UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT, 1995

UNITED NATIONS

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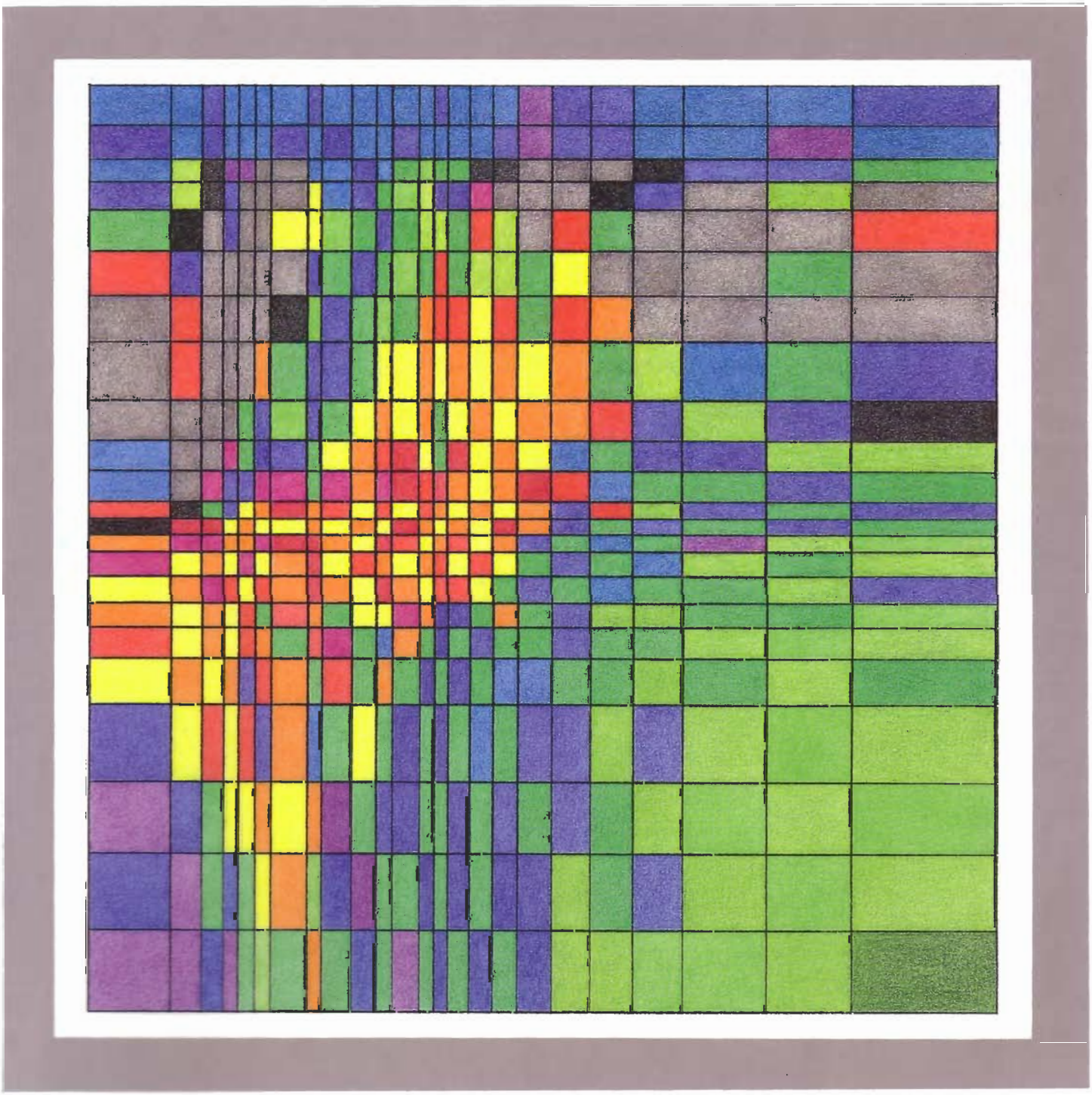

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
GENEVA

TRADE AND DEVELOPMENT REPORT, 1995

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

UNITED NATIONS
New York and Geneva, 1995

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FOREWORD

The *Trade and Development Report* aims to examine the impact of current international economic issues on the economies of developing countries. It does so by comparing current economic performance with that of the preceding year, and by examining future economic prospects, both for the world economy as whole and for the different regions. Here, the *Report* draws on the United Nations World Economic and Social Survey, and on the work of United Nations regional economic and social commissions and the specialized agencies.

Among the major issues raised in this *Report* are:

- **International financial turbulence.** What are the lessons to be learned from the recent sharp movements of the major currencies? What can be done to reduce turbulence and strengthen countries' defences against external financial volatility - but without depriving them of the gains from international economic transactions?

- **Unemployment in OECD countries.** What is the real cause and what is the right remedy? Unless unemployment in OECD countries is effectively tackled, it could derail the post-Uruguay Round trading system and prevent globalization and liberalization from yielding their benefits.

The *Trade and Development Report 1995* suggests answers to these and related questions. In doing so, it takes a distinctive view of the working of the world economy and of global macroeconomic management. Its analysis and policy recommendations are presented as a contribution to the international debate on these matters - a debate which recently received added impetus from the Summit meeting of the "Group of Seven", held in Halifax, Nova Scotia, in June.

The main theme of the ninth session of the United Nations Conference on Trade and Development, to be held in April-May 1996, will be the promotion of sustainable growth and development in a globalizing and liberalizing world economy. The *Report* makes an important contribution to that debate.

Boutros Boutros-Ghali
Secretary-General of the United Nations

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Explanatory notes

Classification by country or commodity group

The classification of countries 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.

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

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 1994* refers to *Trade and Development Report, 1994* (United Nations publication, Sales No. E.94.II.D.26).

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

The term "billion" signifies 1,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

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

Use of a hyphen (-) between dates representing years, e.g. 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 (-) or a zero (0) indicates that the amount is nil or negligible.

A dot (.) indicates that the item is not applicable.

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 to totals because of rounding.

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[1] United Nations publication, Sales No.E/F.94.II.D.24. In Part One, chapter II (tables 5 and 7-9), a revised classification has been used: "Developing countries" include China, Mongolia, Democratic People's Republic of Korea, Viet Nam and the Central Asian States of the former USSR. Other former republics of the USSR (including the Baltic States) are classified in the group "Eastern Europe".

Abbreviations

ASEAN	Association of South-East Asian Nations
BIS	Bank for International Settlements
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
DAC	Development Assistance Committee (of OECD)
DRF	Debt Reduction Facility (of IDA)
EC	European Community (or Communities)
ECA	Economic Commission for Africa
ECAs	export credit agencies
ECE	Economic Commission for Europe
ECGD	Export Credits Guarantee Department (United Kingdom)
ECLAC	Economic Commission for Latin America and the Caribbean
ECOWAS	Economic Community of West African States
ECU	European currency unit
EEC	European Economic Community
EFF	Extended Fund Facility
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESAF	Enhanced Structural Adjustment Facility (of IMF)
ESCAP	Economic and Social Commission for Asia and the Pacific
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
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IBRD	International Bank for Reconstruction and Development (World Bank)
ICT	information and communication technologies
IDA	International Development Association
IFC	International Finance Corporation
ILO	International Labour Organisation
IMF	International Monetary Fund
LAIA	Latin American Integration Association
LDC	least developed country
LIBOR	London Inter-Bank Offered Rate
MERCOSUR	Southern Common Market

MFI	multilateral financial institution
MFN	most favoured nation
NAFTA	North American Free Trade Agreement (Canada-United States-Mexico)
NAIRU	non-accelerating inflation rate of unemployment
NAWRU	non-accelerating wage rate of unemployment
NBER	National Bureau of Economic Research
NIEs	newly industrializing economies
NIESR	National Institute of Economic and Social Research
ODA	official development assistance
OECD	Organisation for Economic Cooperation and Development
R&D	research and development
RAP	Rights Accumulation Programme
RBP	restrictive business practice
RCA	revealed comparative advantage
SAF	Structural Adjustment Facility
SAP	Structural Adjustment Programme
SDR	special drawing right
SITC	Standard International Trade Classification
STF	Systemic Transformation Facility (of IMF)
TNCs	transnational corporations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organization
VAT	value added tax
WTO	World Trade Organization

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OVERVIEW

by the Secretary-General of UNCTAD

Global trends

The world economy has been losing steam in 1995. This year, growth in Latin America as a whole will fall from 3.7 per cent to 2 per cent - which is nearer to Africa's rate than Asia's. The developed market economies will also slow down, in part because of the cyclical deceleration in the United States, and in part because the decline of the dollar and import cuts in Latin America have weakened demand for the exports of Western Europe and Japan. However, growth in the developing countries of Asia will accelerate; and a number of countries in Central and Eastern Europe will also show continued advance. But commodity prices will on the whole be considerably below their 1994 levels.

1994 had seen a significant quickening of the tempo of world economic growth, up from 1.7 per cent in the previous year to 3.1 per cent. Most regions participated in this acceleration, particularly Western Europe, whose cyclical recovery from recession was largely responsible for the doubling of growth in the developed market economy countries. All three developing regions grew faster than in the previous year, with Asia continuing to outpace the others and Africa lagging behind; in that continent, population growth continued to outstrip income growth. China's expansion was trimmed a little while remaining extremely rapid. A number of countries in Central and Eastern Europe registered impressive advances, but many others experienced further declines.

International trade grew even faster than world output, thus helping to spread growth across the world economy. Both the United States and Western Europe received a strong impetus from exports, especially to the rest of the world, in particular developing countries in East and South-East Asia and Latin America. Intra-regional trade in these parts of the world also continued to grow rapidly. In Latin America this was in no small measure due to the region's largely consumer-driven import boom, whereas in East and South-East Asia it went alongside a relocation of production driven by foreign direct investment, much of it originating in the region. Moreover, a number of primary producers benefited from sizeable and widespread increases in non-oil commodity prices. These reflected ephemeral influences such as the cyclical upturn in world economic activity and speculative trading.

However, for many countries structural factors restraining growth performance proved stubborn. In Japan, for instance, debt deflation continued to reinforce the country's chronic underconsumption; stimulative action, once again, was too little and too late to generate a genuine recovery. In Africa, Structural Adjustment Programmes continued to bring only a modest improvement in the growth rate. Long-term development performance remains depressed by commodity dependence, poor infrastructure, over-indebtedness, low levels of domestic investment and caution by foreign investors, as well by political instability and conflicts.

External financing and debt

External financing continued to be concentrated among relatively few developing countries and economies in transition. Commercial bank lending to Africa, West Asia and Eastern Europe decreased in 1994.

The Paris Club took a significant step forward in adopting the new Naples terms, but the results fall short of expectations. The new terms allow for a 67 per cent reduction of debt service of the poorest and most indebted countries (compared to 50 per cent under the enhanced Toronto terms) and, where the debtor is ready to exit from the process of debt rescheduling, reduction of the stock of non-concessional debt by 50 per cent or 67 per cent. The implementation of these terms has, however, been rather hesitant. The eligibility criteria have unduly restricted the number of countries benefiting from most favourable treatment. Furthermore, the budgetary, legal or policy restrictions on debt reduction faced by some creditors risk preventing the much-needed stock treatment from becoming a reality. Besides, the scope of debt eligible for reduction has been narrowed considerably. While the Naples terms may significantly reduce the debt service ratio for over half of the 33 low-income countries studied, the ratio for many others will remain too high.

One important reason is the heavy weight of multilateral debt. The debt of highly indebted low-income countries to the multilateral financing institutions warrants serious attention. These institutions have already taken some steps to provide relief, by in effect refinancing hard loans with concessional funds. The IMF and the World Bank have also adopted the "rights accumulation" approach to deal with protracted arrears. However, the measures taken have not been sufficient to resolve the problem of arrears and to prevent the multilateral debt service burden in a number of countries from increasing at a dangerous pace. Current schemes could be improved, for example by allowing interest payments on arrears and current debt service obligations to be suspended during the programme of rights accumulation. However, this would still not suffice - the main constraint is funding.

A number of constructive proposals have been made recently which are designed to provide additional multilateral debt relief without diverting development assistance from other uses or increasing the pressure on bilateral donors (many of whom are reducing their aid budgets):

- the sale of a portion of IMF gold reserves;
- a new SDR allocation, a portion of which would be used to alleviate multilateral debt;
- drawing on the reserves and loan-loss provisions of multilateral financial institutions.

Such proposals deserve urgent and sympathetic consideration.

Latin America's slowdown

The main reason for the Latin American slowdown is the reversal of capital flows. The collapse of the peso in December 1994, besides forcing Mexico into severe recession, involved a shift of sentiment regarding shares and currencies in "emerging markets". It marked the second major disruption of international financial markets in response to crisis involving a developing country's external payments

and reserves (the first being in the early 1980s). The reverberations would have been even more extensive in the absence of the Mexican rescue package. As it was, external bond issues by Latin American entities virtually dried up during the first quarter of 1995, and access to the international financial markets remains limited.

In Argentina, where the currency is fixed to the dollar and the money supply to the level of foreign reserves, the "tequila effect" led to a contraction of domestic credit. This put a sudden brake on economic activity - which, in turn, damaged bank solvency. By contrast, in Brazil, the effect was felt in currency depreciation. The drying up of external credit has meant that the authorities cannot maintain price stability as they had begun to do before the outbreak of the Mexican crisis, namely by allowing the real exchange rate to appreciate and the trade balance to worsen. That country's prospects for stabilization hinge, more than ever, on fiscal reform.

The external financial turbulence that engulfed Latin America took most observers and market participants by surprise. However, readers of the *Trade and Development Report* have received repeated warnings that the surge of capital flows to Latin America was bound to peter out. The bubble could have been prevented through capital controls, which are consistent with IMF Articles of Agreement and practised by a number of highly market-oriented Latin American countries.

The basic weakness of the flow to Latin America was that, unlike that to East and South-East Asian countries (which were initially also hit by the international financial turbulence but eventually survived unscathed), it was based not on high rates of domestic savings and investment and a competitive exchange rate, but on massive privatization receipts and on liquid flows attracted by the combination of high interest rates and real currency appreciation. This allowed the inflow to generate its own momentum ("bandwagon") even though it was fuelling a consumer boom while simultaneously eroding the competitiveness of exports, thus producing huge and rising deficits on current account without a commensurate increase in productive capacity.

The dynamic described was especially marked in the case of Mexico, and once the bubble had grown sufficiently it was bound to burst. The conclusion, still denied in many quarters, is that the crisis stemmed from the economic strategy itself (which had received the blessing of the international community), rather than from a slippage. The dangers of euphoria on the part of investors were overlooked by both Mexico and its creditors - and sometimes explicitly denied on the grounds that deficits generated by private-sector borrowing and lending decisions are invariably benign. This notion, which should have been dispelled by Chile's debt crisis in the early 1980s, had been transformed into a doctrine in the United Kingdom, and then reexported to Latin America as an article of faith.

A number of Latin American countries now face another round of severe adjustment. The scale of the balance of payments correction that might be needed by the two main adjusting countries is conceivably very large: their current account deficits amount to more than 50 per cent of their exports. It may be impossible to avoid a major reduction in domestic absorption and imports, since the capacity to export has not been sufficiently enlarged in recent years: investment in tradeables has been weak ever since the debt crisis, and too much investment has gone into services and residential construction. Besides, private saving rates have tended to decline. Moreover, the simultaneous loss of capital inflows and of growth momentum will make the reconciliation of the income claims of different social groups - and hence the containment of inflation - more problematic. The maintenance of fiscal balance - one of the main achievements of the period of reform - will also be rendered more difficult. The need for import cuts by several major economies simultaneously will involve a loss of external markets for all countries in the region. Equally, their push for foreign markets may impose great strain on trade relations; indeed this has already been the case within MERCOSUR.

For adjustment to succeed in laying the basis for sustained growth in the future, it must correct three weaknesses which have been highly evident in the course of Latin America's recent recovery from debt crisis: (a) inadequate competitiveness; (b) a low rate of reinvestment of profits; and (c) insufficient investment in infrastructure. The right remedies are unlikely to be found by orienting policy towards

regaining the confidence of portfolio managers; their mood swings are, in any case, extremely difficult to keep pace with. A further round of rethinking of economic policy may be required. Perhaps the right starting point is to consider how several countries in Asia have succeeded in penetrating world markets, utilizing external savings and regulating their financial systems.

Systemic risk and derivatives

A rethinking of financial policies has already begun, as regards systemic risk and derivatives. Large trading losses for several banks and the insolvency in February 1995 of Barings due to positions in futures have served as an alert regarding the risks in derivatives markets. Policy makers and financial regulators are worried above all about systemic risks and their potential for causing a crisis that would lead to a breakdown in the financial system and in its three key functions of credit allocation, payments and the pricing of financial assets. Concern as to risks in derivatives markets was one of the factors behind the call of the G-7 countries at their Halifax Summit for a strengthening of international cooperation in financial supervision to safeguard the financial system and to prevent an erosion of prudential standards.

Among the lessons to be learnt from historical instances of collapse or extreme strain in derivatives markets are the need for strong legal and institutional frameworks, including clearinghouses with adequate resources as well as arrangements for settling obligations which avoid huge rises in short-term exposure capable of impairing institutions' creditworthiness and thus endangering the payments system. Another lesson, especially important for developing countries, is that the use and trading of derivatives should be an organic extension of hedging and balance-sheet management. Artificial initiatives such as the establishment of futures and options exchanges purely to attract business to nascent financial centres are likely to lead to markets dominated by speculation that poses a threat to the entire financial sector.

Many recent initiatives regarding derivatives are directed at internal controls. While such initiatives concern firms in the first instance, ultimately they are also capable of reducing systemic risk. Prudential initiatives on the part of the European Union, the Basle Committee and others are intended to reduce or control banking and securities risks more generally. The result of these initiatives so far is only the beginning of a harmonized regime for financial regulation, with a coverage of subjects and firms that is far from complete. While systemic risk will be reduced by improved prudential standards, it will continue to be present during periods when high volatility in asset markets endangers participants or is accompanied by major insolvencies.

Unemployment in the North

Unemployment is now a veritable scourge in the developed market economies. Open unemployment has risen sharply in the OECD countries, from an average of 3.2 per cent of the labour force in 1960-1973 to 7.3 per cent in 1980-1994. Last year, 34 million people were out of work.

The problem is not only one of the vast numbers involved. The quality of the new jobs created has on the whole been poor. In the United States, for instance, employment has grown significantly faster

than in most other industrial countries, but most of the new jobs created are low-paid. As a result, a large part of the labour force has been suffering from stagnant or even declining rates of pay, and has failed to share in the growth of national income.

In many quarters, the twin problems of unemployment and low pay are being blamed on the growth of international trade and investment, especially manufactured imports from developing countries, with the main culprit being the exploitation of cheap third-world labour. The solutions typically advocated include the imposition of higher labour standards in the developing world or other barriers to imports. Others, less inclined towards protectionism, ascribe unemployment in their own country or region to a loss of competitiveness. Though not targeted at developing countries in particular, this diagnosis, too, is a recipe for trade conflict, for it implies that unemployment at home can only be lowered at the expense of one's trading partners.

Such neomercantilist approaches, which run counter to the letter and spirit of the Uruguay Round, would prevent globalization and liberalization from yielding their benefits. While all countries would be adversely affected, the threat to the developing countries and countries in transition would be particularly serious, since their outward-oriented development strategies will only succeed if markets in developed countries are sufficiently open to accommodate rapidly increasing exports.

The idea that the rise in structural unemployment in the North, especially of unskilled workers, is largely due to North-South trade reflects the coincidence of sharply rising imports of manufactures from developing countries and high and rising rates of unemployment from the early 1970s onwards.

There can be little doubt that unskilled northern labour has been displaced on a significant scale in a number of industries, including clothing and footwear, in which developing countries have succeeded in increasing their market share. None the less, the growth of North-South trade does not provide a convincing explanation of the unemployment problem as a whole.

- The South's receipts from manufactured exports are largely spent on buying other manufactured goods from the North, thus generating jobs. However, it is true that even a balanced growth of exports and imports of manufactures could in theory result in losses of unskilled jobs in the North. The reason is that such labour, being more abundant in the South, is used more extensively in southern than in northern manufactured exports.

- The North has a considerable surplus on manufacturing trade with the South. This surplus adds to total effective demand and to the number of jobs in the North (without necessarily reducing employment in the South). The contraction of its trade surplus was responsible for significant job destruction in the North during the late 1980s. The prime cause of that contraction was not the increase in manufactured imports but the depression of oil and other commodity prices, together with the rise in interest rates and debt crisis, which extinguished a sizeable portion of the import capacity of developing countries; balance-of-payments pressures also forced many developing countries to increase export shipments at knock-down prices. The 1990s have seen an increase in the North's trade surplus, with the import boom of Latin America, for instance, serving to generate higher demand for its export industries; however, this source of job creation has proved no less fickle than the financing that generated it.

- Even so, differences among developed countries in structural unemployment are unrelated to differences in their trade balances with developing countries; for instance, between 1970 and 1993 the country that suffered the second-largest decline in its trade balance with developing countries - Canada - had the largest increase in total manufacturing employment, whereas the country with the smallest - Italy - lost a fifth of its manufacturing jobs.

- If increased imports from the South had indeed been a major cause of unemployment of unskilled workers in the North, the corresponding increase in exports to the South should have succeeded in creating excess demand for skilled workers. However, demand for skilled workers in the North has also been weak. For example, in the United States, unemployment among men with upper second-

ary or higher education rose from 2.1 per cent in 1970 to 3.9 per cent in 1989, in Germany from 1.8 per cent in 1978 to 5.0 per cent in 1987, and in France from 2.6 per cent in 1979 to 4.1 per cent in 1990. True, in a number of countries the wage differential between skilled and unskilled work has widened, but this has come from lower or stagnant wages for unskilled work, not from a jump in pay for skilled labour as a whole.

- Numerous instances can be cited of job losses in high-skill industries (e.g. chemicals) and of employment gains in low-skill sectors (e.g. rubber and plastics).

- The emergence of new competition in labour-intensive manufactured products is nothing new in economic history. In the 1950s and 1960s, for instance, the industrially most advanced countries became subject to greatly intensified competition from Italy and Japan without suffering mass unemployment; indeed, several of them experienced such a shortage of unskilled labour that they encouraged large-scale immigration. Between 1960 and 1970, the import penetration of Italy in the markets of the (then) five other EEC countries rose from 0.4 per cent to 2.4 per cent; these are roughly the same ratios as for import penetration by developing countries in the (expanded) EEC market in 1970 and 1990, covering a period twice as long.

- Not all manufactured exports from developing countries are labour-intensive; nor does their competitive advantage always derive from "cheap" or "sweatshop" labour. The developing countries that have been most successful in manufactured exports have experienced rapidly rising wages, and have upgraded the technological and skill content of their production. Some of them have themselves been losing market share in labour-intensive goods to newcomers - but without suffering unemployment as a consequence.

These considerations suggest that while the greatly increased volume of manufactured imports from developing countries has indeed caused significant job losses in certain industries, the explanation for the sharp rise in mass structural unemployment lies elsewhere. The same point applies regarding redundancies resulting from the introduction of new technology - a factor which many analysts view as more important than imports from developing countries. The real question, in both cases, is why it has been so difficult for the labour displaced to be redeployed at remunerative wages elsewhere in the economy - as in the Golden Age of the 1950s and 1960s.

One explanation - which appears to command consensus among economists and which increasingly influences the perspectives of policy makers - is that various man-made rigidities are obstructing the labour markets from bringing the demand for and supply of labour into balance. The rigidities usually cited include laws and regulations that make labour more costly for employers (such as social charges, severance pay and restrictions on job assignments and hours worked) or which prevent wages from falling (such as high unemployment benefits or minimum wages). On this view, the key to resolving the unemployment problem lies in deregulating the labour market and reducing the Welfare State.

The rationale of this approach is essentially microeconomic. It is undoubtedly true that if an individual enterprise were accorded the opportunity to operate more flexibly in the labour market, it would normally respond by expanding its work-force and output, to capture a larger share of the market for its products. But if all enterprises were accorded the same opportunity, none might choose to expand output, unless the level of aggregate demand also rose.

Labour market deregulation is not designed to produce such an increase in aggregate demand. However, it could reduce it by shifting income from wage earners, who spend a relatively high proportion of their incomes, towards profits but without stimulating additional investment out of profits. Moreover, firms might respond to increased flexibility by shedding labour, particularly if they were initially facing a squeeze on profits because of inadequate sales. If carried out on a large enough scale, this response, too, could, in turn, reduce the level of demand. Thus, while increased labour market flexibility would certainly make it possible for firms to utilize their capital stock more efficiently, it would not by itself provide an incentive to hire or invest on a larger scale (unless, of course, it made export production more profitable, in which case it would serve simply as a device to export unemployment).

Labour markets have, in fact, become considerably more flexible over the past decade without bringing a faster pace of employment creation. The evidence suggests that employers have used that flexibility to gain competitiveness by restructuring, downsizing and labour-shedding, rather than to enlarge productive capacity and add to their labour force. However, this is not to suggest that the phenomenon of "jobless recovery" has derived from increased labour market flexibility; as will be explained below, the main factor has been the weakness of investment and growth.

Besides, labour market flexibility is no solution, even in theory, to the problem of insufficiency in the number of good jobs. Rather, flexibility has proved to be an effective way to transform open unemployment into disguised unemployment, i.e. take people off the dole into low-paying, low-productivity occupations, for instance in services. This is evident from the experience of the United Kingdom, where the labour market reforms of the 1980s have made it more akin to the United States than other Western European countries. On one estimate, some 80 per cent of the jobs created in that country between 1979 and 1987 were low-productivity and low-pay; for the United States, the figure has been put at 50 per cent.

On the other hand, countries with a highly protected agricultural sector of significant size (most notably Japan) have a considerable volume of disguised unemployment in low-productivity farm jobs. When due account is taken of cross-country differences in disguised unemployment, the developed market economies appear to have a roughly similar record as regards genuine employment creation.

A worsening performance as regards jobs over the past two decades has gone hand-in-hand with a significant slowdown in capital formation. For the OECD area, the annual growth of fixed capital formation fell from about 6 per cent in 1960-1973 to 1.1 per cent in 1973-1979 and 3.1 per cent in 1979-1990. This failure to return to previous rates of investment is to be explained not by high labour costs or low profitability of the existing capital stock, but by the macroeconomic environment.

The generally restrictive monetary policies implemented in the last two decades have shunted economies into low-growth paths in which low demand growth and low potential output growth have fed back into one another. Frequent underutilization of the existing productive capacity has made for slow capital formation. The slow growth of potential output has, in turn, provided the justification for persisting in macroeconomic policies that limit demand growth to that of potential output growth. These policies have thus created a weak economic growth dynamic, and generated an increasing imbalance between the labour force and the tools - i.e. capital - to employ labour productively.

