideration of the possibility of complementing the Agreement with provisions on competition policy.

The proposal that WTO should establish a link between multilateral trade rights and obligations and labour standards was put forward shortly before the conclusion of the Uruguay Round but rapidly became the most controversial issue among the possible new issues for consideration in WTO. This initiative is seen by developing countries as aimed at undermining their comparative advantage and providing protectionist interests with a further "trade remedy" directed at their exports. In this connection, the recent debate on this issue at the eighty-first session of the International Labour Conference (June 1994) resulted in the establishment of a working party to discuss and reflect on all relevant aspects of the social dimensions of the liberalization of international trade.

The proliferation of statements emphasizing the importance of the institutional outcome of the Uruguay Round (i.e the establishment of a "new" organization), as opposed to the substantive results embodied in the constituent agreements, may have had the unfortunate effect of setting up WTO as a target against which protectionist forces can rally. There is some evidence that political interest groups, driven by essentially parochial sectoral interests, are uniting to oppose ratification of the WTO Agreement on the basis of supposed threats to "national sovereignty". Similarly, the conversion of GATT into the WTO appears to be used by others opposed to giving a primary role to the United Nations in the economic field, to claim that the institutional outcome of the Uruguay Round is a reason for downgrading the involvement of the United Nations proper in trade and development issues.

While the overall result of the various Agreements has been to strengthen the multilateral trading system and extend its competence, it has not fundamentally modified the character of the GATT system or its underlying precepts. The extension of the mandate of GATT to cover new areas of the international economic debate was not accomplished through the negotiation of comprehensive agreements addressing the totality of issues and interests in each of these fields. The scope of WTO is confined to the narrower range of matters with respect to which Governments were willing to accept contractual obligations that would be subject to an overall dispute settlement process which, in the last resort, would be enforced through trade sanctions. This particular characteristic of WTO constitutes a fundamental limitation to the extent to which its scope may be extended so as to impose multilateral disciplines in additional "trade-related" areas. The frontiers of WTO's authority will be delineated by the extent to which countries are prepared to submit their policy measures in additional fields to contractual obligations that could expose these policies to the threat of possible trade sanctions.

Experience indicates that the process of trade liberalization and the extension of disciplines to new areas create their own momentum, in that differences in the application of norms among countries in many other areas are perceived as providing advantages to countries with lower standards in terms of their ability to compete, i.e. the so-called "level playing field" approach referred to above. The issues listed as possible candidates for inclusion in the WTO work programme also include wider economic, social and political issues that may both influence, and be influenced by, trade flows. A widespread preoccupation seems to be that the outcome of negotiations aimed at linking these various areas to the multilateral trading system could significantly add to the arsenal of protectionist "trade remedies" which the Uruguay Round has so painstakingly attempted to discipline, with varying degrees of success. However, in order to preserve and strengthen the system, additional positive measures are required, rather than simply exemptions from the disciplines, to assist those parties which may be disadvantaged, at least temporarily, by the inevitable adjustment process; a "safety net"' is needed for those which will simply be unable to compete effectively, including particularly disadvantaged countries and groups within countries. The question arises as to whether further multilateral negotiations should aim at establishing disciplines in all areas where lack of effective rules can affect competitiveness in international trade. There is also the issue of how to address the problems - social, economic and otherwise - that arise from changes in the size and direction of trade flows.

The international community will have to decide whether these issues are appropriate subjects for trade negotiations, or whether they should primarily be considered as problems of "governance" in the United Nations context. ■

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Printed in Switzerland
GE.94-53060
August 1994 – 9,220

UNCTAD/TDR/14

United Nations publication
Sales No. E. 94.II.D.26

ISBN 92-1-112360-7
ISSN 0255-4607