Restrictive monetary policies and financial deregulation together have pushed up interest rates to historically high levels. In 1981-1993 the average long-term real interest rates in the United States, France, Italy and Canada were more than three times, and in the United Kingdom more than twice, the 1956-1980 level. Moreover, financial deregulation, together with the increasing tendency to gear monetary policy to monetary aggregates or price movements, has made interest rates and exchange rates more unstable. The increased volatility of key financial variables has, in turn, been reflected in the increased volatility in the components of aggregate demand such as consumption, exports and imports. In the United States, Japan, Germany and France, the increase in the volatility of real consumption expenditure from 1961-1973 to 1982-1994 ranged from 78 per cent to 167 per cent, that of real exports from 57 per cent to 263 per cent, and of real imports from 46 per cent to 162 per cent. The uncertainty created by such volatility has served to discourage private investment in fixed assets.

In some industrialized countries, private investment has also been adversely affected by declining public investment, especially in infrastructure. In the United States, Germany and the United Kingdom general government real investment in fixed capital has risen much less than GDP since the 1970s; indeed, in 1990 in the latter two countries it was 15 per cent below the 1972 level. On one estimate, if the stock of public capital in the United States had grown at the same pace in 1966-1987 as in 1947-1965 (instead of declining by 10 percentage points) annual GDP growth in the United States would have been 1.3-1.9 percentage points higher.

The preceding discussion suggests that the solution to the employment problem lies, in the main, in raising the tempo of investment and growth. It has been estimated that if the capital stock in manufacturing in European OECD countries had grown after 1973 by a modest 1 percentage point more than was actually the case, by 1992 there would have been an extra 3.9 million jobs in manufacturing and about 4.1 million in services.

Before turning to the macroeconomic policies needed for faster growth, it needs to be emphasized that supply-side policies are also necessary, in order to ensure that expansion does not run into bottlenecks. In particular, training and skill formation will need close attention. There is also a strong case for shifting policy towards providing employment subsidies, rather than unemployment benefits. They would be a small charge on government budgets, since they would help raise output, and thus tax revenue. Moreover, they would prevent the loss of skills (and morale) that typically results from long-term unemployment, and encourage the provision of on-the-job training for people who would otherwise remain idle.

To step up investment rates, the prime need is to provide business with lower capital costs, on the one hand, and improved prospects for sales, on the other. If Governments and central banks prevent the economy from growing faster than 2.5 per cent (except temporarily during recovery from recession), firms will not be inclined to expand their capacity any faster. Consequently, output growth will be little more than what is possible utilizing productivity growth alone - inevitably leading to mounting unemployment.

The notion that a faster pace of demand expansion would only lead to faster inflation is unjustified under current economic conditions. These are crucially different from the 1970s: there is not only much greater slack and flexibility in the labour market but also greatly increased global competition. This has greatly reduced the ability of unions and enterprises to translate increased demand for labour and goods into higher wages and prices. Consequently, there is now a much closer link between wages and productivity. In the current recovery, although rates of capacity utilization have risen to historically high levels and commodity prices have recovered somewhat, inflation has continued to decline, falling below 3 per cent during 1994 in most countries; in Japan, inflation has been replaced by "price destruction". Real earnings of labour have been either falling or rising much less than productivity, and declines in unit labour costs are a general phenomenon. Price stability has been particularly remarkable in the United States, where growth has been vigorous. Productivity has been rising at rates not seen since the 1960s, thanks to an investment-driven recovery - virtually the first since the 1970s.

It cannot be emphasized enough, however, that it is not possible to eliminate unemployment simply by expanding demand. This can be achieved only over a number of years, by raising productive capacity.

Increased public sector investment in infrastructure is also essential for job creation in some countries, for the reasons already given, as well as because it is needed to promote technological dynamism and innovation in areas such as telecommunications, computers and information processing. Such investment needs to be accompanied by more business-like budgeting. Since public investment creates productive assets, it should be separated from current spending and evaluated in much the same way as is the practice for private investment. Investment by the public sector financed by borrowing should not be treated as deficit spending, any more than investment by private firms. Any countercyclical expenditure policy should be conducted through the capital budget, and the current budget should not be allowed to run up a structural deficit. However, the capital budget should also be balanced over the long term; in other words, public investment should be self-financing.

With the exception of Japan, fiscal policy has not been used for demand management since the early 1980s. Nevertheless, almost all countries have seen their budget deficits and debt increase rapidly. Almost everywhere interest payments on government debt have become the major source of deficits. To make it possible to use fiscal policy once again for macroeconomic management, it will be necessary to tackle the overhang of public indebtedness. As explained in the *Trade and Development*

Report 1993, a one-time levy on holdings of financial assets might be the best way to bring down public debt to manageable levels quickly and without subjecting the economy to a painful deflation.

Removing the debt overhang would also reduce the constraints placed by bond markets on monetary policy. However, unless monetary policy itself is reoriented towards growth and employment, little progress in accelerating growth will be possible. Monetary policy should aim at establishing low and stable interest rates, and tolerate greater variation in inflation over the cycle. The recent experience of the United States shows that swings in interest rates can seriously disturb the balance sheets of banks and other businesses, generate uncertainty, and destabilize currency and bond markets. An ability to use fiscal policy more actively would support such a reorientation of monetary policy.

The balance of payments consequences of expanding employment in a single country also need attention. In countries that are open to trade, a considerable portion of any demand expansion will leak abroad. Floating exchange rates can reduce the leakage by putting downward pressure on the exchange rate, but this can result in imported inflation. When inflationary pressures are strong, countries will be reluctant to expand, in order to avoid devaluation. On the other hand, when, as now, deflation is a greater danger than inflation, they may be tempted to resort to devaluation. A generalized quest for devaluation might eventually produce the desirable result of a worldwide lowering of interest rates. However, the process of competitive devaluation itself might disrupt international trade and payments; and the ensuing risk and uncertainty might be more costly than the benefits of lower interest rates. Consequently, policies to increase employment need to be internationally coordinated, in order to secure low and stable interest rates and avoid exchange rate instability. The latter objective would also call for concerted currency market interventions, as well as controls on short-term capital movements.

In the absence of a strategy of tackling unemployment by "lifting all boats", Governments may find it difficult to resist political pressures in favour of protectionist "solutions", with adverse consequences for all. For instance, the imposition of trade restrictions linked to higher labour standards might seem an easy way to reduce third-world competition. The rationale for improving labour standards in the South lies in protecting workers in that region, not in saving jobs in the North.

In any event, raising southern labour costs would not go far towards saving northern labour-intensive industries. Since productivity differentials are much narrower than wage differentials, it would worsen the terms of trade and reduce incomes in the North. Besides, the real wages of unskilled workers would fall as import prices rose. At the same time, higher labour costs would reduce employment, output and exports in the South. Poorer countries that face difficulties in exporting would be hit hardest: the major exporters of manufactures in the developing world have already industrialized, and now enjoy quite high wages and labour standards.

Similarly, trade tensions could also build up within the North. It is perhaps significant that some countries that are habitually reluctant to increase home demand on the grounds that it would be inflationary have also become increasingly willing to take policy action to promote exports - and thus aggregate demand. Moreover, events in recent months have evoked memories of the competitive devaluations of the inter-war period, with accusations that the United States is encouraging dollar depreciation and that Spain, the United Kingdom and Italy have been the unfair beneficiaries of the large exchange rate movements within Europe. The view has also been expressed that the NAFTA partners of the United States should not be permitted to engage in currency depreciations.

It would be unrealistic to expect the international trading system to evolve in the right direction, notwithstanding the Uruguay Round, unless the twin problems of unemployment and low wages in the developed market economies are tackled by increasing the prosperity of all. It is to be hoped that the international cooperation needed to obtain such an outcome will be forthcoming despite the end of the Cold War - and that international behaviour will not revert to the pattern of competition and conflict characteristic of the 1930s.

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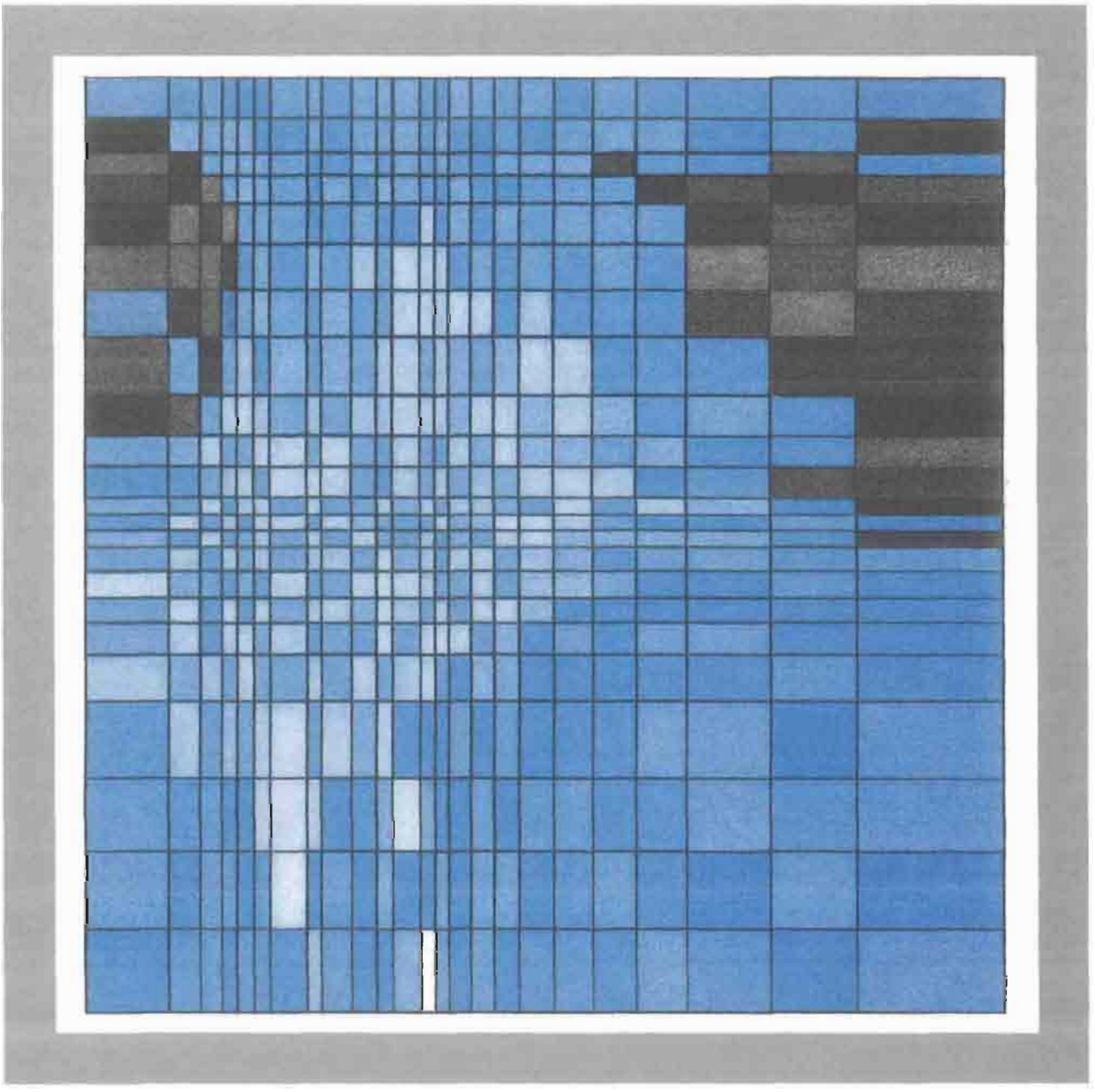
GLOBAL TRENDS



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Chapter I

THE WORLD ECONOMY: PERFORMANCE AND PROSPECTS

A. Recent performance

1. Overview

World output growth accelerated sharply in 1994, to reach 3.1 per cent, compared to 1.7 per cent in the previous year, as a result of recovery in developed market-economy countries and continued high rates of expansion in developing countries and in China, while the contraction of output in Central and Eastern Europe continued (see table 1). Although the recovery was broadly based, the pattern of growth continued to vary among regions, and within regions there were substantial variations among countries.

In keeping with the trend in recent years, production continued to be outpaced by trade. Thanks to the continued expansion of trade in manufactures, world trade rose in volume by close to 9 per cent in 1994 (see table 2). This increase in trade was the highest for two decades, far exceeding the growth of world output.[1] There was continued strong expansion in Asia and the Americas and a rapid recovery in Western Europe, where trade rose nearly three times faster than output. The share of intraregional trade also rose most markedly in those regions where total trade grew most (i.e., in both Asia and the western hemisphere).

World trade grew even more rapidly in current dollar terms, largely because of the sharp increases in prices of many non-oil primary commodities, but also because of the fall in the value of the dollar vis-à-vis other major currencies.

Because of an upsurge in demand, speculative trading and a declining dollar, the nominal prices in dollar terms of many non-oil commodities rose sharply during most of 1994. After having reached record lows at the beginning of the 1990s, the terms of trade of non-oil primary commodities with respect to manufactures also rose substantially in 1994 (see table 3). Petroleum prices, however, continued to fall and their terms of trade with manufactures reached a new low. Many of the price changes also reflected vagaries in supply. Most notably, frost in Brazil and lower production in Colombia, Côte d'Ivoire and Indonesia led to a tight supply situation in coffee. Prices of cotton and copra also rose due to reduced supplies. On the whole, the commodity price increases were both sizeable and widespread: among foodstuffs and tropical beverages, they concerned coffee, cocoa, rice and sugar; among agricultural raw materials cotton, rubber, hides and skins; and among minerals aluminum, tungsten ores, copper and nickel (see table 3). However, other commodity prices continued to fare badly, notably tea, beef and bananas, as well as iron ore. Despite the many substantial increases in nominal terms, for most commodities the declining trend in real terms since 1970 was hardly dented. Moreover, the expected

Table 1

WORLD OUTPUT, 1980-1995

(Percentage change)

Country group	1980-1990[a]	1991	1992	1993	1994[b]	1995[c]
World	2.9	0.2	1.2	1.7	3.1	2.9
Developed market-economy countries	2.8	0.3	1.3	1.4	3.1	2.5
of which:						
United States	2.7	-1.1	2.6	3.0	4.1	2.7
Japan	4.1	4.3	1.2	0.1	0.6	0.5
European Union	2.3	0.7	-0.4	-0.5	2.8	2.8
of which:						
Germany[d]	2.3	1.8	-3.6	-1.3	2.9	2.5
France	2.3	0.7	1.4	-0.9	2.7	2.5
Italy	2.2	1.3	0.9	-0.7	2.2	3.0
United Kingdom	2.7	-2.3	-0.5	1.9	3.8	2.8
Central and Eastern Europe	2.1	-11.9	-15.3	-9.4	-10.1	-4.2
Developing countries	2.8	3.1	4.1	3.8	4.4	4.5
of which:						
America	1.3	3.7	2.9	3.1	3.7	2.0
Africa	1.6	2.8	1.8	1.4	2.0	3.3
Asia	4.3	3.3	6.1	4.8	5.3	6.0
Least developed countries	2.2	0.6	1.0	3.3	1.4	2.3
China	8.8	7.2	12.0	12.2	11.8	9.6

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

a Annual average.

b Estimate.

c Forecast.

d Including the eastern *Länder* after 1990.

slowdown of industrial expansion in many major markets and sluggish recovery in Western Europe, in combination with the expected expansion of supply, will tend to dampen the price movements of many commodities during the coming months. Production of copper, for example, which was reduced in both 1993 and 1994, is increasing again and new mines have started up or are planned in Canada, Chile, Indonesia, Mexico, Peru and the United States. Supply can also be expected to rise substantially for other minerals. Indeed, since the beginning of 1995, prices of many primary commodities have weakened, in some cases considerably. These include a broad range of foodstuffs, tropical logs and also important metals such as tin, aluminium, nickel, copper and phosphate rock. Consequently, the recent rise in prices of non-oil commodities could well prove to be short-lived.[2]

2. Developed market-economy countries

At 3.1 per cent, the rise in output for the developed market-economy countries as a whole in 1994 was almost double that of the previous year, as recovery strengthened and became more widespread in Western Europe. Inflation remained subdued, but unemployment in Western Europe remained high and a major preoccupation.

Table 2

EXPORTS AND IMPORTS BY MAJOR REGIONS AND ECONOMIC GROUPINGS, 1992-1994

(Percentage change in volume over previous year)

Grouping/region	Exports			Imports		
	1992	1993	1994[a]	1992	1993	1994[a]
World	5.2	3.1	8.9	5.8	1.2	8.8
Developed market-economy countries	4.4	-1.2	9.0	5.6	-2.9	8.9
of which:						
United States	7.4	4.6	9.0	10.4	11.7	13.2
Japan	1.6	-1.9	1.7	-0.6	3.7	12.2
Western Europe	3.2	0.8	10.1	2.8	-3.8	6.4
France	4.9	-0.9	6.4	0.7	-4.0	7.0
Germany	2.1	-5.7	13.6	2.3	-9.6	6.2
Italy	3.6	11.1	10.8	3.3	-9.3	5.6
United Kingdom	2.2	-0.1	10.8	6.4	0.1	6.9
Developing countries	6.4	10.2	8.3	11.3	7.9	8.7
of which:						
America	2.1	11.8	8.3	17.0	7.3	11.7
Africa	-8.5	5.2	2.0	4.6	3.3	4.9
West Asia	3.9	11.4	-1.5	15.0	-1.6	-5.1
Other Asia	12.5	10.3	11.5	10.0	11.4	12.0

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

In the United States, the cyclical upswing which started in late 1991 showed no signs of slowing down. In spite of tighter monetary policy, and fuelled by strong growth in fixed investment and private consumption, output growth accelerated from 3.0 per cent in 1993 to 4.1 per cent in 1994 - the highest increase for 10 years. Public spending, however, fell because of cuts in the defence budget. The volume of exports rose sharply, by 9 per cent, which was double the growth of the previous year; but the increase of imports was even larger (13 per cent). The depreciation of the dollar and increased productivity were major factors behind the fast expansion of United States exports, which also benefited from continued strong demand from the developing countries and the recovery in Western Europe noted above, as well as appreciation of the yen. The spillover of domestic demand into imports was particularly marked for office machinery and telecommunication equipment, sectors in which domestic investment was strong. In contrast to the early stages of the recovery, growth in 1994 was accompanied by a rapid increase in employment, and by a fall in unemployment to 6.1 per cent. While capacity utilization rates rose considerably, consumer price increases slowed down.

The turnaround in economic activity in the European Union greatly exceeded expectations. Total output rose by 2.8 per cent in 1994, against a decline of 0.5 per cent in the previous year. Indeed, with the exception of Sweden, in all countries where output had declined in 1993, growth in 1994 more than compensated for the previous decline. The recovery was particularly vigorous in Denmark, Finland, Ireland and Norway; in Finland, as well as in Sweden, 1994 marked a turnaround from the long and severe recession which had started in 1991.

Strong export demand was the main factor behind recovery in the European Union and the recovery itself contributed much to the rapid expansion of world trade in 1994, just as the region's

Table 3

WORLD PRIMARY COMMODITY PRICES, 1992-1995

(Percentage change over previous year)

Commodity group	1992	1993	1994	April 1995[a]
All comodities	***-2.5***	***-3.5***	***17.1***	***-0.7***
All food and beverages	***-2.7***	***1.9***	***19.6***	***-3.5***
of which:				
Tropical beverages	-14.0	6.1	75.0	4.0
Coffee	-20.1	15.5	118.2	7.0
Cocoa	-8.2	1.9	24.8	5.0
Tea	8.1	-4.9	-4.4	-2.3
Food	-2.1	0.7	10.1	-4.3
Sugar	1.0	10.6	19.7	-6.6
Beef	-7.9	6.6	-10.9	-12.4
Maize	-2.4	3.7	1.3	0.6
Wheat	20.0	1.7	4.9	-13.6
Rice	-8.6	-6.6	33.6	-5.7
Bananas	-15.6	-7.4	-0.5	-30.8
Vegetable oilseeds and oils	7.5	0.0	24.4	-9.5
Agricultural raw materials	***-2.4***	***-3.2***	***13.3***	***11.2***
Hides and skins	-3.4	28.6	30.6	12.7
Cotton	-24.6	0.0	37.5	29.3
Tobacco	0.0	-1.6	2.7	-7.1[b]
Rubber	5.3	-2.2	33.2	20.1
Tropical logs	4.7	-5.0	2.8	0.0
Minerals, ores and metals	***-3.7***	***-14.7***	***13.6***	***-1.3***
Aluminium	-3.7	-9.2	29.6	-1.6
Phosphate rock	0.0	-10.6	0.0	0.0
Iron ore	-4.9	-11.0	-9.5	5.8
Tin	9.0	-15.4	5.9	-1.3
Copper	-2.4	-16.2	20.6	-2.8
Nickel	-14.2	-24.4	19.8	-13.5
Tungsten ore	0.4	-39.9	24.1	17.6
Crude petroleum	***-0.4***	***-11.4***	***-4.1***	***16.9***
Memo item:				
Manufactures[c]	***3.0***	***-6.8***	***4.2***	..

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

a Change from December 1994

b End of March 1995.

c Unit value index of exports of manufactures from developed market-economy countries.

fall in output and demand accounted for the slower growth of world trade in 1993. But while among EU countries trade helped to sustain the fast pace of exports from Western European countries, most of the increase in exports was accounted for by strong demand in third countries, especially from developing countries in Asia, but also from North America and countries of Central and Eastern Europe. Exports were most buoyant in investment and related goods, thus benefiting those countries

specializing in these exports, notably Germany. Export performance, however, was also affected by changes in competitiveness brought about by currency realignments. Thus, currency depreciations appear to have improved the competitive position of Finland, Ireland, Italy, Spain, Sweden, and the United Kingdom. The strength of external demand, however, was sufficient to sustain exports from other EU countries also.

Inflation slowed down somewhat, in spite of the increases in world commodity prices noted above, and inflation rates tended to converge around a relatively low level. With the recovery in output, unemployment rates, which had been rising in recent years, appear to have stabilized in some cases; in the United Kingdom, where it had been rising much faster than in other EU countries, the rate of unemployment fell in 1994.

The recovery in Germany in 1994 was swift, with GDP growing by 2.9 per cent after a decline of 1.3 per cent in the previous year. Strong export growth in the first half of the year stimulated a recovery in domestic demand. In the United Kingdom, exports (including oil exports) largely accounted for accelerated growth, from 1.9 per cent in 1993 to 3.8 per cent in 1994, thus continuing the upswing which started in 1992. Recovery was also strong in France and Italy, where GDP grew respectively by 2.7 per cent and 2.2 per cent, following a decline of about 1 per cent.

The divergence in monetary policy between Germany and the United States continued in 1994, but with a reversal of their earlier roles. In the first half of the year, the Bundesbank cautiously lowered interest rates to support recovery, whereas the Federal Reserve Board raised interest rates on six separate occasions between February and mid-November, in anticipation of a resurgence of inflation. However, the Board's assumption that 2.5 per cent is the rate of sustainable growth may be unduly pessimistic[3]; in determining policy, it is important to know whether the increase in productivity during recovery is a purely cyclical phenomenon or whether it reflects a change in the trend of productivity growth. The current situation in the United States is very similar with respect to productivity, wage rates and unit labour costs to that in the mid-1960s, when during four years (1964-1967) the economy was able to grow at about 5 per cent annually without high inflation. Past investment, particularly in information technology, could well result in a rising productivity trend at the present time.

In Japan, growth in 1994 was weak and erratic in spite of supportive fiscal and monetary policies. Output grew by less than 1 per cent as the effects of the adjustment process of earlier years were compounded by the rapid appreciation of the yen and continued political uncertainty. While exports were well sustained in value, due to the high yen, their volume growth was small (after a decline in the previous year). By contrast, the strong yen favoured imports, in particular of labour-intensive consumer goods from overseas subsidiaries of domestic firms. The volume increase in imports was as high as 12 per cent (see table 2).

The trade imbalances of developed countries were reinforced in 1994. Thus, among the major countries, the large trade surpluses of Germany, and to a lesser extent Italy, continued to widen during the year; and in Japan, despite the much faster volume increase in imports than of exports, the trade surplus continued to grow, on account of a large improvement in the terms of trade. On the other hand, the trade deficit of the United States worsened, thanks to its relatively faster recovery.

3. Developing countries and China

Demand from developing countries, notably those in Asia and Latin America, played a key role in the speedy recovery of Western Europe. For developing countries as a whole, output continued to expand in 1994, accelerating to 4.4 per cent, from 3.8 per cent in the preceding year. However, there was much variation among countries and regions.

Africa

Among the developing regions, Africa has yet to show tangible signs of a strong recovery and sustained growth, despite several years of implementing structural adjustment programmes (SAPs). The economic situation remains precarious and worrying, and contrasts sharply with the trends in Asia and Latin America. The region's share of both world output and trade has continued to shrink, whereas its share of world population has

Box 1

DEVALUATION OF THE CFA FRANC

The Communauté financière africaine (CFA), established in 1948, consisted of 13 African countries until 1988, when the Comoros also became a member. The initial 13 countries had two separate monetary arrangements. In West Africa, the Union monétaire Ouest Africaine (West African Monetary Union) consists of seven countries (Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal and Togo) with a common central bank (Banque Centrale des Etats de l'Afrique de l'Ouest). In Central Africa there is a Union Monétaire de l'Afrique Centrale, comprising six countries (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon) with its own common central bank (Banque des Etats de l'Afrique Centrale). The two groups maintain separate currencies, although they are commonly referred to as the CFA franc.[1]

Full and free convertibility of the CFA franc into the French franc is guaranteed by the Bank of France at fixed parities. In return, the CFA member States are required to deposit 65 per cent of their foreign exchange reserves in French francs with the Bank of France, and the central banks of both groups, as well as the central Bank of Comoros, also keep an operation account with the French Treasury. Both the CFA and the Comorian franc had been pegged at a parity of 50 to the French franc until 12 January 1994, when the CFA franc was devalued by 50 per cent (raising the parity to 100) and the Comorian franc was devalued by one third (raising the parity to 75).

Following the devaluation, measures were taken to strengthen the institutional framework for the harmonization of macroeconomic policies among members. In West Africa, the West African Monetary Union and the Communauté économique de l'Afrique de l'Ouest were combined into a West African Economic and Monetary Union, while in Central Africa, the Communauté économique et monétaire de l'Afrique Centrale (Central African Economic and Monetary Community), was established, incorporating the Union économique de l'Afrique Centrale and the Union monétaire de l'Afrique Centrale.

The underlying rationale for the devaluation of the CFA franc involved the following considerations:

- There had been a deep and persistent economic crisis in CFA countries since the bottom fell out of the markets for commodities in the mid-1980s. During 1985-1992, the highest annual growth of real GDP per capita was only 1.3 per cent (in Chad), at the other extreme there was a decline of 6.7 per cent per annum (in Cameroon).[2]

  Most CFA countries depend heavily on commodity exports. Prior to 1985, world commodity prices were at levels that generated sufficient export earnings to finance development projects. Exports from these countries were competitive because the French franc depreciated against the dollar. After 1985, however, with the world in recession and declining commodity prices, their terms of trade deteriorated. Furthermore, their exports became less competitive in world markets as the French franc appreciated against the dollar (while remaining in line with the Deutsche mark within the European Monetary System). In relation to 1980, the terms of trade change ranged from a decline by the end of 1992 of as much as 47 per cent for Cameroon to an improvement of 16 per cent for Chad.[3]

- There was a general consensus that the CFA franc was overvalued, to an extent that has been estimated, for the beginning of 1994, to range from 13 per cent for Equatorial Guinea to as much as 68 per cent for Cameroon.[4] The fixed parity with the French franc deprived the CFA countries of the option of currency devaluation, and thus constituted a major hindrance to the effective implementation of structural adjustment programmes (SAPs).

- The future of the CFA franc needed to be reviewed in the light of monetary integration in the European Union pursuant to the Maastricht Treaty.

Box 1 (concluded)

To support the devaluation, IMF and the World Bank announced the release of about $1.5 billion to the franc zone countries, initially as stand-by credits and subsequently as drawings on the enhanced structural adjustment facility (ESAF). The French Government, for its part, agreed to write off development loans totalling FF 18.4 billion to Cameroon, the Congo, Côte d'Ivoire and Gabon, and FF 6.6 billion to the other 10 countries. The devaluation was accompanied by far-reaching programmes designed to address problems of fiscal, monetary and financial imbalances. Also, measures were taken to freeze prices of essential commodities, control rents and stabilize public utility tariffs in order to minimize the welfare loss of the less privileged. In the immediate aftermath of the devaluation, prices rose sharply, higher than initially anticipated, entirely wiping out the effects of the nominal devaluation in some countries. The initial inflationary impact, however, was contained through a marked moderation of increases in wages and salaries in both the public and the private sectors, and is expected to be attenuated with the passage of time.

The trade and other effects of devaluation during the first year were mixed. The removal of most of the distortions in the structure of relative prices, combined with some recovery in world commodity prices, primarily benefited countries with a strong agricultural base and primary commodity exports, such as Côte d'Ivoire and Cameroon, in contrast to those with limited economic potential, such as Equatorial Guinea and the Comoros. In particular, there was a significant improvement in the competitiveness of cotton exports from Benin, Burkina Faso, Mali, Chad, Togo, the Central African Republic and Niger.

The change in parity was expected to bring about an improvement in the external balance as well as an increase in government revenue from import duties. Higher revenue would result from an enlarged duty base as the sizeable unrecorded cross-border trade between the CFA countries and their closest neighbours was curtailed. With respect to the external balance, there is evidence, albeit preliminary, that the CFA countries, taken together, fail to satisfy the necessary *a priori* Marshall-Lerner condition that the sum of the price elasticities of exports and imports be greater than unity for an improvement in the external sector to occur.[5] The inflow of FDI since devaluation has been lower than anticipated.

Among countries, post-devaluation progress and prospects appear to be brightest for Burkina Faso and Mali while the situation is less clear in Benin, Niger, and Togo. In some countries, such as Central African Republic and Chad, prospects are uncertain due to the termination of financial support from IMF in view of their failure to abide by the agreements with the Fund on the accompanying devaluation measures.

It is perhaps premature to evaluate the overall medium-term effects of the implementation of restrictive fiscal and monetary policies, including differential interest rates and selective credit policies, as well as dual or multiple exchange rate controls. These policies are expected to stimulate the repatriation of private capital and to ensure an improvement of public finances that would allow increased public savings for investment. In their semi-annual meeting in Brazzaville, Congo, in September 1994, finance ministers of the franc zone countries stressed the importance of adhering to SAPs and of pursuing follow-up measures to the devaluation.

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1 Of the 14 CFA countries, 9 are LDCs. The other five are Côte d'Ivoire and Senegal in West Africa and Cameroon, Congo and Gabon in Central Africa.

2 Only two other countries had positive average annual growth rates during the same period: Senegal (0.3 per cent) and Burkina Faso (0.9 per cent). For details, see UNCTAD, *The Least Developed Countries, 1995 Report* (United Nations publication, Sales No. E.95.II.D.2), table 33.

3 With the exception of Comoros and Equatorial Guinea, for which data are not available, only three other countries had terms of trade at the end of 1992 which were better than in 1980: Senegal (1 per cent), Burkina Faso (3 per cent) and Mali (12 per cent).

4 UNCTAD, *op cit.*

5 For a detailed discussion, see J. K. Thisen, "The devaluation of the CFA franc: Some preliminary results"; paper presented to the Spring World Project LINK Meeting (New York, 15-18 March 1995).

continued to rise. In addition to the adverse impact of political instability, ethnic conflicts and vagaries of weather, economic performance in the region continues to be characterized by low productivity, inefficient management, failure to diversify from a narrow production and export base, and high vulnerability to the external economic environment.

Most African countries still rely on a few primary commodities for much of their export earnings.[4] Mineral fuels and related materials continue to dominate the region's exports, followed by beverages and tobacco. Accordingly, the sharp increase in a wide variety of non-fuel primary commodities in 1994 noted above led to an increase of 2.6 per cent in the purchasing power of exports and a slight improvement (0.5 per cent) in the terms of trade of African developing countries, as compared to a fall of 4.8 per cent and 5.0 per cent, respectively, in the previous year.

Weather conditions in 1994 were better in most of Africa than in 1993, and agricultural output was consequently above average. At the same time, drought in the third quarter of 1993 and the first quarter of 1994 precipitated famine conditions over a wide area, affecting some 10 countries in the central, eastern and southern African subregions.

Civil conflicts and political crises continued to disrupt and paralyse production in many countries (especially Burundi, Liberia, Rwanda, Sierra Leone, Somalia, Sudan and Zaire), with important repercussions on their neighbours. As a result, and also because of the effects of natural disasters, there has been an unprecedented increase in the number of refugees and displaced persons in Africa.

For African developing countries as a whole output growth was higher in 1994 than in the previous year, but at around 2 per cent it remained lower than population growth, resulting in a further decline of per capita GDP. The rise in the prices of primary commodities, as well as the recovery in Western Europe, benefited African countries to a varying extent. The major exporters of petroleum continued to suffer from depressed prices, and in spite of better prices for many other commodities, the trade deficit of the region widened further in 1994.

In North Africa[5], which accounts for more than half of the region's overall output, there was a notable increase in output in 1994 primarily because of the strong economic recovery in Morocco, which had been badly affected by drought in the previous year. However, in Algeria, the largest economy of the subregion, growth continued to be constrained by low oil prices and very high debt service, whereas United Nations sanctions continued to affect the economy of the Libyan Arab Jamahiriya.

In West Africa[6], which is responsible for more than one-fifth of the region's output, growth is estimated to have fallen from 4.0 per cent in 1993 to 2.1 per cent in 1994, mainly because of strikes in the oil industry in Nigeria, which has the largest economy of the subregion. In Gambia, and even more so in Liberia, there was a large decline in output. At the same time, the substantial devaluation of the CFA franc in January of 1994 had a mixed impact on franc zone countries (see box 1). In Côte d'Ivoire, the largest CFA economy in the subregion, there was virtually no growth at all in 1994.

Central Africa[7], with more than 10 per cent of the region's output, is the only subregion where output has declined consecutively for five years. Contributing to the substantial decline in 1994 were the Congo, Cameroon, Rwanda and Zaire, where there was a virtual breakdown of the financial system. The performance of the three oil exporters in the subregion was relatively poor. In Cameroon there was a fall in output not only in the oil sector but also in agriculture and industry; and despite higher oil production, the economy of Congo was hampered by continuing budgetary problems and that of Gabon by debt-servicing difficulties.

In East and Southern Africa[8] which stretches from the Horn of Africa to the southern part of the continent and accounts for some 17 per cent of regional output, there was a notable improvement in economic performance, but with much variation among countries. Those where output is estimated to have declined include Angola, Lesotho, Malawi, Somalia and Swaziland. Economic results in Zambia remained disappointing despite the implementation of a wide-ranging reform programme. There was some recovery in Kenya, a relatively large economy, as strict budgetary management led to an improvement in the financial situation. Mauritius, Namibia, Uganda and Zimbabwe continued to sustain their growth.

Latin America

In Latin America, the expansion which began in 1991 continued in 1994, with growth accelerating slightly to 3.7 per cent, from 3.1 per cent in 1993. A modest annual growth rate of around 3 per cent in recent years for Latin America as a whole has been accompanied by increasing success in controlling inflation and a large, and at times growing, current account deficit, sustained by an even larger inflow of capital. The countries which failed to grow in 1994 include: Haiti, which is now recovering from the prolonged recession that started with the outbreak of its political crisis; Honduras, where a prolonged drought reduced agricultural production and the shortage of electricity became more acute; and Venezuela, which slid into deeper recession. GDP grew by 3-5 per cent in 15 other countries of the region.[9] Rates above this range were achieved in Peru (11.0 per cent), Guyana (8 per cent) and Argentina (6.0 per cent), but there was virtually no growth in Jamaica and Cuba.[10]

Achieving high growth combined with low inflation has been the major policy challenge in many developing, as well as developed, countries in recent years. For Governments in Latin America bringing down the high rate of inflation has been the top priority. The success of their policies to that end can be judged by the continuous decline in the rate of increase of consumer prices for the region as a whole (excluding Brazil) from 49 per cent in 1991 to 22 per cent in 1992, 19 per cent in 1993 and 16 per cent in 1994. In the course of 1994, Brazil became one of the 12 countries which achieved notable progress in stabilization.[11] Hyperinflation of some 50 per cent per month was brought to an end, when the *Real Plan* was put into effect in July 1994, and the monthly inflation rate was reduced to 2-3 per cent. Brazil is the largest economy in the region and its average rate of inflation in 1994 consequently brings up the rate for Latin America as a whole to around 30 per cent. Success in containing inflation in the region was achieved through a combination of policies which differed from country to country. It has largely depended since 1990 on using the exchange rate as a nominal anchor, which generated a serious trade-off between price stability and competitiveness (see Part Two below, chapter II).

Trade grew rapidly in Latin America in 1994, and was most buoyant for imports. Exports benefited not only from the strength of demand in major trading partners, especially the United States, but also from large increases in the prices of many commodities, especially tropical beverages and metals, which led to an improvement in the terms of trade. In all, the value of exports rose by an estimated 14 per cent in 1994, a marked acceleration from the previous year. Most countries of the region shared in this export expansion and only in Haiti was there a fall in earnings. Exports of manufactures grew significantly, but commodities still account for a large share of total exports in many countries.

The growth of exports (8.3 per cent in volume), however, continued to lag behind that of imports (11.7 per cent), particularly in Brazil, Mexico, Argentina (the three countries which resorted to devaluation for disinflation) and Colombia. On the other hand, imports into Venezuela actually declined, on account of recession and foreign exchange restrictions. For the region as a whole, the trade deficit widened further in 1994, though by less than in previous years, the largest trade deficits being recorded by Mexico and, though to a much lesser extent, Argentina. In contrast, significant improvements in the trade account were recorded by Chile, thanks to its good export performance, and by Venezuela, on account of the sharp drop in imports. Intraregional trade continued to expand rapidly.[12]

The increase in the region's trade deficit was accompanied by a widening current-account deficit, financed by massive inflows of foreign capital. The adverse current balance rose slightly to $49.7 billion in 1994, from $46.0 billion in the previous year, whereas net capital inflows amounted to $56.6 billion, a slight decline from the peak of $65.1 billion in 1993.[13] The Mexican currency crisis in December 1994 and the turnaround in capital flows have raised important questions about the sustainability of these deficits and macroeconomic stability in a number of countries which have relied on such flows for disinflation and growth (as discussed in Part Two, chapter II, below).

Asia

Developing Asia continued to be the most dynamic region in the world economy, with growth accelerating to 5.3 per cent in 1994, from 4.8 per cent in 1993. Countries in the region continued to

benefit from the further strengthening of the yen as Japanese industries moved labour-intensive manufacturing processes to other Asian countries. As a result of this process, linkages in trade and investment among countries in the region have become even stronger.

Trade, including intraregional trade, continued to be buoyant in 1994. In East Asia, there was a strong growth of exports, but an even faster growth of imports. In a few countries, imports rose in volume by over 30 per cent and exports by over 20 per cent. There were particularly large increases in imports into Malaysia and the Republic of Korea, but with the exception of the latter country the growth of imports slowed down in the NIEs[14] and also in China. Much of the accelerated growth of exports from developing Asia was accounted for by the NIEs (notably Hong Kong and the Republic of Korea), as well as by China (after a brief pause in 1993). In most of the region's major exporting countries exports continued to expand steadily. The steady or accelerated expansion of exports continued to stimulate domestic activity, which in turn stimulated import growth. Much of the faster growth of exports in 1994 was accounted for by manufactures, with a relatively high value-added content, but many countries still rely heavily on primary exports, and export performance among such countries was very varied. For example, while Viet Nam had a sizeable increase in rice exports, weak petroleum prices reduced the export earnings of Brunei Darussalam, whereas a good performance in the non-traditional export sectors sustained the earnings of two other major petroleum exporters in the region, namely Indonesia and Malaysia.

Strong import demand in East Asia also contributed to sustaining export expansion in other developing countries, especially those in South Asia; as a result, there was a significant increase in the share of Asian developing countries in South Asian exports. Trade performance among South Asian countries varied, but in general exports were buoyant and continued capital inflows helped to finance payments deficits, allowing in some cases an increase in international reserves.

In spite of substantially increased export earnings, many Asian developing countries continued to incur trade deficits, due to their large imports of capital goods and industrial raw materials. China, too, ran up a trade deficit in 1993 for the first time since 1990, but devaluation brought about a reduction of imports in 1994. With the exception of Indonesia and Taiwan province of China, all the developing countries in South-East Asia had trade deficits in 1994.

West Asia is the only subregion where growth slowed down in 1994, due in part to depressed oil prices. Led by exports and investment, growth in both the NIEs and the ASEAN-4[15] was the highest since the late 1980s, reaching 7.5 per cent, against 6.0 per cent and 6.5 per cent, respectively, in 1993. Of the four NIEs, growth was particularly high in the Republic of Korea, from 5.5 per cent in 1993 to 8.3 per cent, stimulated in part by domestic investment. Similarly, strong investment demand, due in part to public expenditure on infrastructure, together with higher inflows of FDI, enabled the ASEAN-4 to maintain or exceed their growth rates of the previous year. In particular, recovery in the Philippines, which began in 1993, when there was a growth of 2.0 per cent, after two years of virtual stagnation, accelerated in 1994, to reach 4.3 per cent.

In South Asia output grew sharply, from 3.2 per cent in 1993 to 5.1 per cent in 1994, as the recovery in India gathered momentum. Despite drought and a cotton virus, growth in Pakistan reached 4.0 per cent, against 2.6 per cent in the previous year, driven by an increase of over 15 per cent in industrial investment and substantial inflows of FDI. So far, the implementation of stabilization policies in the subregion has met with mixed success. The effect of demand management policies to contain inflation was offset to varying extents by cost-push factors, especially increases in administered prices in the context of price reforms.

The least developed countries as a whole suffered a setback in 1994; GDP growth fell to 1.4 per cent, after having reached 3.3 per cent the previous year. More so than in preceding years, the greatest contribution to growth came from the Asian LDCs, which implemented a variety of structural and market-oriented policy reforms. Production was virtually stationary in the African LDCs and even declined slightly in island LDCs (see box 2).

After two successive years of over 12 per cent growth, the Chinese economy slowed down somewhat in 1994, even though growth remained at the two-digit level. During the year, the country suffered severely from natural disasters, with heavy floods in the south and severe drought in the north. Despite the implementation of an austerity pro-

Box 2

THE LEAST DEVELOPED COUNTRIES: PERFORMANCE AND PROSPECTS

Growth in the LDCs as a whole in 1994 was disappointing, reaching only 1.4 per cent, against 3.3 per cent in the previous year. The slower growth occurred in spite of the fact that several LDCs benefited, in differing degrees, from higher world prices of non-fuel primary commodities, notably, coffee, cotton and copper. Coffee is important to Burundi, Ethiopia, Madagascar, Rwanda, Uganda and the United Republic of Tanzania; cotton to Benin, Burkina Faso, Chad, Mali, Sudan and Togo; and copper to Zaire and Zambia.

A major offsetting factor was the direct and indirect impact of civil wars and political crises not only in several African LDCs but also in Afghanistan and Yemen. Of the 48 LDCs, 32 are in Africa and almost one-quarter of them are beset with political instability and armed conflict. Countries of the franc zone were also affected in varying degrees by the substantial devaluation of the CFA franc in January 1994. In other African countries, bad weather resulted in poor harvests.

Short-term prospects for the LDCs are not encouraging, in view of the continuing armed conflicts and political instability in many countries. Even if there is good weather that favours agricultural output, production in most countries remains hampered by inadequate infrastructure. Some countries will continue to benefit from improved commodity prices and the strengthening of recovery in industrial countries. All will continue to need substantial ODA flows and other external support.[1]

1 For a more detailed review of the performance and prospects of LDCs, see UNCTAD, *The Least Developed Countries. 1995 Report* (United Nations publication, Sales No. E.95.II.D.2).

gramme in mid-1993 to provide more effective and stricter macroeconomic controls, inflation continued to accelerate in 1994. Retail prices rose by 21.7 per cent, against 13.2 per cent in 1993, due largely to sharp increases in food prices, which accounted for an estimated 60 per cent of overall inflation. Since China has emerged as an important locomotive for growth in the region, the performance of its economy has both a direct and an indirect impact on its neighbours, particularly Hong Kong and Taiwan province of China, through linkages in trade and investment.

4. Central and Eastern Europe

In Central and Eastern Europe, the contraction of production since 1990 continued in 1994, when output declined by a further 10.1 per cent, slightly exceeding the 9.4 per cent decline in 1993. Nevertheless, the trade of these countries, especially exports, rose markedly in value in 1994, leading to a general improvement in trade balances. In particular, the surplus of the Russian Federation rose to a record level of almost $20 billion. In several countries the resumption of export expansion followed a protracted period of contraction; the expansion was particularly rapid in the Czech Republic, Hungary, Poland and Slovakia. The recovery of demand, particularly in Western Europe, was the principal factor behind this improved export performance, but supply factors also contributed in many instances, such as improved competitiveness, resulting from lower production costs or devaluation. Intraregional trade also showed renewed growth, especially that involving Poland and the Czech Republic.

Economic performance among the countries has become more diversified, reflecting the varying degrees of progress being achieved through the pursuit of diverse market reforms and economic policies. There has, however, been a discernible tendency, in a growing number of countries, for output to stop contracting and even begin to expand. The countries in the region now fall into two major distinct and contrasting groups: those of the former USSR, which are in general still struggling to halt and reverse the decline in output, and those outside the former USSR, which appear to be embarking on a path of recovery.

In the countries outside the former Soviet Union, there was a marked general improvement in external positions (except for Hungary). The recovery of demand in the OECD countries, particularly in Germany and the United States, boosted exports, and exports to other transition economies also rose. Total exports from these countries in current dollar terms increased by some 15 per cent in 1994. Imports rose much less, resulting in a substantial reduction in the overall current account deficit. Because of this strong export demand and a revival of domestic investment, economic recovery exceeded earlier expectations. For this group of countries as a whole, there was a sharp reversal of GDP growth, from a decline of 1.7 per cent in 1993 to an increase of 3.7 per cent in 1994. The recovery was broadly based, although growth rates varied greatly, ranging from less than 1 per cent in Bulgaria to some 5 per cent for Poland, Slovakia and Slovenia and as much as 6-7 per cent in Albania and Yugoslavia. The Former Yugoslav Republic of Macedonia was the only country where output continued to decline, but at only half the rate of 1993.[16]

Progress was achieved in stopping inflation in this group of countries; inflation rates were lower than in 1993, with the exception of Bulgaria, which had undertaken a sharp devaluation, together with radical adjustments in the price of energy and important increases in food prices. The Czech Republic and Slovakia continued to enjoy the lowest inflation rates (10 per cent and 13 per cent, respectively), whereas restrictive monetary policies led to a substantial reduction of the rate in Albania, Romania and The Former Yugoslav Republic of Macedonia. A spectacular decline of inflation was achieved in Croatia, from over 1,500 per cent in 1993 to less than 100 per cent in 1994; and in Yugoslavia, where there was hyperinflation of 20,000 per cent per month at the end of 1993, inflation was only just over 3 per cent by the end of 1994.[17] Success in reducing inflation was much more modest in Hungary and Poland. In those two countries, as well as in Bulgaria, further declines in the inflation rate have been impeded by institutional and structural rigidities and other factors, such as substantial currency devaluation and large budgetary spending, as well as by increases in the domestic tax rate and in energy prices.

Among the countries of the former Soviet Union, the Baltic States have succeeded much more than the members of CIS in stabilizing and reforming their economies. In 1994, output continued to fall in Latvia and Lithuania, but much less than in 1993, whereas in Estonia the decline appears to have come to an end. However, in all three countries, inflation remained relatively high and their external accounts deteriorated further due to a rapid expansion of imports.

The fall in output in the CIS countries exceeded expectations. Their combined GDP fell even more than in 1993 - as much as 16 per cent, against 11.5 per cent in 1993. For the Russian Federation the decline was some 15 per cent, and it was considerably greater in Armenia, Azerbaijan, Georgia, the Republic of Moldova and Tajikistan, where conflicts and political instability seriously disrupted the productive system. The fall in output in the CIS countries may, however, be exaggerated by their national statistics. For example, there is a discrepancy between Russian indicators of production and of consumption. Real GDP is derived from production data, but alternative estimates, based on a reconciliation of official data on production and on consumption, suggest that the decline in real GDP from 1989 to 1944 may be one third, rather than the official figure of one half.[18]

Accompanying the decline in output in many of the CIS countries was a sharp acceleration of inflation, which can be attributed ultimately to incoherent and ineffective monetary and fiscal policies. The success in Russia and Ukraine, for example, following the implementation of tight monetary and fiscal policies in late 1993, was short-lived. Failure to establish a coherent sequence of goals and priorities, and lack of consistency in choosing and applying appropriate instruments of policy, have so far greatly hindered achievement of the goals of establishing financial stability and a liberal market environment.

B. Short-term outlook

In the wake of the Mexican financial crisis and the subsequent faster depreciation of the dollar against both the yen and the Deutsche mark, forecasts for 1995 are subject to a considerable degree of uncertainty. In commodity markets, available indications are for a levelling-off of price rises for most non-food items, especially metals, or a even price declines. The major exceptions are coffee, cocoa and oil, where some increase is projected. The world economy is expected broadly to lose some of its current momentum and grow by 2.9 per cent in 1995 (see table 1). In keeping with the trend in recent years, the volume of world trade is projected to grow twice as fast as production. For the developed market-economy countries as a whole, a small decline in growth is expected, to 2.5 per cent (from 3.1 per cent in 1994) due to a slowdown in the United States (from 4.1 per cent to 2.7 per cent). While recession is expected to continue in Japan, growth in the European Union is projected to remain at its 1994 rate of 2.8 per cent, but unemployment will continue to be a major policy issue in most countries. Inflation, however, is expected to remain low, in view of the sizeable margins of spare capacity.

Growth in developing countries as a whole is expected to continue at roughly the accelerated rate of 4.4 per cent achieved in 1994, but disparities in performance among the various regions will persist and become even more pronounced. Prospects for the African region are mixed and uncertain. The problems of external trade, debt and financial resource flows are so closely interwoven that none can be resolved effectively without substantial progress on the others. Much will depend on the evolution of commodity prices and world demand, on the one hand, and on weather conditions and the resolution of political conflicts and civil wars, on the other. The latter have had, and continue to have, severe repercussions on social and economic conditions in the region. While recovery in Western Europe, Africa's traditional markets and major development partners, can be expected to continue, the outlook regarding some key commodity markets is less certain.

Short-term prospects for Latin America have been seriously affected by the direct and indirect impact of the Mexican financial crisis. As a consequence, in spite of the strengthening of recovery in the industrial countries and favourable commodity prices, growth in the region as a whole is expected to slow down, from 3.7 per cent in 1994 to 2 per cent. Growth in Brazil, Chile and Peru will continue to be robust, whereas in Argentina it may be negative. For Venezuela, a further decline in output is expected, and in Mexico there is likely to be a fall of 5 per cent. However, given the low level of savings and investment rates in the region, relative to past trends or to the high-growth economies in Asia, Latin American countries will still be dependent on substantial inflows of capital to finance investment and will thus continue to be vulnerable to the volatility of such flows. There is also the risk that the flow of capital into the region may be further reduced or even dry up.

The prospects for developing Asia continue to be bright. Growth is expected to further accelerate, reaching 6.0 per cent in 1995 (5.3 per cent in 1994), as the expansion of intraregional trade and investment continues. The recent sharp depreciation of the dollar, to which many Asian currencies are directly or indirectly linked, can be expected to have a mixed impact. On the one hand, the corresponding depreciation of regional currencies against the world's major currencies, particularly the yen, should lead to an improvement in export competitiveness relative to Japan and should strengthen export competitiveness in the Japanese market. On the other hand, the depreciation could also slow the decline in inflation rates by increasing the domestic cost of imports, particularly from Japan. In this respect, Taiwan province of China and Thailand will be the most severely affected, and Hong Kong and China the least.

The Government of China remains determined to pursue its ambitious plans to upgrade the country's industrial base and infrastructure. Inflation, however, has persisted, in spite of the austerity measures taken. Combating inflation has become

the top economic priority in 1995, even though the cost in terms of unemployment has become increasingly high. Policies have been adopted to increase investment in the agricultural sector, to further tighten fiscal and monetary measures and controls over fixed investment, as well as to monitor closely the distribution channels for all goods.[19] As the austerity measures and restructuring policies begin to bite, the effect in 1995 is expected to be a more moderate growth of under 10 per cent (after three successive years of roughly 12 per cent growth).

Growth performance in Central and Eastern Europe as a whole is likely to be rather better than in 1994, with continuing sharp differences between the CIS countries and other countries of the region. Indeed, the gap between the two groups, which first emerged in 1993 and widened in 1994, can be expected to widen further.

Outside the former USSR, growth is expected to reach some 4 per cent in 1995, a slight improvement over the previous year, thanks to favourable external conditions and continued progress in structural reforms. Poland, Slovenia and the Czech Republic are leading the way to recovery, while for some other countries a crucial factor will be whether peace and stability can be restored. In spite of the progress which has been made so far, the economies of all these countries remain fragile and vulnerable to a resurgence of inflation or political unrest.

In the former area of the USSR, the Baltic states appear to be well placed to benefit from an expansion of trade, especially with western countries, as well as from FDI; growth in 1995 may well reach 4-5 per cent. Prospects for the CIS countries are more gloomy and uncertain. In some countries little can be achieved before peace is restored and an end is put to conflict and hostilities; in all determined efforts are still required, within the democratic process, to establish and implement coherent and consistent policies. Some further decline in output in 1995 cannot be excluded.

C. Uncertainty in short-term forecasting

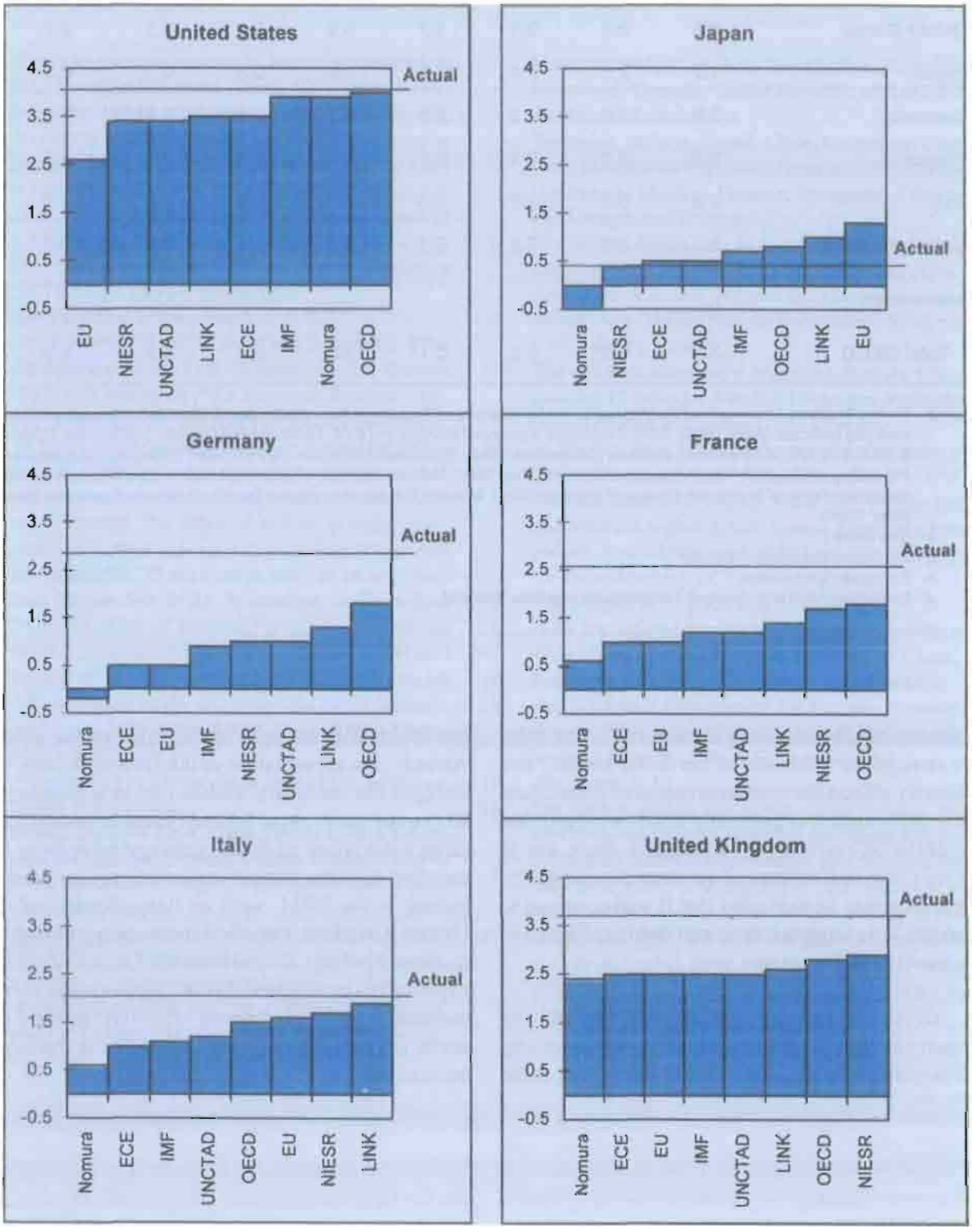
The fact that the recovery among developed market-economy countries in 1994, especially in Europe, was faster than was expected at the beginning of the year is indicative of the hazards of short-term forecasting. The task has become more complicated as a result of the structural changes which have taken place in recent years both within countries and globally, as well as of sharp swings in exchange rates. Chart 1 compares forecasts of GDP growth for 1994 by various international organizations and research institutions for selected OECD countries with their actual outcome. For all countries except Japan forecast growth was lower than actual growth. The size of the gap varied according to country and also according to the forecasting institution. The variation among institutions was smaller for the United States economy (if one ignores the very low estimate of the European Commission) than for the major Western European economies. On the other hand, the forecasting error, and its variation among the forecasting institutions, is quite large for Germany. The range of forecasts was from -0.2 per cent (Nomura Research Institute) to 1.8 per cent (OECD), whereas actual growth was 2.9 per cent. Forecasts for Japan, ranging from -0.2 per cent to an increase of 1.8 per cent, fall more or less evenly on both sides of the actual outcome of 0.6 per cent.

Forecasts for 1995 for selected OECD countries by the same international organizations and research institutions are presented in table 4. The full impact and consequences of the continued depreciation of the dollar vis-à-vis the yen and the

Chart 1

GDP GROWTH IN SELECTED OECD COUNTRIES IN 1994: COMPARISON OF ACTUAL GROWTH WITH FORECASTS BY VARIOUS INSTITUTIONS

(Percentage)



Source: Table 1 and *TDR 1994*, table 3.

Table 4

ALTERNATIVE FORECASTS OF GDP GROWTH IN 1995 FOR SELECTED OECD COUNTRIES

(Percentage)

Country	LINK	ECE	OECD	EU	IMF	NIESR	Nomura	UNCTAD[a]
United States	2.8	3.0	3.1	3.2	3.2	3.5	3.3	2.7
Japan	1.2	2.5	2.5	1.6	1.8	0.8	0.7	0.5
Germany	2.9	3.0	2.8	3.0	3.2	2.8[b]	2.8	2.5
France	3.2	3.0	3.1	3.1	3.2	2.8	2.7	2.5
Italy	2.8	3.0	2.7	3.3	3.0	3.4	2.6	3.0
United Kingdom	3.0	3.0	3.4	3.1	3.2	3.5	2.8	2.8
Memo item:								
Total OECD	3.1[c]	3.0[d]	3.0	3.1[c]	3.2[c]	2.8	2.5	2.5

Source: United Nations, University of Pennsylvania and University of Toronto, "Project Link World Outlook" (mimeo), post-LINK meeting forecast (April 1995); ECE, *Economic Survey of Europe in 1994-1995,* United Nations publication, Sales No. E.95.II.E.1; *OECD Economic Outlook* (December 1994); European Commission, *European Economy, Supplement A* (April/May 1995); IMF, *World Economic Outlook* (May 1995); National Institute of Economic and Social Research (London), *National Institute Economic Review* (February 1995); Nomura Research Institute (Tokyo), *Quarterly Economic Review* (May 1995).

a See table 1.

b Excluding the eastern *Länder*.

c European Union only.

d Excluding Australia, Iceland, Luxembourg and New Zealand.

Deutsche mark have not yet been felt. The relative strength or weakness of the dollar directly and indirectly affects the competitiveness of other countries. Although it is generally acknowledged that the dollar is currently undervalued, there are as yet no clear indications of its strengthening. Indeed, it cannot be excluded that it will continue to weaken. This uncertainty is inevitably reflected in the short-term forecasts.

Given the existing exchange rate regime, important changes in relative competitiveness among EU countries could occur in the event that there are substantial changes in the value of the dollar. Already, the appreciation of the Deutsche mark has obliged the monetary authorities in a number of EU countries to raise interest rates to prevent too large a deviation of their exchange rates from the existing parities. Countries not at present participating in the ERM, such as Italy, Spain and the United Kingdom, may find it necessary to tighten monetary policy. Interest rates in Germany are not expected to be lowered. Over-cautiousness by the monetary authorities could seriously shorten the current expansionary phase of recovery in the world economy.

Notes

1 Trade in services appears to have risen much less than merchandise trade during 1994, thus reversing a trend observable throughout the past decade. It is likely that the expansion of world merchandise trade in 1993 was understated while that for 1994 was overstated, due to incomplete data coverage in 1993, when customs controls among members of the European Union were abolished and a new system for the collection of trade statistics (INTRASTAT) was introduced.

2 See Part Two below, chap.I, sect. B.1.

3 See Lawrence R. Klein and Yuzo Kumasaka, "The Re-opening of the U.S. Productivity-led Growth Era", *NLI Research* (NLI Research Institute), No. 76, February 1995; see also Part Two below, chap.I.

4 In 1993, primary commodities accounted for 86 per cent of Africa's foreign exchange earnings, as they did more than two decades ago. Out of the 53 African countries, the share of non-oil primary commodities in total exports was more than 90 per cent in 9 countries, 70 per cent or more in 18 and more than 50 per cent in 35. In contrast, in South-East Asia, the share of (non-oil) primary commodities in total exports fell from 63 per cent to 36 per cent from 1965 to 1987. See Economic Commission for Africa, *Report on the Economic and Social Situation in Africa, 1995* (E/ECA/CM.21/3), Addis Ababa, March 1995, para.114.

5 Algeria, Egypt, Libyan Arab Jamahiriya, Morocco, Sudan and Tunisia.

6 Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone and Togo.

7 Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon, Rwanda, Sao Tome and Principe, and Zaire.

8 Angola, Botswana, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, Somalia, Swaziland, Uganda, United Republic of Tanzania, Zambia, and Zimbabwe.

9 Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Mexico, Panama, Paraguay, Trinidad and Tobago, and Uruguay.

10 For further details, see Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Economy of Latin America and the Caribbean 1994* (United Nations publication, Sales No. E.94.II.G.96), table A.2.

11 The other countries were Argentina, Bolivia, Chile, Ecuador, El Salvador, Mexico, Nicaragua, Paraguay, Peru, Trinidad and Tobago, and Uruguay.

12 In the first four years of the decade, the share of intra-trade in total Latin American exports roughly doubled. Intra-trade tripled within the Andean Pact and doubled within LAIA (Latin American Integration Association) and MERCOSUR (Southern Common Market). ECLAC, *op.cit.*, box 2.

13 *Ibid.*, tables A.15 and A.16.

14 NIEs are defined here as Hong Kong, Republic of Korea, Singapore and Taiwan province of China.

15 Indonesia, Malaysia, Philippines and Thailand.

16 See Economic Commission for Europe, *Economic Survey of Europe in 1994-1995* (United Nations publication, Sales No.E.95.II.E.1), table 3.1.1.

17 *Ibid.*, table 3.3.1.

18 For further details see Evgeny Gavrilenkov and Vincent Koen, "How Large Was the Output Decline in Russia? Alternative Estimates and Welfare Implications," *IMF Working Paper* WP/94/154 (December 1994).

19 In March 1995, the 1995 targets for real GDP growth and retail price inflation, originally set at 10 per cent and 13 per cent, respectively, were revised to 8-9 per cent and 15 per cent.

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Chapter II

INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

A. Recent trends in external financing

During 1994 and early 1995 there were marked differences in the growth of the major categories of external financing from the international financial markets (exemplified in table 5). To a significant extent these differences reflected the impact of unsettled conditions on issues of debt securities. In consequence, 1994 was characterized by a slowdown in new external bond issues after the first quarter, accompanied by indications of greater reluctance among investors to purchase instruments with long maturities. Uncertainties were exacerbated at the end of the year by the bankruptcy of Orange County in California and the outbreak of the Mexican currency crisis. The more difficult conditions now prevailing in financial markets led, *inter alia*, to a very large fall in new bond issues by Latin American entities in the first four months of 1995 and to the postponement of international equity issues by companies from developing countries. The ripple effects of the Mexican crisis are also generally viewed as having contributed, together with such factors as rising interest rates (illustrated by table 6), to the ubiquitous declines in prices which took place in major emerging financial markets between mid-December 1994 and mid-January 1995.

As is evident from table 5, flows to developing countries of some major categories of financing broadly followed the movements experienced by other borrowers. But for new issues of international equities developing countries' share underwent a sharp increase.

There has been a progressive blurring of the distinction between external bonds (instruments underwritten by syndicates of banks) and medium-term Euronotes (originally sold by dealers on an agency basis). The latter, an important constituent of the category "other non-underwritten facilities" in table 5, may now be distributed via underwriting syndicates, and are no longer so clearly separable from external bonds on the basis of their initial maturities (on average originally shorter than for international bonds).[1] Thus the two instruments have become increasingly interchangeable for many purposes. The increased difficulties faced by developing-country borrowers planning new bond issues after the first quarter of 1994 appear to have led to greater recourse to Euronotes by entities in Latin America (especially Mexican ones).

The international equity issues of developing countries increased to more than $15.5 billion in 1994, a level almost double that of the previous year.[2] This rise was largely due to an increase in issues originating in South and South-East Asia. Total external purchases of developing-country equities also include those of shares in local markets, and figures for net inflows in this form (i.e. purchases less sales) show a fall from over $60 billion in 1993 to about $40 billion in 1994.[3]

Total claims on developing countries of banks in the BIS-reporting area (shown in table 7) increased more rapidly in 1994 than those on all borrowers. Their faster expansion reflected a sub-

Table 5

SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES OF DEVELOPING AND EASTERN EUROPEAN COUNTRIES THEREIN, 1990-1994

Category	*1990*	*1991*	*1992*	*1993*	*1994*
External bond offerings					
Total ($ billion)	229.9	308.7	333.7	481.0	426.9
Percentage share of:					
Developing countries	2.3	3.2	5.0	10.3	10.5
Eastern Europe	0.7	0.5	0.4	1.2	0.6
Syndicated credits					
Total ($ billion)	124.5	116.0	117.9	136.7	202.8
Percentage share of:					
Developing countries	17.3	24.4	15.5	15.1	11.7
Eastern Europe	2.4	0.1	0.2	0.4	0.6
Eurocommercial paper programmes					
Total ($ billion)	48.3	35.9	28.9	38.4	31.8
Share of developing countries *(per cent)*	1.9	2.8	11.8	7.0	6.6
Committed borrowing facilities[a]					
Total ($ billion)	7.0	7.7	6.7	8.2	4.9
Share of developing countries *(per cent)*	30.0	58.4	25.4	14.6	55.1
Other non-underwritten facilities[b]					
Total ($ billion)	17.9	44.3	99.0	113.6	243.1
Share of developing countries *(per cent)*	1.7	1.6	4.5	5.7	5.0
International equities[c]					
Total ($ billion)	7.3	23.4	23.5	40.7	44.9
Share of developing countries *(per cent)*	13.7	21.4	30.6	20.1	34.7

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

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

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

c 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.

stantial rise for countries of South and South-East Asia, a much smaller one for those of Latin America, and falls for those of Africa and West Asia. Claims also decreased for countries of Eastern Europe. The expansion of claims on South and South-East Asia (which was accompanied by a slight fall in 1994 in new syndicated bank credits to the region from the level of 1993) reflects the region's growing importance in total global financial transactions and the accompanying development of its local and regional banking centres.[4]

The movement in claims on Latin American borrowers was affected by debt-reduction agreements with creditor banks, especially that of Brazil finalized in April 1994, and a banking crisis in

Table 6

SELECTED INTERNATIONAL INTEREST RATES

(Period averages in per cent per annum)

A. London Inter-Bank Offered Rate (LIBOR) on six-month deposits in selected currencies

Currency	1992	1993	1994	1995 (Jan-March)
United States dollar	3.90	3.41	5.07	6.60
French franc	10.16	7.92	5.95	6.89
Deutsche mark	9.41	6.95	5.35	5.27
Japanese yen	4.32	2.96	2.36	2.29
Pound sterling	9.65	5.93	5.80	7.14

B. Selected long-term interest rates

	1992	1993	1994	1995 (Jan-March)
United States dollar[a]	7.52	6.46	7.41	7.71
French franc[b]	8.96	7.04	7.52	8.12
Deutsche mark[c]	7.91	6.48	6.94	7.43
Japanese yen[d]	6.54	4.34	4.50	4.23
Pound sterling[e]	9.67	7.87	8.05	8.54

Source: IMF, *International Financial Statistics*, May 1995, and OECD, *Financial Statistics Monthly*, various issues.

a US Government bonds ("composite" over 10 years).

b Public and semi-public sector bonds.

c Public sector bonds with maturities of 7 to 15 years.

d Central Government bonds (10-year benchmark).

e 20-year Government bonds.

Venezuela. The impact of these developments was partly offset by a continuing expansion of lending to Colombia, Argentina, and Mexico, much of it at short term to the latter two countries. Significant contributions to the decline in banks' claims on Eastern European countries resulted from transfers to official agencies and from sales of Russian bank debt, together with operations associated with the debt-reduction agreements of Bulgaria and Poland.

During the first half of 1994 the vigorous growth of the previous two years in the net flow of export credits to developing countries was not sustained (see table 8).[5] Indeed, total net flows to Africa and Latin America were actually negative. For particular countries changes in net flows continue to reflect differences in the costs and other terms associated with official insurance from ECAs for financing and payments arrangements for their imports as well as in demand for export credits. The costs and other terms of official insurance have been especially important in depressing the levels of such credits to African countries, of which over 50 per cent in 1993 and over 60 per cent in the first half of 1994 experienced net outflows. There were also substantial increases during early 1994 in the frequency of net outflows from countries in Latin America and West Asia.

Access to major categories of financing from international financial markets continued to be concentrated in 1994 on a relatively small group of developing countries and economies in transi-

Table 7

EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA[a] VIS-A-VIS DEVELOPING AND EASTERN EUROPEAN COUNTRIES, 1990-1994

	1990	1991	1992	1993	1994	Stock (end-1994)
	Percentage rate of increase[b]					*$ billion*
All developing countries[c]	-2.5	0.4	10.2	2.6	8.1	661
Of which in:						
America	-13.2	-0.4	6.9	1.0	1.8	232
Africa	-4.1	-8.5	-4.4	-7.8	-6.3	43
West Asia	4.7	-7.5	26.7	1.4	-2.6	94
South and South-East Asia[d]	15.2	11.0	12.5	8.6	21.3	287
Central Asia[e]	..	..	..	..	104.3	1
Europe[f]	-10.2	-17.7	-11.2	-8.0	-4.6	5
Eastern Europe[g]	-12.3	-1.6	4.1	-4.0	-16.0	79
Memo items:						
All borrowers[h]	11.4	-0.9	3.0	5.1	4.1	7103
14 highly indebted countries[i]	-13.7	-1.4	4.6	0.7	0.9	235

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: Bahrain and Lebanon; and in South and South-East Asia: Hong Kong, Singapore and Vanuatu.

d Including Oceania and (from 1993) China, Democratic People's Republic of Korea, Mongolia and Viet Nam.

e Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Turkmenistan, and Uzbekistan.

f Malta and former Yugoslavia.

g Figures up to 1993 include Czechoslovakia and the former USSR; thereafter they include Belarus, Czech Republic, Estonia, Latvia, Lithuania, Moldova, Russian Federation, Slovakia and Ukraine.

h Including multilateral institutions

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

tion. Thus, for example, three Latin American countries (Argentina, Brazil and Mexico) were recipients of approximately 40 per cent of sums raised in the form of external bond issues by countries and territories other than certain major offshore financial centres.[6] A similar proportion went to five countries of South and South-East Asia (China, Indonesia, Republic of Korea, Taiwan province of China and Thailand). Of the economies in transition only Hungary was a major borrower in this form. Monies raised through new syndicated bank credits were still more concentrated, five countries of South and South-East Asia (China, Indonesia, Republic of Korea, Malaysia and Thailand) accounting for 70 per cent. Four of those five countries (all but Malaysia) accounted for almost the whole growth in 1994 of the value of claims[7], after adjustment for movements of exchange rates, of banks in the BIS-reporting area on developing countries and territories (other than certain major offshore financial centres).[8] These four countries, together with India and Pakistan, were responsible for approximately two thirds of the new international equity issues by entities in

Table 8

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]

Region	1990		1991		1992		1993		1994
	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half	2nd half	1st half
All developing countries	35	42	42	40	41	39	36	42	52
Of which in:									
Africa	32	42	46	36	42	48	52	56	62
America	27	41	41	41	51	46	38	40	62
West Asia	36	43	71	36	57	36	14	43	57
South and South-East Asia[c]	48	48	24	48	17	17	30	36	30
Central Asia[d]	..	..	..	..	..	..	..	..	12
Memo item:[e]									
14 highly indebted countries[f]	4	7	7	7	4	7	1	8	8
Eastern Europe[g]	4	6	-	4	3	2	3	-	6

B. Net flow and stock in mid-1994

(Millions of dollars)

Region	1990	1991	1992	1993	1994 (first half)	Stock (end June 1994)
All developing countries	7 586	5 900	17 201	20 021	5 748	249 526
Of which in:						
Africa	-3 800	1 361	2 583	825	-1 062	61 260
America	4 543	3 712	4 641	6 347	-379	67 815
West Asia	5 017	2 472	1 687	4 520	1 283	45 287
South and South-East Asia[c]	1 959	-1 244	8 348	7 572	6 225	70 559
Central Asia[d]	..	..	..	..	189	718
Memo item:						
14 highly indebted countries[f]	5 031	3 392	7 196	7 143	711	84 209
Eastern Europe[g]	-1 021	10 406	8 015	6 891	-3 160	48 163

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 and (from 1993) China, Democratic People's Republic of Korea, Mongolia, and Viet Nam

d Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

e Number of countries.

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

g Up to 1993, figures include Czechoslovakia and the former USSR: thereafter they include Belarus, Czech Republic, Estonia, Latvia, Lithuania, Moldova, Russian Federation, Slovakia and Ukraine.

Table 9

CHANGES IN REPRESENTATIVE INDICES OF STOCK MARKET PRICES IN SELECTED DEVELOPING COUNTRIES

(Percentage change in local currency during the period)

Country	1994		1995		
	Jan-Nov	December	January	February	March
Latin America					
Argentina	-13.0	-11.6	-5.3	-20.1	16.4
Brazil	1140.1	-6.5	-10.8	-15.8	-8.9
Chile	45.5	-4.8	-0.3	-1.7	-0.8
Colombia	13.5	4.6	10.0	-7.0	-7.7
Mexico	-0.4	-8.3	-11.9	-26.0	18.3
Peru	54.0	-1.3	-19.7	-10.5	4.1
Venezuela[a]	20.0	13.2	-6.2	-1.4	-1.5
South and South-East Asia					
China	-18.0	-5.2	-13.2	-2.3	17.8
India	15.5	-6.0	-9.4	-5.6	-2.9
Indonesia	-18.0	-2.7	-7.6	4.6	-5.5
Malaysia	-20.6	-4.1	-9.1	10.9	0.5
Pakistan[a]	5.6	-5.9	-12.8	4.2	-11.1
Philippines	-15.8	3.5	-13.1	3.7	-4.7
Republic of Korea	24.0	-4.4	-9.9	-4.3	5.2
Taiwan province of China	4.8	12.0	-11.5	3.2	0.2
Thailand	-19.0	-0.2	-10.5	5.8	-5.6
West Asia					
Turkey	36.3	-3.3	-7.4	15.4	36.8
Eastern Europe					
Hungary	22.4	-4.9	-21.1	4.1	1.6
Poland	-36.0	-6.1	-17.7	4.8	-4.2

Source: IFC, *Quarterly Review of Emerging Stock Markets,* Fourth Quarter 1994 and First Quarter 1995.

a The changes for 1995 are based on an index different from that used for 1994.

developing countries mentioned earlier. Borrowing in the form of various other instruments was heavily concentrated among a few Latin American countries. For example, Argentina, Brazil and Mexico were responsible for more than 90 per cent of funds raised by developing countries through announced medium-term Euronote facilities.[9] The same three borrowers also accounted for most of developing countries' issues of Eurocommercial paper.[10]

During the period from mid-1994 to April 1995 a number of countries issued external bonds either for the first time or after lengthy absences from the markets for such instruments. These countries included Barbados, Bolivia, Ghana, Guatemala, Lebanon, Pakistan and Tunisia. Similarly, in the spring of 1995 Romania returned to the market for syndicated international bank credits after an absence of about 15 years. However, the accession of such countries has yet to have a major effect on the distribution of financing from the international financial markets for developing countries and economies in transition. The credit ratings of debt securities issued by entities in such countries also reflect this unequal distribution. "Investment grade" ratings[11] by major credit rating agencies for long-term sovereign debt denomi-

nated in foreign currencies (discussed in more detail for Latin American and South and South-East Asian countries in sections B and C) are heavily concentrated among South and South-East Asian countries. The principal countries outside this region which have obtained such ratings from at least one major agency are two Latin American countries (Chile and Colombia), two economies in transition (Czech Republic and Poland) and one African country (Tunisia, which received an "investment grade" rating from Moody's in April 1995).

A number of countries of South and South-East Asia, which were left largely unscathed by the debt crisis of the 1980s, as already mentioned, have increasingly been integrated into the global system of financial markets and in consequence can raise money in them relatively easily. However, the spill-over effects of the Mexican crisis served as a reminder of the continuing vulnerability of their financial markets to the actions of speculative international investors still inclined to lump them with emerging markets elsewhere in the developing world. These spill-over effects were evident in downward pressures on share prices (illustrated for selected countries for the region in table 9) and on exchange rates.[12] They also contributed to substantial declines in external bond and equity issues.[13]

Prices of the debt securities of other developing countries and economies in transition were also adversely affected by the Mexican crisis. But the severest impact (described at greater length in the next section) was reserved for certain Latin American countries. The great majority of other developing countries and economies in transition receive only limited financing from the international financial markets and thus were not seriously affected by the Mexican crisis. However, most of these countries face continuing external financial stringency which at best is likely to be only gradually relaxed.

B. Latin America's financial inflows and outflows

The Mexican crisis of December 1994 not only was associated with large selling of the country's securities by international investors but also was followed by a sharp contraction of external financing for several other countries in the region during the first quarter of 1995. The overall impact of the crisis on the region's net inflow in 1994, definitive assessment of which is not possible at the time of writing, requires some downward adjustment of initial estimates, which had put this inflow at a little more than $55 billion, a figure already almost $10 billion less than that of 1993.[14]

These initial estimates reflected the more difficult conditions faced in 1994 by Latin American borrowers in the international bond markets (noted in the previous section). However, they involved estimating Mexico's net financial inflow without knowledge of the size of the outflows in late December. These outflows are believed to have reduced the net inflow for 1994 from an initially projected level of almost $20 billion to about $10 billion.[15] Estimates for the different categories of Mexico's external financing which include the effects of the crisis point to a substantial net outflow of securities investment by non-residents in forms other than external bonds, thus providing support for warnings in recent issues of *TDR* as to their volatility (see box 4 below). Claims of BIS-reporting banks on Mexico increased during the year by about $8 billion, and net inflows in the form of external bond issues amounted to about $4.5 billion,[16] while foreign direct investment came to more than $8 billion.[17] These figures suggest a net outflow in 1994 due to net sales in other categories of securities investment (short- and long-term) of about $10 billion.

The pre-crisis estimates of the total net financial inflows in 1994 for some other Latin American countries may also require revision owing to the spillover effects of the Mexican crisis, but the

adjustments can be expected to be much smaller than those just described.[18] The estimated total net inflow for Argentina was $10.5 billion. Of this amount, a little less than $3.5 billion was in the form of net issues of external bonds and another $3 billion in the form of claims of BIS-reporting banks, the balance being due to other categories of portfolio and to FDI. The estimated net inflow for Brazil was about $13 billion. Net issues of external bonds accounted for about $1.5 billion of this figure, while the claims of BIS-reporting banks actually fell by about $6 billion, thus pointing to an increase in net flows of other categories of portfolio and FDI of about $17.5 billion. The estimated net inflow for Chile was $3.1 billion. Net issues of external bonds accounted for $0.1 billion, and the increase in claims of BIS-reporting banks for $2.3 billion - figures which imply a net inflow in the form of portfolio and FDI of approximately $1 billion. The estimated net inflow for Colombia was also $3.1 billion, of which net external bond issues accounted for $0.3 billion and the increase in claims of BIS-reporting banks for $1.5 billion. The implied total net inflow of other categories of portfolio and FDI is thus about $1.5 billion, made up mainly of the latter.[19] The estimated net inflow for Peru indicates more than a doubling, from $2.7 billion in 1993 to $6 billion in 1994. Of this amount, the rise in the claims of BIS-reporting banks accounted for $0.3 billion, while the rest was largely due to portfolio equity investment and FDI (much of it associated with the privatization of two companies in the telecommunications sector).[20]

As regards Venezuela, the country had been the recipient of substantial sums from the international financial markets since the beginning of the 1990s, but in 1994 there was a net outflow of $4.5 billion. Although $0.2 billion of this amount was constituted by the net repayment of external bonds, the total reflected mainly the impact of a reduction of about $4 billion in the claims of BIS-reporting banks. This contraction was concentrated on banks' claims on Venezuelan non-bank entities, data for the first half of the year indicating that the country's public sector was particularly adversely affected.[21] Venezuela's difficulties were associated with the impact on the country's creditworthiness of a banking crisis which required government expenditure of more than $8 billion and rescue operations that left 80 per cent of the banking sector in official control.

Since 1991 a good deal of securitized international lending to certain Latin American countries has been in response to opportunities for interest rate arbitrage between United States dollar rates and those in the domestic financial markets of the countries in question. Such opportunities persisted in 1994, as illustrated in table 10, which shows the excess of domestic monthly short-term rates over the rate on United States treasury bills after adjustment for movements in exchange rates. The excess return for the year as a whole is substantial for three of the four countries in the table. But for Mexico it was slightly negative even during the first 11 months of the year, and decisively so for 1994 as a whole (once account is taken of the effects of the large peso devaluation in December). As noted in previous years' *TDR*, much of the inflow in response to these opportunities for interest rate arbitrage was the result of banks taking advantage of the relatively cheap finance available from external investors for profitable on-lending in local currencies. For this purpose banks borrowed not only at short term but also through external instruments with longer maturities such as bonds. This process continued in 1994, three-quarters of Brazil's external bond issues, for example, being those of banks.[22] Such arbitrage was disrupted in early 1995 owing to international investors' shift out of Latin American paper.

In recent years some Latin American countries have adopted policies involving taxes and direct controls with the objective of limiting the problems of exchange rate management and fiscal balance which can result from large external financial inflows.[23] Such measures have continued to be in evidence since those reported in last year's *TDR*. In order to limit upward pressure on its currency, in October 1994 Brazil imposed a one-off tax of 1 per cent on foreign purchases of Brazilian equities, increased the tax on external bond issues by Brazilian entities from 3 per cent to 7 per cent and that paid by non-residents on fixed-interest investments in Brazil from 5 per cent to 9 per cent, and liberalized restrictions on the purchase of dollars in the foreign exchange market. Chile undertook further liberalization of its regulations regarding external investment by institutional investors, and took steps to increase the net demand for foreign currency, such as specifying that banks' reserve requirements against external credits had to be held in dollars, raising the limit on repatriated proceeds from exports that have to be exchanged in the formal exchange market, and extending the permitted period for carrying out such operations.[24] Colombia raised from three to five years the maturity of external credits to which cash reserve requirements apply.[25]

Table 10

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 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]
1993								
January	0.36	0.11	1.81	1.56	0.09	-0.16	1.13	0.88
February	0.93	0.69	2.35	2.11	0.10	-0.15	1.18	0.93
March	0.81	0.57	2.05	1.80	-1.16	-1.40	1.12	0.88
April	0.94	0.70	1.75	1.51	0.54	0.30	1.06	0.83
May	0.67	0.43	1.37	1.12	1.22	0.98	0.98	0.73
June	0.86	0.61	1.38	1.12	2.52	2.26	1.02	0.76
July	0.78	0.53	1.56	1.31	1.30	1.05	0.89	0.64
August	0.67	0.42	1.48	1.23	1.30	1.05	0.88	0.63
September	0.65	0.41	1.62	1.38	2.50	2.25	0.89	0.64
October	0.62	0.37	1.94	1.69	1.31	1.06	0.84	0.59
November	0.75	0.49	2.12	1.86	2.68	2.43	0.93	0.68
December	0.65	0.40	1.89	1.63	-1.98	-2.24	0.74	0.49
Monthly average	0.72	0.48	1.78	1.53	0.87	0.62	0.97	0.73
Annualized monthly average	9.04	5.86	23.53	19.96	10.92	7.69	12.32	9.06
1994								
January	1.53	1.28	0.13	-0.12	0.63	0.39	1.36	1 11
February	1.57	1.30	3.29	3.03	2.08	1.82	-2.43	-2.69
March	1.69	1.40	1.04	0.75	2.09	1.80	-2.59	-2.88
April	1.70	1.39	3.55	3.24	1.98	1.68	4.07	3.77
May	1.83	1.49	2.48	2.14	2.67	2.32	-1.16	-1.51
June	1.71	1.36	1.73	1.38	2.79	2.45	-0.74	-1.09
July	1.67	1.31	13.57	13.21	0.09	-0.27	0.97	0.61
August	1.64	1.27	10.29	9.93	2.92	2.55	1.44	1.07
September	1.70	1.32	8.79	8.41	3.26	2.88	0.41	0.03
October	1.76	1.36	4.38	3.97	1.68	1.28	0.24	-0.16
November	1.83	1.40	5.65	5.22	3.20	2.77	1.17	0.74
December	2.19	1.73	4.18	3.72	1.25	0.79	-34.84	-35.30
Monthly average[g]	1.73	1.38	4.92	4.57	2.05	1.71	-2.68 (0.24)	-3.03 (-0.09)
Annualized monthly average[g]	22.90	17.94	78.02	71.05	27.63	22.49	-27.79 (3.01)	-30.83 (-1.09)

Source: UNCTAD secretariat estimates, based on data of IMF *(International Financial Statistics, various issues)*, Centro de Economia Internacional and Centro de Estudios de Estado y Sociedad (Argentina), and Instituto de Economia do Sector Publico (Brazil).

a Exchange rate adjustments on the basis of end-of-month exchange rates.
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 Implicit monthly returns on 28-day Certificados de Tesoreria (CETES)
f Excess return as compared with United States Treasury bills.
g Figures in parentheses denote averages for the period January-November 1994.

Table 11

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

	Yield spread[a] (basis points)			
	1993		*1994*	
Country	*First half*	*Second half*	*First half*	*Second half*
Argentina				
Public	423	271	333	247
Private	549	365	404	416
Brazil				
Public[b]	536	429	.	.
Private	605	442	366	404
Mexico				
Public[b]	248	214	.	.
Private	562	335	349	384

Source: 1993: information supplied by Merril Lynch; 1994: UNCTAD secretariat estimates.

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.

b No bonds issued in this category in 1994.

The outbreak of the Mexican crisis followed the decision of the government on 20 December to lower the floor exchange rate for the peso against the dollar by about 15 per cent. This decision was a response to large capital outflows as international investors lost confidence in the country's ability to defend existing levels of the exchange rate in the face of the growing deficit on current account ($29 billion or approximately 8 per cent of GDP in 1994), the approaching exhaustion of foreign reserves (which fell more than 30 per cent in the 12 months ending in October 1994), and the high proportion of short-term or other potentially volatile investments in external holdings of Mexican paper.[26] The huge depreciation of the peso subsequent to the decision to allow it to float led to a large international package of financial support (described in section D), and was associated with a precipitous decline in external financing for Mexico and an adverse impact on several other Latin American countries (described below) as well as unfavourable spillover effects on some other developing countries and economies in transition (as described in section A). During this period there was apprehension as to the solvency of Mexican banks and non-financial enterprises, many of which had incurred large debts denominated in foreign currencies, and concern as to possible defaults on foreign debts.[27] So far the latter have been largely avoided.[28] But while Mexico's trade balance has substantially improved, its foreign exchange position remains precarious; and although there is continuing direct investment in the country, flows of other categories of external financing remain depressed.[29]

The immediate impact of the December crisis included not only a drastic decline in investors' willingness to hold Mexican paper but also a more widespread unfavourable shift in sentiment regarding other Latin American countries.[30] Both economies with relatively strong external payments and reserve positions and others generally considered more vulnerable to the effects of short-term capital outflows were adversely affected. Brazil, for example, suffered a net outflow of more than $800 million in the first half of January and one of $6 billion in the first two and a half months of the year, whilst in Argentina there was widespread selling of stocks by foreign investors and a flight from the domestic currency which, through the resulting contraction in the money supply, put the banking system under strain.[31] Stock prices (as measured by the principal local market indices) fell

in both December and January in Argentina, Brazil, Chile, Mexico and Peru. The rise in stock prices in Colombia (as well as the relatively small decline in Chile) during this period was attributed partly to the low participation of foreigners in these markets.[32] The crisis also led to sharp falls in the prices on secondary markets of the bonds of most Latin American countries (and accompanying increases in yields). These conditions proved a deterrent to new issues of external bonds by Latin American entities in the first three months of 1995. At the beginning of the second quarter bond prices stabilized and since the beginning of May, as market conditions improved, Latin American issuers (up to the time of writing mostly Brazilian banks) have begun to return to the international bond markets.

Previous *TDRs* have documented the rather slow progress of Latin American countries towards the full restoration of normal relations with the international financial markets which were disrupted by the debt crisis of the 1980s. This progress continued in 1994. For example, as shown in table 11, in the first half of 1994 yield spreads on the external bond issues of Argentina, Brazil and Mexico remained at their relatively low levels of late 1993 (although they rose slightly in the second half of the year). But, as in 1993, Chile is still the only Latin American country to have achieved an "investment grade" rating for its long-term sovereign debt in foreign currencies from both of the major credit-rating agencies, Moody's and Standard and Poor's, while Colombia has received such a rating from the latter. In November Moody's upgraded Brazil's long-term sovereign foreign currency debt but to a rating still below "investment grade", and in December Standard and Poor's issued a rating on such debt which it had previously left unrated. The principal effects of the Mexican crisis on the country's ratings were on various instruments denominated in domestic currency which were downgraded by Duff and Phelps as well as Moody's and Standard and Poor's.[33] These credit ratings for Latin American borrowers, together with the continued sluggishness of lending to them by banks and in the form of export credits (discussed in section A), indicate the distance still separating most of the region from a complete recovery of creditworthiness.

C. Recent experience in South and South-East Asia and some comparisons with Latin America

The larger economies of South and South-East Asia were less affected than those of Latin America by the more difficult conditions in international bond markets during 1994 (mentioned in section A). But like most major borrowers from Latin America they were not spared the spillover effects in international financial markets of the Mexican crisis and of other unfavourable developments at the end of the year, despite being generally viewed as less vulnerable to shifts in sentiment among global investors owing to both the structure of their external obligations and their long-term economic performance.

Funds raised by South and South-East Asian countries through international bond issues and syndicated credits rose slightly in 1994, to $42 billion, from about $41 billion in in the previous year (which contrasts with corresponding figures for Latin American countries revealing a drop from $22 billion to $17 billion).[34] Indonesia (with $11 billion), China (with $8 billion), and Thailand (with $7 billion) were the largest recipients of flows in these two forms. The creditworthiness of major economies in this region was also evident in the amounts raised by means of international equity issues, which increased from about $3 billion in 1993 to about $10 billion in 1994 (while such issues by Latin American countries seem to have been constant over the period).[35] More than 50 per cent of the international equity issues by South and South-East Asian countries during 1994 were accounted for by China and India, and rest mainly by Pakistan, Republic of Korea, Thailand, and Indonesia.

Trends in the credit ratings of major South and South-East Asian countries have continued to be favourable. For example, Pakistan's long-term sovereign debt received credit ratings for the first time in November 1994 from Standard & Poor's and Moody's (in both cases below "investment grade"). The long-term peso-denominated debt of the Philippines received an "investment grade" rating from Standard & Poor's. Moreover in December 1994 India's long-term foreign currency debt was upgraded to "investment grade" by Moody's. Malaysia and Thailand, both of whose long-term foreign currency debt was already rated "investment grade", received upgradings in 1994.

As the globalization of financial markets proceeds, increasing attention has been paid to both differences and resemblances between the economic performances, external payments positions, and legal and institutional regimes of the principal countries affected by this process in South and South-East Asia and in Latin America. Important dimensions of the first of these subjects, economic performance, is taken up in Part Two of this *Report* (see chapter II). The following remarks supplement the discussion to be found there.

In one particularly important respect, namely their small size in relation to the sums at the disposal of institutional investors in OECD economies, financial markets in Latin American and South and South-East Asian countries are similar. Prices in them are thus highly sensitive to even fairly minor changes in the country or regional weightings adopted for their portfolios by such investors or to volatile changes in sentiment. Thus, for example, at the end of the first quarter of 1995 the average total market capitalization of the emerging markets in Latin America was $48 billion,[36] and for selected South and South-East Asian emerging markets it was about twice that size ($100 billion).[37] Some idea of the order of magnitude of the funds at the disposal of OECD institutional investors can be obtained from a 1992 estimate of $5,600 billion for the assets of pension funds and life and casualty insurance companies of major financial centres.[38]

As in Latin America, the longer-term thrust of policy in South and South-East Asian countries is in the direction of liberalization of their financial markets.[39] This thrust was evident in a number of measures taken in 1994.[40] For example, a law passed in May 1994 allowed easier access for foreign banks to the financial sector of the Philippines. In June Indonesia liberalized regulations regarding joint ventures between indigenous and foreign firms. Moreover, during 1994 several steps were taken by the authorities in Taiwan province of China towards liberalizing its financial markets. For example, the ban on foreign investment in local banks was partially lifted, certain criteria for granting market access to branches of foreign banks were eased, foreign securities firms began to be allowed to establish subsidiaries or branches providing the same services as domestic ones, and restrictions were relaxed on purchases of securities by foreign institutional investors.

Like the main Latin American recipients of external financial inflows, however, a number of South and South-East Asian countries have come up against problems of management of exchange rates and other macroeconomic variables arising from large inflows. In some cases the short-term policy response has also taken the form of measures designed to restrict or control such inflows. For instance, India's central bank imposed guidelines limiting the access of Indian companies to the Eurobond market by stipulating that a group of affiliated companies would not be allowed to make more than two issues during a financial year, and that there must be a minimum gap of 12 months between two issues by a single firm. In addition, 85 per cent of the receipts from these issues should be used within one year for imports of goods or services.[41] As part of its policy towards capital inflows Indonesia imposed limits on external borrowing by commercial banks and public enterprises.[42] China and Thailand, both of which were subject to short-term inflows by arbitrageurs seeking to profit from interest-rate differentials, are apparently contemplating measures to counter such speculation.[43]

Important differences are observable between major recipients of external financing in South and South-East Asia and in Latin America regarding the patterns of their inflows. Reviewing such inflows for selected countries in the two regions between the early 1980s and the early 1990s,[44] *TDR 1993* pointed to continued borrowing from banks by the countries in South and South-East Asia, a development made possible by their avoidance of the debt crisis of the 1980s. Three of the countries in the sample (Indonesia, Malaysia and Thailand) also relied heavily on net inflows of FDI, while the Republic of Korea had greater relative recourse to external bond issues. For the Latin American countries, as their access to external financing improved

Table 12

FEATURES OF THE BALANCE OF PAYMENTS AND EXTERNAL FINANCING OF SELECTED COUNTRIES IN ASIA AND LATIN AMERICA, 1991-1993

(Billions of dollars)

ASIA

	China			Indonesia			Republic of Korea			Malaysia			Taiwan province of China			Thailand		
	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
Current account balance	13.3	6.4	-11.6	-4.3	-2.8	-2.0	-8.7	-4.5	0.4	-4.2	-1.6	-2.1	12.0	8.2	6.7	-7.6	-6.4	-6.9
Per cent of GDP	*3.8*	*1.7*	*-3.0*	*-3.9*	*-2.2*	*-1.5*	*-3.0*	*-1.5*	*0.1*	*-9.4*	*-2.9*	*-3.4*	*6.8*	*4.1*	*3.3*	*-8.2*	*-5.9*	*-5.6*
Direct investment	3.5	7.2	23.1	1.5	1.8	2.0	-0.2	-0.5	-0.5	4.0	4.5	4.4	-0.6	-1.0	-1.5	1.8	2.0	1.5
Portfolio investment[a]	0.2	-0.1	3.0	-	-0.1	-0.2	3.1	5.7	10.7	0.2	-1.1	-1 0	-	0.4	1.1	-0.1	0.9	5.5
Bank claims as a percentage of total external debt[b]	59.2	58.7	54.8	43.3	46.4	39.9	71.4	71.1	67.3	42.5	48.4	57.6	87.6	90.9	89.9	60.0	64.2	66.0

LATIN AMERICA

	Argentina			Brazil			Chile			Colombia			Mexico			Peru			Venezuela		
	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993	1991	1992	1993
Current account balance	-0.6	-6.5	-7.5	-1.4	6.3	-0.6	-	-0.7	-2.1	2.3	0.9	-2.2	-14.9	-24.8	-23.4	-1.3	-1.7	-1.8	1.7	-3.8	-2.2
Per cent of GDP	*-0.3*	*-2.9*	*-3.0*	*-0.4*	*1.6*	*-0.1*	-	*-1.8*	*-5.0*	*5.8*	*1.9*	*-4.3*	*-5.3*	*-7.8*	*-7.0*	*-4.6*	*-5.8*	*-4.6*	*3.2*	*-6.5*	*-3.8*
Direct investment	2.4	4.2	6.3	-	1.3	-0.3	0.4	0.3	0.4	0.4	0.7	-	4.7	4.4	4.9	-	0.1	0.3	1.8	0.4	-0.1
Portfolio investment[a]	-	-0.7	-9.0	3 8	7.4	12.9	0.2	0.5	0.7	0.1	0.1	-	12.1	19.2	27.9	-	-	-	0.2	0.1	0.7
Bank claims as a percentage of total external debt[b]	49.2	51.2	40.5	61.3	63 4	64.8	47.6	59.1	56.3	39.2	43.6	45.3	60.8	61.8	58.8	25.6	19.9	18.5	68.1	69.9	58.6

Source: IMF, *International Financial Statistics*, February 1995; ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean. 1994* (United Nations publication, Sales No. E.94.II.G.96); OECD, *External Debt Statistics*, various issues, and BIS/OECD, *Statistics on External Indebtedness*, various issues.

a Net financial flows in the form of bonds and equities.

b At end of year.

at the beginning of the 1990s, both direct and portfolio investment (in the form of net inflows through bonds and equities) increased, but in most cases the latter more than the former.

As is shown by table 12, during 1991-1993 the countries of South and South-East Asia with current account deficits in 1991 underwent improvements in their external payments positions during the following two years, whilst for those with surpluses the movement was in the opposite direction. For the Latin American countries shown in the table the pattern is more uniform, current account deficits mostly increasing in this period. The figures in the table also point to the continuing tendency among the majority of the countries of South and South-East Asia for FDI, generally the more stable form of net inflow, to account for a larger share of total external financing than portfolio investment. The main exception is the Republic of Korea where negative net inflows of FDI were partly a consequence of its own substantial FDI abroad. The contrast with many of the Latin American countries is striking. For Brazil, Mexico and Venezuela net inflows of portfolio investment have recently been substantially larger than those of FDI, whilst in Chile the two categories have been of a similar magnitude. However, for Colombia FDI was substantially greater than net portfolio investment. Argentina actually experienced net portfolio disinvestment in 1992 and 1993, the figure in the latter year amounting to $9 billion. Net inflows of portfolio investment for Peru during this period reflected a sharp rise in external equity investment in the country in 1993 but to a level still below $0.5 billion.

The greater dependence of most of the Latin American countries in table 12 on portfolio investment, as opposed to FDI, is partly linked to differences in economic performance and in their economic relations both with each other and with OECD economies. Foreign direct investment in South and South-East Asian countries, for example, was stimulated by both the dynamism of their mutual trade and the response of Japanese firms to the appreciation of the yen.[45] However, relatively lower dependence on portfolio inflows in most cases also seems to have reflected more restrictive policies toward such investment from abroad.

D. Reduction of bank debt and the package of financial support for Mexico

As already noted in section A, a large international support operation was mounted in response to Mexico's financial crisis of late 1994. Since mid-1994 there have also been a number of operations involving the restructuring and reduction of the external bank debt of the developing countries and economies in transition.

In May 1994 Gabon signed a rescheduling agreement covering $166 million of its debt to commercial banks and $21 million of its interest arrears.[46] The debt is to be repaid over 10 years, including a two-and-a-half years' grace period, at an interest rate of LIBOR plus 7/8. Some of the obligations included in this agreement were originally covered in an earlier agreement of May 1992 which was not implemented.[47] Poland closed its agreement on debt reduction amounting to $14.3 billion in October 1994. In May 1995, Albania reached agreement with its creditor banks on restructuring debts of $500 million. The banks are to choose between immediate repayment of 20 cents on the dollar or preferential access to 30-year bonds which will be issued in exchange for debt.[48] Ecuador is expected to close an agreement on debt reduction of $7.4 billion in the spring of 1995.[49] The agreement on debt reduction of the Dominican Republic was closed in August 1994.[50] Other debt reduction operations were completed in the third quarter of 1994 for Sao Tome and Principe and Zambia under the IDA Debt Reduction Facility.[51] Sao Tome and Principe extinguished 87 per cent of its commercial bank debt by buying back $10.1 million of eligible commercial bank claims at 10 per cent of face value, while Zambia extinguished $181 million of eligible principal at 11 per cent of

face value. The latter operation was cofinanced by Germany, the Netherlands, Sweden, and Switzerland.

Some headway has also been made in talks between the Russian Federation and its creditor bank committee. In July 1993, an agreement in principle had been reached on reduction of debt, but was not implemented because of the refusal of the Federation to accept the banks' demand to waive certain sovereign rights regarding state-owned assets. Finally, in October 1994 an agreement resolving this issue was signed. Progress can now be expected towards the restructuring of about $25 billion in commercial debt claims over 15 years, with a grace period of 5 years during which neither interest nor principal payments will be due.

At present Panama and Peru are negotiating debt reduction agreements that are expected to involve the settlement of large interest arrears. Under the IDA Debt Reduction Facility an operation for Sierra Leone was at an advanced stage at the time of writing, and operations are in preparation for Ethiopia, Guinea, Mauritania, Senegal, and the United Republic of Tanzania.

The package in support of Mexico was assembled at the initiative of the United States in January 1995. In the version announced on 31 January the package consisted of: (1) $20 billion from the Exchange Stabilization Fund of the United States, of which $3 billion was to be made available immediately, $7 billion at the end of June, and the remaining $10 billion subsequently, should it be needed; (2) an IMF standby credit of $7.8 billion; (3) a sum of up to $10 billion expected to be lent through the Bank for International Settlements by its member central banks, the difference between this target figure and that actually achieved to be met by a further loan from IMF; and (4) $3 billion which was expected to be provided by a group of private commercial banks, led by Citicorp and JP Morgan, in the form of a one-year standby facility (a sum which would be drawn on only after Mexico had exhausted the funds supplied by the United States, IMF, and BIS). However, in mid-March the $3 billion contribution by commercial banks had been abandoned, with the result that there was no longer direct private sector involvement in the rescue. Separate from this package, additional credit was to be made available in the form of a $1 billion loan by a group of Latin American countries (Argentina, Brazil, Chile, and Colombia) and a $3 billion financing from the World Bank and the Inter-American Development Bank pledged towards an emergency fund set up to rescue troubled Mexican banks.

E. Official debt

The official debt of low-income debtor countries and some middle-income countries has continued to cause concern. Paris Club creditors took a welcome initiative in December 1994 in adopting the new Naples terms in favour of the poorest and most indebted debtor countries. With the increasing burden of multilateral debt for low-income countries, measures to alleviate the burden deserve priority attention by the international community.

1. *Rescheduling of official bilateral debt*

Recent developments at the Paris Club

During the second half of 1994, no Paris Club rescheduling took place, as creditors were preparing details of the new terms to be applied to the poorest and most indebted countries, the so-called Naples terms (see box 3). During the first six months of 1995, nine low-income countries and two middle-income countries (Croatia and the Russian Federation) rescheduled their debt at the Paris Club. The latter two countries were accorded maturities of 15 years. The Russian Federation returned to the Paris Club after the expiry of the one-year consolidation period of its earlier agreement.[52] In contrast to its two earlier agreements, it had a stand-by arrangement with IMF before negotiating with the Club. In line with these earlier agreements, the new agreement contained standard terms as well as exceptional clauses. The standard terms applied to the current maturities falling due in 1995: 100 per cent of the principal

and interest were rescheduled over a period of 15 years, including nearly 3 years of grace (the same maturity as in 1994). The exceptional clauses provided for a rescheduling of post-cutoff date debt and previously rescheduled debt. All payments falling due in 1995 on post-cutoff date debt contracted in 1991 were rescheduled over a period of 10 years, including almost 3 years of grace (the same maturity as in 1994). Part of the moratorium interest on previously rescheduled debt falling due in 1995 was also considered: 40 per cent of accrued moratorium interest resulting from the 1993 agreement and a third of accrued moratorium interest resulting from the 1994 agreement were rescheduled over a period exceeding seven years, including almost three years of grace. Finally, principal payments on some of the claims already rescheduled in 1993 (namely arrears on short-term debt and on post-cutoff date debt contracted in 1991) were also rescheduled, with a maturity of 6-9 years, including a grace period of nearly 2 years.

By mid-June 1995, nine low-income countries (Bolivia, Cambodia, Guinea, Guinea-Bissau, Haiti, Nicaragua, Senegal, Togo and Uganda) had rescheduled their debt under Naples terms. Only Uganda received a reduction (to the tune of 67 per cent) of the stock of its eligible debt. For all the others, only arrears and current maturities falling due during the consolidation period were rescheduled. Except for Guinea, which had only 50 per cent of its consolidated debt reduced, they benefited from the 67 per cent reduction option.

Implementation of the Naples terms

By adopting the Naples terms, Paris Club creditors have taken a significant step forward, coming closer towards the so-called Trinidad terms.[53] The Naples terms include the option of reducing the stock of debt; exercise of this option would put an end to the process of repeated rescheduling.[54] They also provide for the level of debt reduction to be raised to 67 per cent. The coverage of debt is also more generous: on a case-by-case basis the amount of debt eligible for rescheduling can include debt previously rescheduled under concessional terms, whether at Toronto or at enhanced Toronto terms. In the case of maturity rescheduling (flow treatment, as opposed to stock treatment), the repayment period for ODA loans is extended to 24 years, under the option of a 67 per cent reduction of non-concessional loans (see box 3).

However, it remains to be seen whether the Naples terms will in practice be implemented in such a way as to provide a new start for the debtor. The key issues are the eligibility criteria for determining the level of debt reduction and the size of debt to be reduced.

In principle, the objective of debt reduction should be to bring debt service into line with the debtor's capacity to pay (thus releasing resources for financing recovery and development). Various indicators are used for measuring debt servicing capacity in the light of growth or export prospects. One approach is to calculate, as a percentage of exports, the level of debt service that the debtor country is able to bear without jeopardizing its growth prospects (taking into account its capacity to attract additional resources, including new aid flows). Another is to estimate the ratio of the present value of debt to exports. The present value of loans can be used to measure the grant element of aid and to gauge its opportunity cost. It can also be useful as a means of comparing different countries' debt burdens when the proportion of their debt in the form of soft loans varies widely. However, it is not well suited to estimate the debt service stream that a particular country can afford, since the prevailing market rate of interest (which is used as the discount rate) has no bearing on the amount of service that the debtor has to pay. A debt service ratio of 20 per cent gives a ratio of present value of debt to exports of 285 per cent at a discount rate of 7 per cent, 250 per cent at a discount rate of 8 per cent and of 222 per cent at a discount rate of 9 per cent.[55] In turn, any value of the ratio of present value of debt to exports can correspond to various alternative debt service streams and debt service ratios, depending on the discount rate used. No particular present-value-to-exports ratio can thus serve as an unambiguous indicator of the minimum debt servicing capacity of the debtor.

The Paris Club has chosen per capita GDP, on the one hand, or the ratio of present value of debt to exports, on the other, as the criterion for determining whether the higher level of debt reduction (67 per cent) may be applied. However, it relies on the balance of payments projections (undertaken in most cases in the framework of IMF credit arrangements) to determine the financing gap and, consequently, the amount of debt service reduction (which determines the extent to which previously rescheduled debt is included).

The Paris Club benchmarks of per capita GDP of less than $500 or a ratio of present value of

debt to exports of more than 350 per cent make 4 of the 29 low-income and severely indebted countries[56] ineligible for the 67 per cent reduction option. It can be argued that, on the basis of other debt indicators, such as protracted payments arrears and high levels of debt service ratios, these countries should be granted the higher level of debt reduction.

The question also arises whether Naples terms should not also be extended to heavily indebted "IDA-only" low-income countries[57] but which have not received concessional Paris Club treatment. Some African countries of the franc zone, such as Congo, have become low-income countries, according to the World Bank's classification, after the devaluation of the CFA franc in 1994. Nigeria and Kenya, although low-income countries (with per capita GDP of less than $500), have received non-concessional treatment. Sao Tome and Principe has not yet rescheduled its debt with the Paris Club.

As already noted, the Paris Club decides on the amount of debt to be considered for rescheduling on the basis of the balance of payments projections. It should be borne in mind that unexpected events might in practice widen the financing gaps and thus create a need for more debt reduction. Some margin of manoeuvre should, therefore, be allowed so that the projections on financing gaps can be reviewed. Moreover, depending on the size of the gaps, it might be necessary to include all eligible debt, as well as to consider rescheduling post-cutoff date debt[58] and deferring payments of moratorium interest. Finally, the *de minimis*[59] level could be set more flexibly, especially in the case of stock treatment, so as to allow a larger proportion of debt to be reduced.

In short, the Naples terms will significantly alleviate the debt burden of low-income countries if Paris Club creditors apply the country eligibility criteria flexibly so as to let all low-income countries with debt servicing difficulties benefit from the 67 per cent debt reduction option. It is also important to allow a generous coverage of debt to be considered for debt reduction: in the case of stock treatment, the size of the debt to be reduced is a critical factor in determining whether the debtor country succeeds in exiting from the rescheduling process.

For Uganda (as already noted, the only country to have received stock treatment), the coverage of debt included in the agreement appears to have been rather restrictive. Only debt previously rescheduled in the framework of two earlier Paris Club agreements was considered for reduction, and the post-cutoff date debt was not rescheduled. The amount of debt covered by this exit rescheduling was equivalent to $139 million, or 46 per cent of its total Paris Club debt (40 per cent of which is post-cutoff date debt). Debt reduction amounted to $50 million, less than 2 per cent of total outstanding debt. Since nearly 70 per cent of its total debt is multilateral, any debt servicing difficulty that Uganda might encounter could be difficult to handle. For the other debtor countries which have received flow treatment (i.e. rescheduling of arrears and current maturities), the exclusion of some debt previously rescheduled under concessional terms has also limited the scope of debt reduction.

Bolivia and Nicaragua, which qualified for stock treatment under the Paris Club criteria, did not receive such stock reduction because of a lack of consensus in the Club on account of legal, budgetary, and policy constraints faced by some creditors.

The adoption of the Naples terms has been heralded as a major step forward in the treatment of low-income debtor countries. The implementation so far of these terms, however, has revealed some hesitancy by creditors to apply the new terms in such a way as to provide the greatest relief to the debtors concerned. The eligibility criteria have unduly restricted the number of countries benefiting from the most favourable treatment. Furthermore, there is a risk that budgetary, legal or policy restrictions by some creditors may prevent the much-needed stock treatment from becoming a reality. Likewise, the narrowing of the scope of debt eligible for reduction has weakened considerably the impact of these progressive measures. The results will therefore fall short of what was originally expected.

Impact of the Naples terms

On the basis of a benchmark debt service ratio of 20 per cent,[60] a simulation of the impact on projected debt service ratios, for a sample of 33 low-income and heavily indebted countries,[61] of a reduction of 67 per cent of the stock of debt shows that this option can have a widely differing impact for four distinct groups of countries (see the annex to this chapter).

- For Bolivia, Cameroon, Congo, Côte d'Ivoire, Honduras, Madagascar, Mozambique, Niger, United Republic of Tanzania, Zaire and Zambia,

Box 3

PARIS CLUB: NAPLES TERMS FOR LOW-INCOME COUNTRIES

Following the G-7 Summit Meeting in Naples, Paris Club creditors agreed in December 1994 on new terms for the poorest and most indebted countries (the so-called new Naples terms). These terms represent an improvement over the earlier enhanced Toronto terms, in that they include an option to reduce debt or debt service by 67 per cent. They thus allow for a reduction, on a case-by-case basis, of either 50 per cent or 67 per cent of the amount (or the equivalent present value) of the debt service - interest and principal payments - falling due during the consolidation period. In addition, in exceptional cases, "stock treatment" can be applied, whereby the stock of non-concessional debt would be reduced by 50 per cent or 67 per cent. This is referred to as an "exit" option, as the beneficiary will no longer need to go to the Paris Club for rescheduling.

Eligibility criteria

In principle, the countries eligible for Naples terms are those that have received Toronto and enhanced Toronto terms.[1] To qualify for a 67 per cent reduction, the countries must have either a per capita GDP of less than $500 or a ratio of present value of debt to exports exceeding 350 per cent.

Countries receiving stock treatment will most likely be those that have a satisfactory track record with IMF and the Paris Club, and that are viewed by the creditors as having the capacity to implement the debt agreement and to exit once and for all from the debt rescheduling process.

Terms

The 50 per cent reduction option

Creditor countries can choose from among the options already included in the enhanced Toronto terms:[2]

- *Debt reduction:* reduction of 50 per cent of debt service obligations, with the remaining half to be rescheduled at market interest rates over a period of 23 years, including a grace period of 6 years;
- *Debt service reduction:* reduction of 50 per cent of the present value of debt service obligations through rescheduling at reduced concessional rates, over a repayment period of 23 years, with no grace period.
- *Commercial option:* for budgetary or legal reasons, creditors would choose simply to reschedule debt service obligations over a period of 25 years, including 14 years of grace, at market rates. This option does not provide for any reduction.

The 67 per cent reduction option

Creditor countries can choose from among the following options:

- *Debt reduction:* reduction of 67 per cent of debt service obligations, with the remaining third rescheduled at market interest rates over a period of 23 years, including a grace period of 6 years;
- *Debt service reduction:* reduction of 67 per cent of the present value of debt service obligations through rescheduling at reduced concessional interest rates, with a repayment period of 33 years, and no grace period;
- *Commercial option:* for budgetary or legal reasons, creditors would choose to reschedule debt service obligations over a period of 40 years, including 20 years of grace, at market interest rates. This option does not provide for any reduction.

Box 3 (concluded)

Stock treatment

If there is sufficient agreement among creditors to reduce the stock of debt, reduction will be achieved through:

- Debt reduction of 50 per cent or 67 per cent, the rest being rescheduled over a period of 23 years, including 6 years of grace, at market interest rates; or
- Reduction of the present value of debt by 50 per cent or 67 per cent. Debt will be repaid at reduced concessional interest rates, over 23 years (including 3 years of grace) under the 50 per cent option, and over 33 years (including 3 years of grace) under the 67 per cent option.

ODA loans

ODA loans will be rescheduled over 40 years (including 16 years of grace) under the 67 per cent reduction option and over 30 years (including 12 years of grace) under the 50 per cent reduction option, at interest rates at least as favourable as original rates.

Scope of debt covered

The debt to be rescheduled is, as before, the medium- and long-term public and publicly guaranteed debt contracted before the cutoff date.[3]

The scope of debt covered will be determined on a case-by-case basis, depending, in principle, on the financing gap requirements of debtor countries. Normally, non-rescheduled pre-cutoff date debt is considered first, with debt previously rescheduled on non-concessional terms (PRD) included if needed.

If the size of the financing gap so requires, debt previously rescheduled under Toronto terms and under enhanced Toronto terms could also be included. The reduction on these categories of PRD would be increased so as to reach the same level of reduction as under the current rescheduling agreement. For example, under the 67 per cent reduction option, PRD under Toronto terms and under enhanced Toronto terms would be further reduced, by 50 per cent and 34 per cent, respectively.

Moratorium interests could also be included. In the case of stock treatment, the payment of moratorium interest could be capitalized for the first three years.

1 These countries are: Benin, Bolivia, Burkina Faso, Cameroon, Central African Republic, Chad, Côte d'Ivoire, Equatorial Guinea, Ethiopia, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Senegal, Sierra Leone, Togo, Uganda, United Republic of Tanzania, Viet Nam, Zaire, Zambia.

2 For the of menu of options, see *TDR 1992*, box 1.

3 The cutoff date is the date before which loans must have been contracted in order to be considered by the rescheduling agreement. This date is usually determined at the first rescheduling and remains unchanged in subsequent reschedulings.

the Naples terms have an important impact, but debt service ratios will remain high.[62] For some of these countries, arrears are so high that the projected debt service ratio for the first three years remains very high. For all of them except Mozambique, the bulk of future debt service represents payments to multilateral financial institutions; for six, post-cutoff date Paris Club debt service is also significant; for more than half, scheduled service

payments on debt owed to other creditors are also high;

- For Ethiopia, Guinea, Guinea-Bissau, Kenya, Nigeria, Senegal, Sierra Leone and Togo the Naples terms not only have an important impact but also reduce debt service ratios to manageable levels - though not until arrears are cleared. These arrears are so large that debt service ratios generally remain very high for the first three years, except for Senegal and Nigeria;

- For Benin, Burkina Faso, Chad, Haiti and Mali the impact of the Naples terms is small, but the debt service ratio is low to begin with;

- For Angola, Central African Republic, Equatorial Guinea, Guyana, Mauritania, Nicaragua, Sao Tome and Principe, Uganda and Viet Nam, the impact of the Naples terms is small, while the debt service ratio remains high. For these countries, future debt service consists mostly of payments to multilateral financial institutions and other non-Paris Club creditors.

In short, the simulation shows that reduction by 67 per cent of the stock of pre-cutoff date Paris Club debt would significantly reduce the debt service ratio for more than half of the countries. For six, the ratio would fall to a manageable level (after all arrears are cleared). However, for most of the countries, it would remain high, and thus so would also the risk of future debt crisis; in some countries, accumulated arrears are extremely high and there is need for vigorous action to deal with the problem. For six countries which continue to have a high debt service ratio after Naples terms, the post-cutoff Paris Club debt service may pose a problem. However, for all those which continue to have a high debt service ratio, multilateral debt and debt owed to other creditors will account for an important share of the future debt service burden. In consequence, after full implementation of the Naples terms, serious consideration will need to be given to the burden of multilateral debt and debt owed to other creditors.

2. *Multilateral debt*

The scale of the problem

The problem of multilateral debt looms large for highly indebted low-income countries.[63] Their multilateral debt more than tripled from 1982 to 1993, reaching a level of $55.5 billion, i.e. over 24 per cent of their total debt outstanding. For 20 countries, multilateral debt accounts for over 40 per cent of the total, and in 7 for over 60 per cent. The share of multilateral debt service exceeded 46 per cent of total debt service for the 41 countries as a whole; for 28 the share was more than one half (and in five countries debt service related exclusively to multilateral debt). The higher share of multilateral debt service, compared to the share of multilateral debt outstanding, is indicative of the preferred creditor status of multilateral institutions which has protected their claims from rescheduling or reduction. Failure to meet debt service obligations, especially on debt owed to the Bretton Woods institutions, entails severe consequences, including suspension of debt rescheduling agreements and cessation of new financial flows. Multilateral debt has often been serviced by accumulating arrears on other types of debt.

The increasing importance of multilateral debt also reflects debt reductions by bilateral creditors and a shift to grant financing by many official bilateral donors. It also reflects the fact that many countries are going through a protracted adjustment process, financed by new loans from multilateral institutions that are often partially used to meet debt service obligations on past loans.

Over the past decade, the multilateral debt of this group of 41 countries has become increasingly concessional. Concessional debt has increased from about one half of total multilateral debt in the early 1980s to over two thirds. There has been a clear shift from non-concessional to concessional financing in new loans provided by both the World Bank and IMF.

The World Bank Group accounted for over half the multilateral debt outstanding at the end of 1993. While IBRD lending declined, the decline was more than offset by higher IDA loans. By contrast, there has been a dramatic drop in the share of IMF lending, from over 29 per cent in 1980-1983 to less than 12 per cent in 1993. As shown in table 13, net transfers from IMF were negative in 1984-1993; however, IMF reported positive net transfers of over $365 million in 1994[64]. The other multilateral institutions, in particular the regional development banks, have also been an important source of financing; they now account for a third of the multilateral debt of the low-income countries.

Table 13

NET TRANSFERS FROM MULTILATERAL FINANCIAL INSTITUTIONS TO HIGHLY INDEBTED LOW-INCOME COUNTRIES

(Millions of dollars)

Year	Total	World Bank Group		IMF	Other multilateral
		Total	IBRD		
1980	2 188	605	135	789	794
1981	2 740	628	54	1 332	780
1982	2 130	944	245	502	685
1983	2 549	927	268	842	781
1984	1 475	1 019	265	-64	521
1985	889	812	-16	-437	514
1986	1 282	1 294	-4	-828	816
1987	1 340	1 515	-108	-836	661
1988	1 307	960	-738	-427	775
1989	1 435	1 267	-394	-623	792
1990	1 745	1 314	-658	-458	890
1991	1 266	444	-1 498	-165	987
1992	1 886	869	-1 092	-232	1 249
1993	1 220	789	-1 219	-369	800

Source: UNCTAD secretariat calculations, based on data of the World Bank Debtor Reporting System.

Levels of trends in debt and debt service alone do not gauge the extent of the multilateral debt problem; they need to be viewed in the context of a country's capacity to pay. Arrears are the first sign of payments difficulties. Of the 41 heavily indebted low-income countries, only 3 were current on their multilateral obligations in 1994. On average, arrears represented more than 60 per cent of scheduled service on multilateral debt (table 14). Most countries have accumulated arrears in respect of loans from multilateral institutions other than those of Bretton Woods. However, Haiti, Liberia, Somalia, Sudan, Zaire and Zambia were reported as having obligations to the Fund which were overdue by six months or more.[65] They accounted for almost all of the SDR 2.9 billion of total arrears to the Fund as of 30 April 1994.[66] All but Haiti were ineligible for access to the general resources of the Fund. Haiti, Liberia, Somalia, Sudan and Zaire were in arrears with the World Bank to the tune of $308 million; however, they accounted for less than one fifth of total arrears to that institution.

Given that multilateral debt accounts, on average, for nearly half the total debt service of the 41 countries under consideration, and if 20 per cent is regarded as the critical threshold for the debt service ratio, a debt service ratio for multilateral debt of over 10 per cent can be considered as dangerous. As shown in table 14, 16 countries had an average multilateral debt service ratio in 1990-1993 of over 10 per cent, namely Bolivia, Burundi, Côte d'Ivoire, Ghana, Guinea-Bissau, Guyana, Honduras, Kenya, Madagascar, Mauritania, Nicaragua, Niger, Sao Tome and Principe, Uganda, United Republic of Tanzania and Zambia. Furthermore, as seen in the preceding subsection, countries which have projected debt service ratios above the critical 20 per cent level after full implementation of the Paris Club Naples terms also have high multilateral debt service. In view of the stagnant trend in export earnings and the bleak prospects for an expansion of concessional flows in real terms, there appears to be a pressing need to find a lasting solution to the debt problem of these countries.

Current multilateral debt relief schemes

Improving the concessionality of the debt

In the face of the protracted nature of the debt problem facing the poor countries, the multilateral institutions, particularly the World Bank and IMF,

Table 14

MULTILATERAL DEBT RATIOS FOR HIGHLY INDEBTED LOW-INCOME COUNTRIES

(Percentage)

Country	1990-1993			1993				
	Debt to GNP	*Debt to exports*	*Debt service to exports*	*Debt to GNP*	*Debt to exports*	*Actual debt service to exports*	*Sched. debt service to exports*	*Arrears to sched. debt service*
All highly indebted low-income countries	***25.9***	***111.6***	***8.4***	***26.0***	***123.9***	***8.3***	***21.3***	***61.2***
Angola	0.9	2.6	0.1	1.0	4.1	0.0	0.7	99.5
Benin	32.3	139.7	5.6	34.3	155.4	5.3	5.8	8.2
Bolivia	41 7	237.3	25.6	41.7	322.4	31.4	31.5	0.0
Burkina Faso	25.1	199.2	7.8	29.8	241.8	7.9	18.4	56.9
Burundi	73.2	729.9	21.7	90.5	873.7	24.1	26.8	10.0
Cameroon	14.5	66.5	9.0	15.3	93.0	16.1	21.9	26.4
Central African Republic	42.3	286.4	6.5	46.9	354.6	4.2	16.7	74.6
Chad	38.1	205.8	3.4	48.6	331.0	5.0	10.0	50.6
Congo	23.9	43.3	1.6	26.3	45.8	0.1	14.7	99.4
Côte d'Ivoire	37.8	91.6	15.1	39.0	92.8	13.9	15.6	10.7
Equatorial Guinea	65.7	184.1	6.4	73.6	187.3	2.1	9.6	78.6
Ethiopia	25.7	295.5	9.2	45.8	371.0	8.4	9.9	15.5
Ghana	44.8	261.4	16.5	52.3	258.8	13.5	14.2	5.1
Guinea	33.5	116.3	5.2	38.8	134.6	3.6	4.3	15.6
Guinea-Bissau	131.2	1992.0	25.6	141.8	2102.1	17.5	166.7	89.5
Guyana	302.4	226.7	31.8	260.2	223.4	14.4	19.7	27.0
Honduras	62.7	167.5	22.2	67.3	181.5	19.6	21.6	9.3
Kenya	42.6	135.6	14.1	58.4	129.8	13.0	13.9	6.5
Lao People's Dem. Rep.	34.1	204.7	3.2	36.3	163.6	2.4	2.4	0.0
Liberia	63.1	130.9	1.9	55.3	117.1	3.4	110.3	96.9
Madagascar	51.7	298.3	14.7	48.4	329.5	11.7	14.8	21.4
Mali	42.9	245.1	7.1	44.8	264.5	5.4	10.8	50.0
Mauritania	75.2	168.5	18.0	90.5	186.2	21.1	24.3	13.3
Mozambique	60.4	196.7	4.8	77.3	211.9	5.7	6.6	14.8
Myanmar	4.0	195.2	4.4	3.5	153.4	3.7	3.7	0.0
Nicaragua	81.1	300.2	32.3	86.5	318.3	17.8	66.2	73.2
Niger	34.6	240.3	10.1	36.9	278.1	20.1	30.8	34.9
Nigeria	13.0	30.1	4.5	13.4	34.7	5.2	5.5	5.4
Rwanda	36.8	506.1	7.5	48.4	680.2	5.8	25.6	77.4
Sao Tome and Principe	287.4	1155.6	12.4	406.2	1206.7	13.3	24.2	44.8
Senegal	31.9	126.5	8.9	34.5	145.0	6.9	12.5	44.9
Sierra Leone	45.9	146.7	7.3	54.5	183.7	7.5	77.4	90.3
Somalia	110.7	869.4	2.6	113.0	781.6	0.3	362.2	99.9
Sudan	33.0	654.1	5.5	23.9	643.2	4.5	434.3	99.0
Togo	45.8	141.5	6.6	55.8	228.5	7.3	9.4	23.1
Uganda	58.6	850.8	36.5	52.2	698.7	24.6	37.5	34.3
United Republic of Tanzania	88.6	390.3	17.5	103.6	344.7	11.8	24.8	52.6
Viet Nam	2.4	9.7	2.2	1.6	5.5	4.9	4.9	0.1
Yemen	12.6	75.9	4.8	10.5	88.2	4.7	5.7	16.7
Zaire	39.4	150.5	6.7	40.4	205.9	1.1	38.4	97.0
Zambia	82.7	199.2	23.7	86.6	236.7	25.8	134.1	80.8

Source: UNCTAD secretariat calculations, based on data of the World Bank Debtor.Reporting System, and IMF balance of payments tapes.

have sought to provide financial support on terms more closely adapted to a debtor's situation by refinancing loans contracted on hard terms with concessional funds. The World Bank's strategy has been to cease non-concessional lending to seriously indebted low-income countries: they now receive only IDA assistance. Of the 41 heavily indebted countries considered in the previous subsection, only Angola and Guyana are not "IDA only". The IDA debt stock of this group rose from $4 billion in 1982 to almost $23 billion in 1993; annual net IDA transfers[67] amounted to around $2 billion in the early 1990s. This strategy has helped countries to cope with the heavy contractual obligations from IBRD loans, while at the same time maintaining positive net transfers (see table 13). For the tenth IDA replenishment, covering the period FY 1994-1996, available resources are expected to reach $18 billion. However, many IDA recipients are reaching commitment ceilings but still require more funds for growth-oriented programmes. The number of eligible claimants has also increased because some traditionally middle-income countries have been relegated to low-income status.

IMF policies have also become more responsive to the needs of poor borrowers. The Structural Adjustment Facility (SAF) was established in March 1986 to provide highly concessional finance to low-income countries. The following year, the Enhanced Structural Adjustment Facility (ESAF) was created,[68] significantly increasing the amount of new resources available to the poorest member countries.[69] An enlarged ESAF which retained the modalities of the preceding facility became operational in February 1994.[70]

For the group of 41 countries under consideration, there has been a major increase in the share of concessional debt to total IMF credit from 12 per cent in 1986 to more than 56 per cent in 1994. At the end of 1994, their total IMF concessional debt outstanding amounted to just over $4 billion. As previously mentioned, there have been negative net transfers from IMF every year from 1984 to 1993.

The regional development banks also have soft windows for low-income countries. However, their resources are limited. The situation for the African Development Bank (AfDB) is particularly acute. Many of the countries in the region are now classified as low-income, with a growing imbalance between the degree of concessionality and income levels, and an inadequacy of soft window resources has resulted in continued lending on non-concessional terms. The Inter-American Development Bank has augmented the scarce resources of its soft loan arm - the Fund for Special Operations - by using internally generated resources; as a result, it has maintained positive net transfers, though only barely.

Dealing with arrears

The procedure followed by multilateral financial institutions (MFIs) to handle overdue debt obligations usually begins with intensified collection efforts, followed by suspension of approval on new loan operations, and finally suspension of disbursements. However, the period of delay in payments to warrant the application of non-accrual status, and the start of loss provisioning for hard loan windows, vary with each institution. Deterrent measures are also adopted by IMF to protect its resources from further use by countries in arrears. If, in spite of mutual efforts to reduce the problem of arrears, a country fails to fulfil its obligations, its voting rights can be suspended, as was the case of Sudan in 1993. Nevertheless, there is a general reluctance to undertake such harsh measures, and MFIs, notably the World Bank and IMF, have adopted special schemes to find mutual solutions to the problem of protracted arrears.

Until 1988, arrears with IMF were cleared using the country's international reserves, supplemented by bridging loans from bilateral creditors. Subsequently, the Fund agreed to an arrangement whereby the country followed a shadow adjustment programme for a year, while a donor support group was being formed. This approach, which puts an excessive burden on bilateral aid, proved inadequate for countries with massive arrears. The Fund consequently introduced in 1990 the Rights Accumulation Programme (RAP), which provides a framework for countries with protracted arrears to establish a satisfactory track record on policy and payments performance.[71] In accordance with a phased schedule, a country can accumulate rights to future drawings of Fund resources up to the amount of the arrears outstanding at the beginning of the programme. Disbursements are made only after the clearance of arrears and are conditional upon satisfactory conclusion of the programme and an endorsement by the Fund of a follow-up arrangement. The RAP is available to countries which had protracted arrears to the Fund at the end of 1989. Of the 11 countries eligible, 5 have cleared

their arrears without recourse to RAPs; Peru and Sierra Leone have completed RAPs and received financing immediately after settling their arrears; and Zambia, following suspension of its RAP because of slippage in some performance criteria, resumed the programme in 1994. The programme remains open to Liberia, Somalia, and Sudan, but those countries have not been able to take advantage of it for a number of reasons, including political and security considerations.[72]

The RAP approach, with its front-loaded policy reform, however, imposes liquidity constraints on an implementing country, since it does not receive new Fund disbursements during the programme period, whereas it is required to pay interest on arrears and current maturities, which implies negative net transfers. Thus, the country typically needs to find financing from elsewhere, both for its development needs and to meet debt service obligations to the Fund.

In 1991, a similar scheme was introduced by the World Bank, namely the programme of "Additional Support for Workout Programs in Countries with Protracted Arrears". The scheme allows eligible countries to accumulate rights to disbursements which are released upon clearance of arrears. The scheme requires strong bilateral support, as the country must continue to service its debt obligations while it is trying to establish a track record in adjustment measures. It has a number of features making it more attractive than RAPs. Additional interest charges apply only to arrears of principal, not of interest, and loan commitments can be made during the performance period. Announcement of loan approvals can help mobilize resources from other donors and the private sector, and where these involve cofinancing it can be done from disbursement by other creditors without prior clearance by the Bank. This scheme had been applied to Guatemala, Nicaragua, Panama, Peru and Sierra Leone.[73]

In a move to encourage prompt payments, the Bank introduced in the early 1990s a one-year waiver of 25 basis points in interest, when payment is made within one month of the due date.

Other debt relief measures

In 1988, the World Bank established within IDA the Fifth Dimension facility, which provides supplementary IDA resources to assist countries in meeting interest payments on outstanding IBRD debt. To be eligible, the countries must be current in their debt service obligations to the Bank and have in place an IDA-supported adjustment operation. This facility is funded by earmarking a portion of IDA reflows, supplemented by bilateral grants; such grants have been made by Finland, Norway and Sweden. In FY 1994, allocations from the facility totalled $265 million to 16 countries, covering 96 per cent of interest payments due on IBRD debt. Cumulative allocations since 1989 amount to $800 million.

Options for further debt relief

Existing multilateral debt relief measures are insufficient, since the problem of arrears has not been eliminated and for a number of countries the multilateral debt service burden is growing at a dangerous pace. In order to avoid the emergence of a widespread crisis which would be detrimental not only to the debtor countries concerned but also to the financial position of the MFIs, additional measures need to be taken. Options for further debt relief include both measures to improve current schemes and further steps.

Improving current schemes

- *Improving the rights accumulation programmes.* At a minimum, interest payments on arrears and current debt service obligations could be suspended during the programme of rights accumulation, so as to avoid negative net transfers; these obligations could then be rescheduled on softer terms. The RAP could also be made available to all countries with protracted arrears, and not just to those with protracted arrears in 1989.

- *Extending existing schemes to other MFIs.* The regional development banks have not devised special schemes for clearing arrears. Their usual practice is to contract bridging loans, which would further raise debt obligations. The African Development Bank has been most affected by this problem, with arrears in 1993 amounting to some $1 billion. It should also consider adopting a Fifth Dimension type of scheme to help poor African countries meet interest payments obligations from its hard window.

More comprehensive debt rescheduling or debt reduction

The various initiatives taken so far by the MFIs to alleviate the debt burden are of limited

scope, since they deal with arrears and refinancing of non-concessional loans mainly by providing new concessional loans. The proposed improvements would not solve the debt problem of some countries, where an economic recovery enabling them to meet obligations from a large multilateral debt stock cannot be envisaged in the foreseeable future. A bolder strategy needs to be pursued. However, it would need to reconcile the objectives of bringing a more decisive solution and preserving the financial health of MFIs.

The effectiveness of current debt relief schemes has largely been constrained by insufficient funding. The various options presented to improve these schemes and to enlarge them, so as to include debt reduction in critical cases, would require additional resources. For this purpose, a number of proposals have been made recently, with the aim of limiting the diversion of development assistance to the alleviation of debt servicing and lessening the pressure on bilateral donors, many of whom are reducing their aid programmes. Thus, proposals have been made to raise additional resources through sales of a portion of IMF gold or a new SDR allocation (a part of which could be used for alleviation of multilateral debt); the new resources could be used for refinancing or, if necessary, reducing the multilateral debt of poor countries:

- *Sale of IMF gold.* IMF holds 103.4 million fine ounces of gold, which were derived from members' subscriptions and are valued in its accounts at around SDR 35 per ounce. At a current market price of $384 per ounce (June 1995), the value of these gold holdings amounts to almost $40 billion. The sale of 10-15 per cent of the gold reserves, which earn no income, could already enable arrears to be cleared or provide meaningful relief to those with serious multilateral debt problems. There is a precedent for such sales in the gold sales to finance the Trust Fund in the late 1970s. Opponents of the proposal argue that the Fund's nature as a monetary institution requires it to maintain a solid financial base to back its operations. But its central role in international finance is widely recognized, and it has the firm political and financial support of major developed countries, as was clearly demonstrated recently in connection with the Mexican rescue package. Ultimately, these factors count more than the level of the Fund's reserves. Another objection is the possible effect on the world price of gold. But, as in the case of the Trust Fund, the sales could be phased over a number of years and gold released gradually to avoid major disruptions in the gold market. Another proposal, put forward by the United Kingdom in 1994, also concerns the sale of (around 10 per cent of) IMF gold reserves. The money from the sales would be reinvested in income-bearing assets and the income used for debt relief;

- *Special allocation of SDRs to provide multilateral debt relief.* The potential inflationary effect of increased global liquidity from a special SDR allocation for this purpose would be minimal, as the amount involved is relatively small. However, the operation would require amendment of the Fund's Articles of Agreement. Alternatively, part of a general allocation of SDRs - which was requested by the Managing Director of the Fund in 1994 - could be voluntarily set aside for multilateral debt relief;

- *Drawing on the reserves and loan loss provisions of MFIs.* Most MFIs have set aside substantial provisions and/or reserves to cover potential losses arising from non-payment of debt service due to them. Consideration could be given to redeploying a small proportion of such provisions and reserves to write down the outstanding stock of non-concessional loans to poor countries, refinance it on IDA equivalent terms, or finance an up-front clearance of arrears.[74]

Conclusions

For the heavily indebted low-income countries the debt crisis is not over. After the initiatives taken by bilateral official creditors the debt problem has now shifted to that of outstanding debt owed to multilateral financial institutions. With few exceptions, a decade of adjustment policies supported by financing from MFIs has not sufficed to halt or reverse the economic stagnation of these countries and increase their capacity to service external debt. The problem of multilateral debt of these countries is serious enough to warrant receiving priority attention on the international agenda. The fundamental question is that of development. There is little doubt that these countries will have to rely for quite some time on highly concessional finance. How to use these funds to increase their export earnings and enhance their development prospects is the real challenge for both recipient countries and the international community.

Notes

1 This convergence of major features of external bonds and medium-term Euronotes has been associated with some double-counting of issues of the two instruments in some reporting systems (as described, for example, in Bank for International Settlements, *International Banking and Financial Market Developments*, August 1994, p. 11).

2 The OECD estimate for international equity issues by developing countries in 1994 (used for table 5) is $15.6 billion. In the May 1995 issue of the World Bank's *Financial Flows and Developing Countries* there is an alternative estimate of $19.6 billion which, however, apparently includes some domestically issued tranches.

3 Data provided by Baring Securities.

4 See, for example, Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending First Half 1994*, January 1995. The figures for banks' claims on Asia were boosted by interbank lending to offshore entities in Thailand.

5 Export credits consist of the trade-related claims of banks and suppliers carrying insurance or guarantees from export credit agencies (ECAs), together with direct government lending classified as official export credits.

6 BIS, *International Banking and Financial Market Developments*, table 13A. The excluded countries and territories with offshore financial centres are those specified in footnote c of table 7. Data in the OECD publication, *Financial Market Trends*, indicate a somewhat lower figure for Latin America's share of external bond issues by developing countries.

7 The claims of BIS-reporting banks include not only loans but also in most cases various categories of international securities among the assets in the institutions' portfolios.

8 The claims of BIS-reporting banks on certain developing countries declined in 1994, contractions being especially large for Brazil, Turkey and Venezuela.

9 BIS, *op. cit.*. Here too Euronotes of the developing countries with offshore financial centres mentioned in footnote 6 are excluded from the total.

10 Eurocommercial paper is a low-cost, short-term financing instrument (with the advantage to some borrowers of not always requiring rating by major credit-rating agencies).

11 "Investment grade" refers to the rating level for debt issues (Baa for Moody's and BBB for Standard and Poor's) below which there is frequently a bar on investment in them by institutional investors.

12 See *NRI Quarterly Economic Review*, Vol. 25, No. 2, May 1995, p. 29.

13 According to BIS (*op. cit.*, May 1995), table 13A, completed international bond issues by South and South-East Asian countries declined almost 30 per cent from the fourth quarter of 1994 to the first quarter of 1995 (a decrease which can be compared to one for developing countries as a whole of more than 40 per cent). The World Bank (*op. cit.*, May 1995, pp. 5-6) gives a lower figure for the fall in the bond issues of South and South-East Asian countries but a higher one for that of all developing countries. It also draws attention (p. 13) to the sharp decline in international equity issues (from about $5 billion to $0.4 billion) by countries in the region. These figures reflect the impact on investors' sentiment not only of the Mexican crisis but also of other unfavourable developments (such as the collapse of Barings).

14 CEPAL, *Preliminary Overview of the Economy of Latin America and the Caribbean Economy 1994* (United Nations publication, Sales No. E.94.II.G.96), tables A.15 and A.16.

15 The preliminary estimate of Mexico's net inflow (*ibid.*) was $19.5 billion. In an Economic Research note of 30 December 1994 JP Morgan estimated the net inflow at $10 billion.

16 Figures for BIS-reporting banks' claims and for net issues of external bonds for Mexico and other Latin American countries specified below are taken from BIS, *International and Financial Markets Developments* (Basle, May 1995), tables 5A and 13A. As noted above, the claims of many BIS-reporting banks include bonds as well as loans.

17 CEPAL, *op. cit.*, p. 30.

18 The figures for total net financial inflows for the Latin American countries specified are all from CEPAL, *op. cit.*. (A more recent estimate of $44 billion for the total net financial inflow to Latin America in 1994, quoted in *Latin American Weekly Report* of 8 June 1995, suggests that the effects of the Mexican crisis on net inflows to other Latin American countries during the remainder of December 1994 were minor.)

19 CEPAL, *op. cit.*, p. 31.

20 *Ibid.*.

21 The figure for the reduction of banks' claims on

Venezuela's public-sector entities in the first half of 1994 is taken from BIS, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending First Half 1994* (Basle, January 1995). The figures in this publication are based on a BIS reporting system different from that of the publication, *International Banking and Financial Market Developments*.

22 This estimate of ING bank is quoted in P. McCurry, "Mexican wave set to hit Brazil's borrowers", *Financial Times*, 20 January 1995.

23 See, for example, *TDR, 1994*, Part One, chap. III, sect. C, and Part Two, annex to chap. II, sect. C.6. For a full discussion of the options for countries which experience policy problems owing to capital inflows see P. Turner, "Capital flows in Latin America: a new phase", *BIS Economic Papers* No. 44 (Basle: Bank for International Settlements, May 1995), pp. 25-31.

24 CEPAL, *op. cit.*, p. 13.

25 ECLAC, *Economic Panorama of Latin America 1994* (LC/G.1837, 16 September 1994), p. 34.

26 According to estimates quoted in *Latin America Weekly Report*, 8 December 1994, of Mexico's inflows of foreign investment during 1988-1993, 44 per cent was direct investment and 56 per cent portfolio equity investment. External holdings of money market instruments were also large. For example, holdings of *tesobonos* (treasury bills with maturities of one, three, six and 12 months denominated in dollars and payable in pesos at the market rate of exchange as of the redemption date), rose from $1.3 billion at the end of 1993 to $4 billion in April 1994 and to $18 billion (of a total outstanding of $28.6 billion) in early 1995. (*Latin American Economy and Business*, July 1994, p. 5, and March 1995, p. 11.)

27 For example, for a sample of 17 of Mexico's largest corporate debtors the proportion of debt denominated in foreign currency varied from 25 per cent to 100 per cent, and the proportion of foreign currency debt covered by foreign currency sales from zero to 173 per cent. Five corporations with proportions of debt denominated in foreign currency ranging from 40 per cent to 91 per cent had foreign-currency sales as a proportion of foreign currency debt ranging from zero to 10 per cent. Corporate debtors were adversely affected not only by the increased value in pesos of their debt-service obligations due to devaluation but also by the associated rise in local interest rates. (T. Bardacke, "Peso's fall packs a double whammy", *Financial Times*, 28 December 1994.)

28 At the time of writing only one company, Aerovias de Mexico, had sought a rescheduling of its obligations to external lenders since the outbreak of the crisis. (See A. Sharpe and L. Crawford, "Devalued peso forces Mexican airline to reschedule Eurobond", *Financial Times*, 9 June 1995.) In the early part of 1995 the Fondo Bancario de Proteccion al Ahorro provided $1.8 billion of assistance to banks in connection with their foreign obligations (money from the support package for Mexico described in section D being used for this purpose) (reported in *Latin American Economy and Business*, April 1995, p. 11).

29 Since the beginning of 1995 Mexican borrowers have raised money from the international financial markets through private placements and certificates of deposit, but the first announced external bond issue appears to have been in June (for the government-owned trade finance bank, Bancomext).

30 According to BIS (*International Banking and Financial Market Developments*, May 1995, tables 11A and 13A), Mexico experienced a reduction in amounts outstanding of its Eurocommercial paper from $3.5 billion to $1.2 billion and net repayments of international bonds of $1.1 billion in the first quarter of 1995. Marketing the Government's short-term debt was often difficult, the refinancing being obtained at high rates of interest.

31 *Latin American Economy and Business*, February 1995 (pp. 2 and 6), March 1995 (p. 6), and April 1995 (p. 2). Of the Latin American countries which have recently received substantial sums from the international financial markets only Colombia was apparently left largely unscathed by the Mexican crisis.

32 IFC, *Quarterly Review of Emerging Markets*, Fourth Quarter 1994, pp. 24 and 26.

33 Duff and Phelps is an agency which issues in-depth rating of a smaller number of bonds than Moody's and Standard and Poor's.

34 BIS, *International Banking and Financial Market Developments*, May 1995.

35 OECD, *Financial Market Trends*, No. 57, February 1994, and No. 60, February 1995 (figures in the latter issue of which may need to be revised upwards for reasons discussed in footnote 2 of section A).

36 This average is derived from the following figures for individual countries: Argentina: $32 billion; Brazil: $132 billion; Chile: $66 billion; Colombia: $17 billion; Mexico: $75 billion; Peru: $8 billion; and Venezuela: $4 billion. (IFC, *Quarterly Review of Emerging Markets*, First Quarter 1995).

37 The country figures were as follows: China: $44 billion; India: $106 billion; Indonesia: $44 billion; Republic of Korea: $178 billion; Malaysia: $206 billion; Pakistan: $10 billion; Philippines: $46 billion; Sri Lanka: $3 billion; Taiwan Province of China: $234 billion; and Thailand: $128 billion. (*Ibid.*)

38 M.S. Khan and C.M. Reinhart (eds.), "Capital flows in the APEC Region", *IMF Occasional Paper 122* (Washington, D.C.: International Monetary Fund, March 1995), p. 25. (In practice only a small proportion of this total - but still a very large amount of money in relation to the capitalization of the financial markets in question - could be invested in developing countries' equities.)

39 See, for example, *TDR 1994*, Part Two, annex to chap. II, sects. C.5 and C.6.

40 The examples which follow in this paragraph are taken from United States Department of the Treasury, *National Treatment Study 1994* (Washington, D.C.: 1994).

41 Asian Development Bank, *Asian Development Outlook 1995 and 1996* (Hong Kong: Oxford University Press (China), 1995), p. 56.

42 *Ibid.*, p. 55.

43 "China to curb cash inflows", *Financial Times*, 20 January 1994, and "The trouble with open markets", *Asian Issuers and Capital Markets. Supplement to Euromoney*, December 1994.

44 *TDR 1993*, Part One, chap. III, sect. A.

45 See *TDR 1994*, Part One, chap I, sect. A.2, and chap II, sect. B.2.

46 Major stages in the negotiation of an agreement reducing debt and debt-service obligations to commercial banks are: (1) the agreement in principle between the debtor and its bank advisory committee (set out in a "head of terms" document); (2) the agreement on a terms sheet between the same parties establishing the options for debt restructuring; (3) selection by creditor banks of their choices among these options, the participation of a minimum number of banks being necessary if the agreement is to proceed; (4) signature by the debtor, the creditor banks and other parties involved in the agreement (such as the United States Federal Reserve if it is providing instruments to be used as collateral); and (5) exchange of instruments or closing, at which point restructured loans are exchanged for bonds, required collateral is deposited and cash payments specified in the agreement are made.

47 See *TDR 1993*, Part One, chap. III, sect. B.

48 A. Sharpe and K. Hope, "Albania secures $500 million debt deal", *Financial Times*, 12 May 1995. It is expected that a contribution to Albania's buyback will be made under the IDA Debt Reduction Facility referred to below.

49 The agreements of Poland and Ecuador were described in *TDR 1994*, Part One, chap. III, sect. B. (Poland's final agreement also included the buyback or funding of debt in the form of revolving short-term arrangements.)

50 The principal features of the agreement were described in *TDR 1993*, Part One, chap. III, sect. B.

51 Under the IDA Debt Reduction Facility (established in 1989) 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. Other donors may provide cofinancing in the form of grants in support of individual debt-reduction operations under the facility.

52 See *TDR 1994*, Part One, chap. III, sect. E, for a description of the 1994 Paris Club agreement of the Russian Federation.

53 Under the Trinidad terms, proposed by the United Kingdom in 1990, Paris Club creditors would cancel two-thirds of the stock of debt owed by eligible countries in a single operation, with the remaining debt rescheduled over 25 years (including 5 years of grace) and interest payments capitalized for the first 5 years. The repayment schedule would be linked to the debtor country's export capacity.

54 Some low-income countries have had as many as 11 Paris Club reschedulings. Repeated rescheduling has created great uncertainty for the financing of those countries' adjustment programmes, and has also given rise to significant administrative costs.

55 The ratio of present value of debt to exports is equivalent to the debt service ratio divided by the discount rate, assuming a constant flow of annual debt service payments and a very long maturity.

56 Including countries which have rescheduled their debt under the Toronto or enhanced Toronto terms, and Cambodia and Haiti, which have already rescheduled their debt under the Naples terms.

57 "IDA-only" countries are low-income countries which have access only to IDA resources; for the list of such countries, see World Bank, *Annual Report 1994*, appendix 9.

58 For a third of countries eligible for the new terms, the cutoff date is more than 10 years old. It should be noted that in recent years the Paris Club has agreed to defer payments of arrears on post-cutoff date debt for a number of countries with particularly acute debt servicing problems.

59 The *de minimis* level of debt is a specified minimum amount of debt which is covered by the rescheduling agreement. Creditors whose claims are less than this specified amount do not participate in the rescheduling agreement.

60 A benchmark debt service ratio of 20 per cent has been used here for a number of reasons. Over the past 12 years (1983-1994) countries of the sample were actually able to make debt service payments equivalent on average to 22 per cent of their exports of goods and services (after debt reschedulings and accumulation of large arrears). However, per capita GDP growth rates were negligible (and sometimes negative). A debt service ratio of 20 per cent perhaps would allow these countries to release additional resources to finance some per capita GDP growth, especially if export growth remains weak and if external capital inflows stagnate. For some countries this threshold level is still high: their ratios of actual debt service payments to exports were well below 20 per cent, while payments arrears were also significant.

61 All countries of the sample are accumulating arrears.

62 It should be noted that for Cameroon, Guinea-Bissau, Honduras and Niger the impact of the Naples terms is less important if arrears are ignored.

63 The group of highly indebted low-income countries under consideration in this subsection includes 32 of the countries examined in the previous subsection that are potential beneficiaries of the Naples

terms and 9 other countries with significant amounts of multilateral debt or debt service (i.e. Burundi, Ghana, Lao People's Democratic Republic, Liberia, Myanmar, Rwanda, Somalia, Sudan and Yemen).

64 Information on 1994 transfers form other multilateral agencies was not available at the time of writing.

65 In December 1994 Haiti cleared all its arrears to multilateral institutions with the help of contributions from bilateral donors.

66 See *IMF Annual Report, 1994*.

67 IDA loans are interest-free, but carry a service charge of 0.75 per cent a year, with a maturity of 40 years and a grace period of 10 years.

68 The lending terms were identical to those of SAF (0.5 per cent annual interest, 10 years maturity, and 5½ years grace period).

69 Under SAF, the amount potentially available to each eligible member country is equal to 50 per cent of its quota. Under ESAF, an eligible member country may borrow a maximum of 190 per cent of its quota, although this limit may be increased, in exceptional circumstances, up to a maximum of 255 per cent.

70 IMF, *op.cit.*

71 See *TDR 1993*, box 18, for a description of the RAPs of Peru and Zambia.

72 IMF, *op.cit.*

73 For an assessment of the programme, see Percy Mistry, *Multilateral Debt: An Emerging Crisis?* (FONDAD, The Hague, 1994).

74 See Percy Mistry, *op.cit.*, p.42.

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Annex to chapter II

IMPACT OF THE NAPLES TERMS

For a sample of 33 low-income and heavily indebted countries, a simulation showing the impact on their projected debt service ratios of a reduction by 67 per cent of debt stock was undertaken by the UNCTAD secretariat. This sample has been chosen for illustrative purposes. It includes low-income countries which have rescheduled their bilateral official debt with the Paris Club, with or without concessional terms, as well as Sao Tome and Principe, which has never rescheduled its debt with the Paris Club but has an extremely high debt burden. Some low-income debtor countries were not considered because of lack of reliable data on Paris Club debt projections.

The simulation is applied to the option of reduction by 67 per cent of the stock of non-concessional pre-cutoff date debt (with the remainder rescheduled at market interest rates over 23 years, including 6 years of grace), pre-cutoff date ODA debt being rescheduled over 40 years (including 16 years of grace). The following assumptions are made:

- For each country, export revenues expand at the trend rate of 1984-1994;
- The eligible Paris Club stock of debt includes all non-rescheduled and previously rescheduled debt as well as arrears on the pre-cutoff date debt. Since information was not available for debt previously rescheduled at concessional terms, the 67 per cent reduction had to be applied to the total stock of eligible debt. As the debt which has already benefited from debt reduction measures under Toronto and enhanced Toronto terms can at best be reduced by only 50 per cent or 34 per cent, respectively, the assumption of an across-the board 67 per cent reduction will overestimate the impact of the new terms;
- Other arrears (including arrears on post-cut-off date Paris Club debt) are treated in two alternative ways. The first ignores arrears in projecting debt service, while the second simply assumes that payments of these arrears are deferred and made over a period of three years (without late interest).

Statistics on debt stock (at the end of 1994) and debt service projections are derived from the World Bank Debt Reporting System. Future debt service, as projected by the World Bank, tends to be underestimated, as new loan commitments, short-term debt and IMF credit cannot be taken into account. In addition, beyond the year 2000 it is found that projections on debt service become less reliable. For this reason, simulation is undertaken only for the first six years after the implementation of the stock treatment.

The results of the simulation are reported in tables A and B. Table A shows the projected debt service ratios for each debtor country before and after the 67 per cent stock reduction is applied. Table B shows the percentage distribution of debt service related to different components of the debt.

Table A

PROJECTED DEBT SERVICE RATIOS (WITH AND WITHOUT ARREARS), BEFORE AND AFTER NAPLES TERMS

(Percentage)

Country		1995		1996		1997		1998	1999	2000
		I*	I**	I*	I**	I*	I**			
Angola	Before	33	74	20	58	12	49	10	9	7
	After	28	55	19	45	12	36	9	8	7
Benin	Before	9	11	8	10	10	12	10	10	10
	After	6	8	6	8	6	8	6	6	6
Bolivia	Before	46	48	42	44	35	37	31	28	23
	After	25	26	25	26	23	25	20	19	18
Burkina Faso	Before	7	9	6	8	6	7	6	5	5
	After	6	8	5	7	5	7	5	4	4
Cameroon	Before	30	43	30	43	28	41	24	23	19
	After	26	36	24	34	23	33	20	17	16
Central African Rep.	Before	17	36	16	34	16	34	16	15	15
	After	17	29	16	28	16	29	16	15	15
Chad	Before	10	14	10	14	11	15	12	11	10
	After	8	11	8	11	9	12	10	9	8
Congo	Before	36	87	35	87	31	83	27	21	17
	After	24	54	25	55	24	55	24	18	15
Côte d'Ivoire	Before	36	67	32	62	29	59	27	23	22
	After	28	53	24	49	22	46	20	19	18
Equatorial Guinea	Before	25	57	8	38	9	36	9	7	6
	After	23	50	7	31	7	29	7	6	5
Ethiopia	Before	22	39	22	38	20	36	18	15	13
	After	19	35	17	33	16	31	14	12	11
Guinea	Before	25	42	23	39	20	36	16	16	15
	After	19	32	18	31	16	29	13	12	11
Guinea-Bissau	Before	37	80	30	68	18	52	17	16	14
	After	33	63	27	53	14	37	12	12	10
Guyana	Before	32	40	30	37	27	33	24	25	31
	After	28	35	26	33	23	29	21	20	25
Haiti	Before	4	10	4	10	3	10	3	3	3
	After	4	9	3	9	3	8	3	3	3
Honduras	Before	32	37	32	36	27	32	25	23	20
	After	29	33	26	30	22	26	20	17	14
Kenya	Before	21	28	19	26	15	22	13	12	10
	After	18	24	16	21	13	18	11	10	8
Madagascar	Before	41	110	35	101	25	88	19	19	17
	After	28	77	25	72	21	65	16	15	13
Mali	Before	20	22	19	21	14	16	11	10	8
	After	20	22	17	19	12	13	9	8	7

Table A (concluded)

Country		1995 I*	1995 I**	1996 I*	1996 I**	1997 I*	1997 I**	1998	1999	2000
Mauritania	Before	25	48	24	45	22	44	21	18	16
	After	21	44	21	43	20	41	18	16	14
Mozambique	Before	113	246	72	198	65	185	66	75	70
	After	89	222	61	187	48	168	47	53	48
Nicaragua	Before	129	244	111	225	120	232	106	90	77
	After	122	230	106	212	117	221	102	87	75
Niger	Before	40	64	38	62	29	53	31	32	35
	After	33	46	33	46	27	40	30	30	31
Nigeria	Before	34	52	34	52	26	44	22	20	9
	After	18	22	17	21	14	18	13	12	11
Sao Tome & Principe	Before	63	207	55	199	53	198	49	47	47
	After	63	199	54	189	53	189	47	43	43
Senegal	Before	16	23	14	21	13	19	11	10	9
	After	13	17	12	16	11	15	10	8	8
Sierra Leone	Before	26	70	23	66	17	60	14	14	15
	After	14	43	14	43	12	41	10	10	10
Togo	Before	18	25	17	23	15	21	15	16	15
	After	12	15	11	14	10	13	10	10	9
Uganda	Before	30	48	31	50	34	52	36	32	35
	After	28	44	29	45	31	47	33	28	32
United Republic of Tanzania	Before	62	118	55	108	45	95	37	29	28
	After	36	83	32	76	30	72	29	21	20
Viet Nam	Before	60	123	51	109	46	98	40	35	30
	After	57	108	54	97	45	88	40	34	30
Zaire	Before	71	175	39	144	37	41	38	35	32
	After	27	64	27	64	27	64	27	25	24
Zambia	Before	32	89	28	84	21	75	18	20	22
	After	20	76	19	73	16	68	13	11	10

Source: UNCTAD secretariat estimates, based on data of the World Bank Debtor Reporting System.

* Excluding arrears.

** Including arrears, which are assumed to be repaid over a period of three years.

Table B

PROJECTED NEW DEBT SERVICE (EXCLUDING ARREARS) BY CATEGORY OF DEBT AFTER IMPLEMENTATION OF NAPLES TERMS

(Percentage distribution)

Country/category[a]	1995	1996	1997	1998	1999	2000
Angola						
Paris Club debt	30.4	17.4	21.4	18.6	23.5	21.2
of which: post-cutoff	25.4	10.5	11.1	6.2	10.4	6.5
Multilateral debt	0.6	1.0	1.3	1.6	1.7	1.8
Other	69.0	81.6	77.2	79.7	74.8	77.1
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Benin						
Paris Club debt	25.5	25.5	23.7	28.6	28.0	28.8
of which: post-cutoff	3.0	3.0	2.8	9.9	10.6	11.5
Multilateral debt	58.4	58.3	61.5	58.4	60.1	59.6
Other	16.1	16.1	14.8	13.0	11.9	11.6
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Bolivia						
Paris Club debt	15.9	15.3	16.8	19.2	24.8	29.3
of which: post-cutoff	5.2	4.8	5.9	6.9	12.0	15.6
Multilateral debt	67.1	68.9	69.7	77.0	71.6	67.0
Other	17.0	15.7	13.5	3.8	3.7	3.8
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Burkina Faso						
Paris Club debt	9.4	9.4	9.3	9.2	9.6	9.5
of which: post-cutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	66.4	66.9	68.9	69.5	76.1	77.8
Other	24.2	23.6	21.9	21.3	14.2	12.7
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Cameroon						
Paris Club debt	50.4	50.3	50.8	55.3	53.8	55.1
of which: post-cutoff	42.8	42.1	42.1	45.4	42.4	42.7
Multilateral debt	34.4	34.7	34.0	35.9	36.5	34.5
Other	15.1	15.0	15.1	8.8	9.7	10.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Central African Rep.						
Paris Club debt	13.3	12.8	11.7	10.6	13.2	16.6
of which: post-cutoff	9.3	8.9	8.0	6.9	9.1	12.7
Multilateral debt	54.3	58.8	54.2	52.3	52.1	50.4
Other	32.4	28.4	34.1	37.1	34.7	33.0
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Chad						
Paris Club debt	15.6	14.6	12.7	11.5	11.2	13.2
of which: post-cutoff	5.7	5.4	4.9	4.5	4.1	5.7
Multilateral debt	70.1	72.0	76.0	78.5	78.6	77.9
Other	14.3	13.4	11.3	9.9	10.3	9.0
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Congo						
Paris Club debt	28.6	25.6	27.4	29.3	38.5	45.4
of which: post-cutoff	12.9	10.7	12.2	13.4	17.4	20.3
Multilateral debt	25.8	17.6	16.8	16.4	18.7	19.6
Other	45.5	56.8	55.8	54.3	42.8	34.9
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Côte d'Ivoire						
Paris Club debt	19.0	21.2	23.2	27.0	28.9	29.8
of which: post-cutoff	10.8	11.8	12.8	16.1	17.6	17.9
Multilateral debt	45.6	44.6	44.6	39.5	36.7	33.7
Other	35.4	34.2	32.2	33.6	34.3	36.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0

Table B (continued)

Country/category[a]	1995	1996	1997	1998	1999	2000
Equatorial Guinea						
Paris Club debt	72.5	18.2	15.4	18.3	20.3	19.5
of which: post-cutoff	68.7	6.1	5.1	8.5	9.5	8.3
Multilateral debt	14.7	50.0	64.1	64.6	63.5	65.2
Other	12.8	31.8	20.5	17.1	16.2	15.3
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Ethopia						
Paris Club debt	5.5	5.7	6.2	6.5	7.4	8.8
of which: post-cutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	18.2	20.7	22.9	27.4	35.5	43.1
Other	76.3	73.6	70.9	66.0	57.2	48.1
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Guinea						
Paris Club debt	15.3	16.7	14.3	18.5	21.8	30.5
of which: post-cutoff	9.2	10.4	7.7	10.3	13.6	21.4
Multilateral debt	24.0	25.8	30.1	38.9	39.6	45.5
Other	60.7	57.5	55.6	42.5	38.6	24.0
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Guinea-Bissau						
Paris Club debt	8.6	9.3	16.0	15.9	15.2	14.9
of which: post-cutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	23.4	25.5	41.8	42.5	47.0	53.8
Other	68.0	65.2	42.3	41.6	37.9	31.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Guyana						
Paris Club debt	7.7	7.8	8.3	8.9	8.9	6.8
of which: post-cutoff	1.3	1.3	1.3	1.4	1.6	1.2
Multilateral debt	45.9	46.5	51.6	50.0	46.2	35.7
Other	46.4	45.7	40.1	41.1	44.9	57.5
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Haiti						
Paris Club debt	7.1	7.3	7.3	7.5	7.3	7.1
of which: post-cutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	91.0	90.8	91.3	91.0	91.2	91.4
Other	1.9	1.9	1.5	1.5	1.5	1.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Honduras						
Paris Club debt	10.5	11.5	12.9	14.2	13.5	16.2
of which: post-cutoff	3.5	3.9	4.3	4.7	3.0	4.0
Multilateral debt	70.2	73.3	70.5	70.4	72.0	69.3
Other	19.3	15.2	16.5	15.5	14.6	14.6
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Kenya						
Paris Club debt	6.3	6.7	7.8	8.7	9.1	10.9
of which: postcutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	45.8	49.3	55.7	57.2	55.7	51.4
Other	47.9	44.0	36.6	34.1	35.2	37.7
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Madagascar						
Paris Club debt	31.9	31.1	30.2	33.2	33.2	37.3
of which: post-cutoff	18.9	17.2	14.2	12.8	12.8	15.1
Multilateral debt	29.0	32.9	39.7	47.0	47.2	46.4
Other	39.2	36.0	30.0	19.8	19.6	16.3
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Mali						
Paris Club debt	7.2	7.6	9.8	13.0	13.8	17.9
of which: post-cutoff	0.5	0.5	0.7	1.0	1.8	5.3
Multilateral debt	24.3	27.4	36.4	54.3	54.4	53.7
Other	68.5	65.0	53.8	32.7	31.8	28.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0

Table B (continued)

Country/category[a]	1995	1996	1997	1998	1999	2000
Mauritania						
Paris Club debt	8.4	8.5	9.0	9.9	11.2	12.9
of which: post-cutoff	2.7	3.0	3.3	4.0	4.6	5.8
Multilateral debt	40.9	44.2	41.9	40.4	44.5	46.6
Other	50.6	47.2	49.1	49.8	44.4	40.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Mozambique						
Paris Club debt	11.7	16.5	18.9	18.4	15.7	17.0
of which: post-cutoff	3.8	5.4	5.5	5.4	4.7	5.4
Multilateral debt	10.8	15.2	22.8	24.9	21.8	22.9
Other	77.6	68.4	58.3	56.7	62.5	60.2
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Nicaragua						
Paris Club debt	2.4	2.7	2.5	2.8	3.6	4.2
of which: post-cutoff	0.7	0.8	0.7	0.8	1.3	1.6
Multilateral debt	19.7	20.1	15.7	17.7	19.3	22.5
Other	77.9	77.2	81.8	79.5	77.0	73.4
Total debt service	100.0	100.0	100.0	100 0	100 0	100.0
Niger						
Paris Club debt	14.4	15.3	21.0	21.8	21.8	27.2
of which: post-cutoff	9.1	10.0	14.5	15.9	16.0	21.6
Multilateral debt	30.4	31.6	36.4	30.9	27.7	25.1
Other	55.2	53.1	42.7	47.4	50.5	47.7
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Nigeria						
Paris Club debt	33.5	30.4	34.0	33.6	33.1	30.3
of which: post-cutoff	16.0	12.7	13.2	11.6	9.8	4.4
Multilateral debt	31.3	31.0	35.0	33.9	32.5	32.6
Other	35.2	38.5	31.0	32.5	34.3	37.1
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Sao Tome & Principe						
Paris Club debt	4.3	5.1	5.2	5.8	6.4	6.4
of which: post-cutoff	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral debt	42.5	52.9	53.7	67.5	74.1	74.1
Other	53.2	42.0	41.1	26.7	19.5	19.5
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Senegal						
Paris Club debt	20.1	19.2	21.3	24.2	27.8	34.2
of which: post-cutoff	11.2	9.8	11.7	13.9	16.0	21.9
Multilateral debt	64.0	63.3	61.4	59.5	58.5	52.1
Other	15.9	17.5	17.3	16.3	13.7	13.7
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Sierra Leone						
Paris Club debt	38.7	39.1	42.9	53.3	53.1	53.2
of which: post-cutoff	11.8	12.7	11.6	15.6	15.5	16.9
Multilateral debt	34.3	34.1	27.9	36.8	36.1	34.3
Other	26.9	26.8	29.2	9.8	10.8	12.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Togo						
Paris Club debt	23.7	27.3	32.4	29.7	32.1	34.8
of which: post-cutoff	8.4	10.3	13.7	12.3	14.4	15.5
Multilateral debt	50.2	56.4	62.6	62.1	59.8	56.2
Other	26.2	16.3	5.1	8.2	8.2	8.9
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Uganda						
Paris Club debt	8.7	6.6	5.3	5.8	6.6	6.5
of which: post-cutoff	6.1	4.1	3.0	3.5	4.0	4.1
Multilateral debt	59.8	62.4	64.7	62.3	61.2	50.8
Other	31.5	31.0	29.9	32.0	32.3	42.7
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0

Table B (concluded)

Country/category[a]	1995	1996	1997	1998	1999	2000
United Republic of Tanzania						
Paris Club debt	27.9	26.2	27.2	27.7	37.6	38.0
of which: post-cutoff	11.5	8.5	9.4	10.3	14.6	15.1
Multilateral debt	32.7	33.2	33.7	34.7	40.6	41.2
Other	39.5	40.6	39.1	37.6	21.8	20.8
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Viet Nam						
Paris Club debt	3.7	3.2	3.2	3.3	3.5	3.6
of which: post-cutoff	1.1	0.5	0.5	0.5	0.5	0.6
Multilateral debt	0.5	0.5	2.4	2.4	0.4	0.5
Other	95.8	96.3	94.4	94.3	96.1	95.9
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Zaire						
Paris Club debt	46.7	46.8	48.8	50.3	53.2	56.6
of which: post-cutoff	7.7	7.7	9.7	10.8	11.5	12.4
Multilateral debt	46.1	46.1	42.9	40.3	37.3	35.1
Other	7.2	7.0	8.3	9.4	9.5	8.4
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0
Zambia						
Paris Club debt	34.5	34.8	37.5	35.4	39.5	42.4
of which: post-cutoff	16.6	16.2	15.6	10.0	10.4	10.5
Multilateral debt	54.2	56.2	55.9	57.0	53.2	50.7
Other	11.3	9.0	6.6	7.6	7.2	6.9
Total debt service	100.0	100.0	100.0	100.0	100.0	100.0

Source: UNCTAD secretariat estimates, based on data of the World Bank Debtor Reporting System.

a Multilateral debt service includes that due to IMF.

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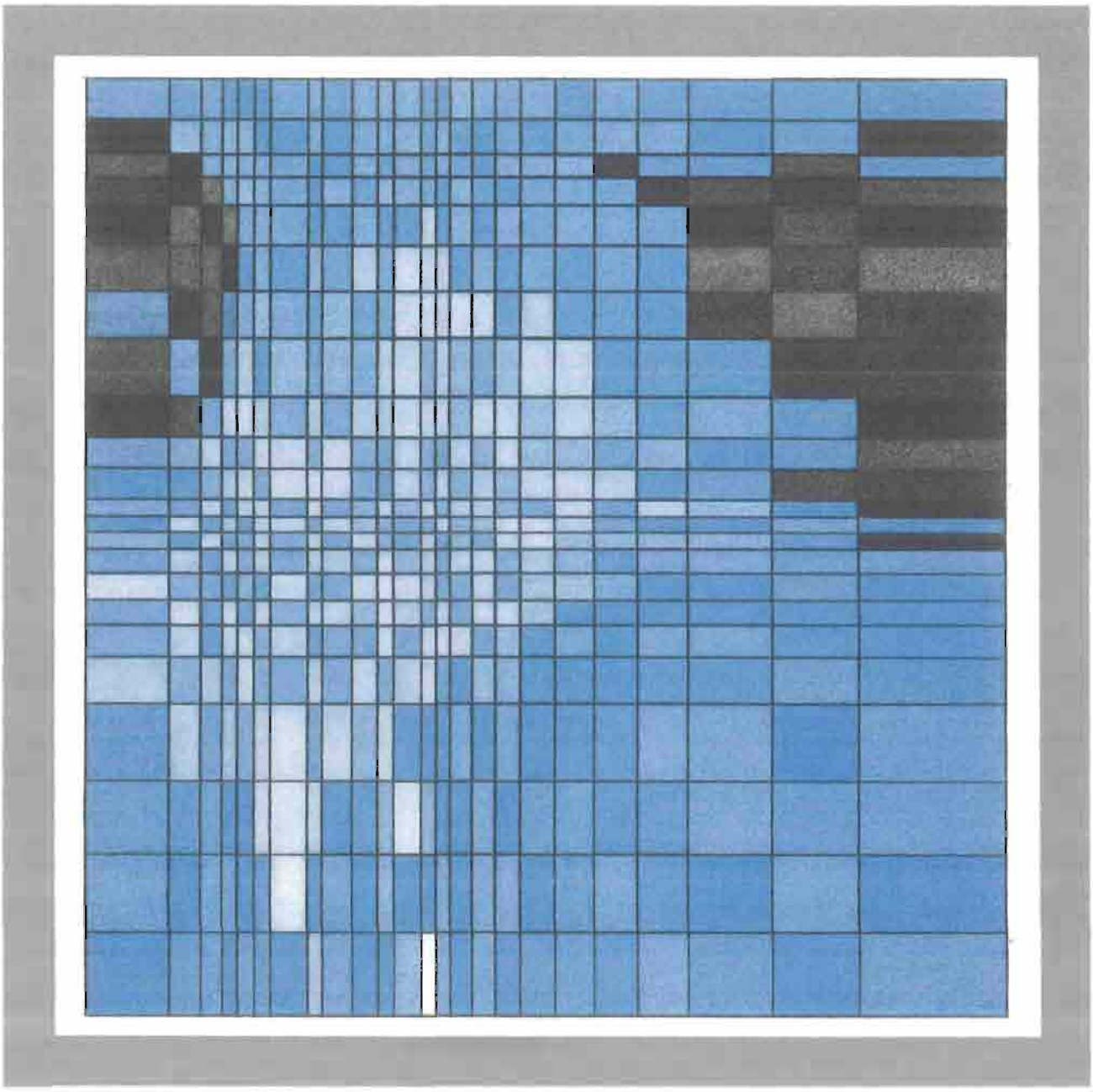
RETHINKING ECONOMIC POLICIES



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Chapter I

CONVERGENCE OF GROWTH, INFLATION AND UNEMPLOYMENT IN THE NORTH

An important characteristic of the economic cycles among the major industrial countries in the early 1990s was their lack of synchronization. Japan continued to expand relatively rapidly throughout 1990-1991, and the spillover of demand from German unification supported growth in continental Europe, but growth in the United Kingdom and the United States decelerated and both countries eventually entered recession. Subsequently, both Japan and Germany experienced a sharp slowdown, while the United States and the United Kingdom embarked on a vigorous recovery.

The recovery of the United States and the United Kingdom economies continued to gather force in 1994, rather than levelling off as had been expected at the beginning of the year. The expected recession in continental Western Europe proved to be extremely short; the downturn was reversed in early 1994, much earlier and much more rapidly than had been anticipated. The convergence of growth rates in the United States and Western Europe has also been matched by a convergence towards a stable inflation rate of around 3 per cent. Japan, on the other hand, has continued to experience sluggish growth as well as lower inflation.

Current prospects are for even greater uniformity in terms of growth and inflation. But the convergence is towards a rate of expansion that will be insufficient to produce sustained employment growth. It is also associated with renewed instability in exchange rates and financial markets, as well as with increased trade tensions.

This experience stands in sharp contrast with the view that greater convergence of macroeconomic policies and performance will generate greater stability. It also challenges the view that an orderly system of international trade and finance will naturally follow if every country "puts its house in order", irrespective of what the others are doing; for, it is precisely such behaviour that is disturbing international trade and finance.

This chapter reviews these developments. The lessons from experience are followed by an analysis of chronic unemployment in major industrial countries in order to arrive at a set of macroeconomic policy recommendations (expounded later in this Report - see Part Three, chapter IV) designed to overcome unemployment and instability.

A. Demand, employment and inflation

1. *Weak employment, income gains and consumption*

Despite a return to a more synchronized cyclical behaviour of income growth in the world's major advanced economies in 1994, growth rates differed considerably; they were around 4 per cent in the United States and the United Kingdom, about twice the rate achieved in continental Western Europe (2.5 per cent), and growth in Japan was a mere 0.6 per cent. Moreover, there have been large disparities in job creation. Reductions in unemployment have been confined to the United States

Table 15

CURRENT BALANCE OF PAYMENTS ACCOUNT AND BUDGET BALANCES IN SELECTED OECD COUNTRIES

(Percentage of GDP)

Country	Current account balance					Budget balance[a]				
	1990	1991	1992	1993	1994	1990	1991	1992	1993	1994
United States	-1.7	-0.1	-1.1	-1.6	-2.3	-2.5	-3.2	-4.3	-3.4	-2.0
Japan	1.2	2.2	3.2	3.1	3.0	2.9	3.0	1.8	-0.2	-2.0
European Union	-0.4	-1.0	-0.9	0.2	0.2	-4.1	-4.6	-5.3	-6.4	-6.0
Germany	3.1	-1.1	-1.1	-1.1	-1.2	-2.0	-3.3	-2.9	-3.3	-2.7
France	-1.3	-0.6	0.3	0.8	0.7	-1.6	-2.2	-3.9	-5.8	-5.7
Italy	-1.6	-2.1	-2.3	1.2	1.6	-10.9	-10.2	-9.5	-9.6	-9.7
United Kingdom	-3.4	-1.3	-1.8	-1.7	-0.9	-1.2	-2.7	-6.2	-7.7	-6.8
Spain	-3.4	-3.2	-3.2	-1.1	-1.0	-4.1	-4.9	-4.2	-7.5	-6.8

Source: *OECD Economic Outlook,* December 1994 (annex tables 29 and 50).

Note: A minus sign (-) indicates a deficit.

a General government financial balance. Totals for the European Union are estimates by the UNCTAD secretariat, using GDP weights of OECD (p.A2 of the source).

and the United Kingdom; the rapid resumption of growth in continental Western Europe has not reversed the upward trend in unemployment rates which started at the beginning of the decade.

However, even in the United States and the United Kingdom, rising employment has not been accompanied by an increase in real wages at rates similar to those of previous recoveries, while in other countries real wages have been stagnant or falling. For example, in the United States real average hourly earnings in the business sector in the fourth quarter of 1994 rose by only 1.7 per cent over the fourth quarter of 1993, and in manufacturing there was a decline of over 2 per cent. In the United Kingdom real household disposable income increased by just over 1 per cent over the previous year.

With uncertainty over employment and slow growth in real purchasing power, consumer spending has remained subdued even in those countries where employment rose. In a number of countries increasing consumer expenditure has been the result of a rise in the propensity to consume (i.e. a fall in savings ratios) and reductions in net wealth (i.e. increased household indebtedness). For instance, in Germany and Italy household savings ratios have been unprecedentedly low. A fall in the ratio cannot, however, sustain increased consumption expenditure over the medium term.

The slow and erratic recovery of consumer spending that underlay the slow, shallow recession in the United States in the early 1990s (the so-called "double dip") now seems to be occurring in Europe. This lack of strong consumer demand has meant that investment in new plant and equipment has been geared towards restructuring and retooling in order to gain competitiveness in international markets rather than towards growing domestic sales. Consequently, investment has produced neither substantial expansion in productive capacity nor increased employment. Restructuring better to meet foreign competition has consisted of cutting costs and increasing productivity by reducing labour and raw material inputs.

In Japan, low wage growth, combined with historically high levels of unemployment, and falling asset prices have kept consumer spending sluggish despite income tax rebates and falling retail

prices. Although expenditure on durables rose, total household consumption fell by 0.6 per cent in FY 1994. As a result, retail sales declined in the early part of the second quarter of 1995, and the system of lifetime employment came under mounting pressure.

2. Trade tensions and excessive reliance on exports

An important contribution to the recent cyclical recoveries has been made by exports. Although the vigorous expansion of the United States economy in 1994 provided a stimulus to world trade, rising import demand in developing countries was also a major element in the export-led recovery of the industrialized countries. Most Western European countries now have trade surpluses, and in the European Union (EU) as a whole the current account was in surplus in both 1993 and 1994. Even in the United Kingdom, which had chronic trade deficits during the 1980s, there was a marked improvement, although this may have been more due to changes in factor income flows than to an improvement in the balance of trade in non-oil goods and services. Germany, Spain, and the United Kingdom have current account deficits around 1 per cent of GDP, while in the United States the deficit is roughly double that ratio. Only in that country - thanks to its relatively faster recovery - has there been a deterioration in the external balance (see table 15).

The United States deficit, which stabilized at around $13 billion per month in the last half of 1994, when the annual growth of the economy was about 3 percentage points higher than in most other major industrial countries, is likely to diminish in 1995 as growth slows down (unless it slows even more in other countries). The deficit did not change substantially in the first quarter, despite the drop in exports to Latin America. This was due in part to the increased trade surplus with the Asian NIEs in February and March. With an underlying growth of exports of 9 per cent in 1994, which exceeded the growth of world trade, and export growth in the fourth quarter alone at an annual rate of over 20 per cent, against a corresponding import growth of less than 13 per cent, the United States external balance is likely to improve as imports slow in 1995.

Substantial currency devaluation in Italy, the United Kingdom and Spain since the EMS crisis of September of 1992, together with the continued weakness of the dollar, have also contributed to improved export performance in those countries. Despite appreciation of its currency, Germany also increased exports, roughly in line with the growth in world trade, first to the Far East and then to Europe, while sales to the United States declined.

Only Japan continues to experience imbalances, in the form of what appears to be a persistently increasing surplus. Although there has recently been some adjustment in volume terms (imports have been rising more than three times faster than exports), in current dollar terms there has been little correction, in particular with respect to the bilateral balance with the United States. Here also, part of the explanation is to be found in sharp currency appreciation, which has caused the dollar value of Japan's exports to increase despite falling volumes, and that of imports to decline despite rising volumes. However, in the last half of 1994 there was an increase in export volumes to the United States. Overall, with imports growing about 10 per cent faster than exports, the net contribution of the foreign balance to Japanese growth is negative.

With the exception of trade between Japan and the United States, the major current account imbalances of the 1980s have been eliminated. None the less, frictions in trade persist that are similar to those of the 1980s. This is because the improvements in trade balances, either absolutely or relatively, have been accompanied by substantial changes in real exchange rates and consequently sharp shifts in international competitiveness, which have hurt producers in countries with appreciating currencies and revived memories of the competitive devaluations of the inter-war period. Tensions are high not only in the framework discussions between Japan and the United States. In France and Germany, for example, there are suggestions that producers in Spain, the United Kingdom and Italy have been the unfair beneficiaries of the large exchange rate movements which have taken place over the last two years.

European government and central bank officials have also recently argued that the weakness of the dollar was due to lax United States budgetary policy, despite the fact that the United States government budget deficit as a ratio to GDP, at around 2.0 per cent in 1994 and a predicted 1.8 per cent in 1995, was the lowest of the major developed countries, including Germany (see table 15). Indeed, current estimates suggest an even bet-

Table 16

UNITED STATES NON-FINANCIAL CORPORATIONS: ANNUAL CHANGES IN PRODUCTIVITY AND RELATED MEASURES, 1985-1994

(Percentage)

Measure	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*	*1993*	*1994*
Productivity	1.0	2.6	1.7	1.9	-1.6	1.1	2.0	3.0	3.0	2.6
Real hourly compensation	0.5	2.8	-0.5	0.0	-1.3	-0.1	0.6	1.6	0.0	-0.1
Unit labour costs	3.1	2.0	1.4	2.2	5.1	4.1	2.7	1.6	0.0	-0.2
Total unit costs	2.5	2.1	1.0	2.6	5.4	3.8	3.0	0.5	-0.5	-0.1
Unit profits	-0.2	-10.8	14.7	6.6	-8.2	-0.6	-1.7	7.6	14.0	12.2
Implicit price deflator	2.3	0.8	2.2	3.0	4.1	3.4	2.6	1.1	0.8	1.1

Source: UNCTAD secretariat calculations, based on data of the United States Bureau of Labour Statistics.

ter budget outcome in the United States. Thus concern over the difficulty in managing sizeable imbalances in trade and payments flows which dominated discussions of policy coordination in the 1980s has been replaced by tensions over the size of the currency adjustments and changes in relative competitiveness which have been necessary to eliminate them in the 1990s.

3. *Uneven investment performance*

In the United States a period of industrial restructuring was triggered by the downturn in 1990.[1] Since then investment has risen rapidly, at a rate of over 12 per cent per annum in 1993 and 1994. Expenditure on new plant and equipment rose by an annualized almost 20 per cent in the first quarter of 1995. This investment-led recovery has sharply improved productivity and international competitiveness, particularly in manufacturing, where the United States had lost its structural trade surplus in the early 1980s. Hourly wages in manufacturing rose by merely 2.8 per cent in 1994, while productivity increased by 4.9 per cent, resulting in a fall in unit labour costs of 2 per cent. For the non-financial business sector as a whole, real hourly earnings have remained virtually unchanged while productivity has risen at rates not experienced since the 1960s (see table 16).

In the United States increased investment expenditures, by increasing productive capacity, are thus translating into both reduced domestic inflation and increased international competitiveness and exports. The continued weakness of the dollar has served to reinforce this process, although the devaluation of the Mexican peso and the fall of the Canadian dollar brought about a slight appreciation in the real effective exchange rate of the dollar in the beginning of 1995.

The rise in investment, which had initially been concentrated in computers and electronics, had little impact on capacity in 1992 and 1993. However, in 1994 capacity was increasing at around 3 per cent at an annual rate, and there have been peaks so far in 1995 of over 4 per cent. Investment has also been reverting to the more traditional areas of plant and business construction, which tends to confirm that the objective may, at long last, be to shift from restructuring and labour shedding to enlarging productive capacity.

In Europe, as already noted, the recovery has not generated a continuing increase in investment for enlarging capacity. In the United Kingdom, investment in manufacturing was down 5.3 per cent in real terms in 1993 and rose by 2.3 per cent in 1994, accelerating in the last half of the year. Weak investment during the current recovery in the United Kingdom poses a serious policy dilemma. Some

60 per cent of manufacturing firms report that they are working at full capacity, and average capacity utilization is back roughly to the rate prevailing in 1989. While productivity in manufacturing rose vigorously in 1993 and 1994, this was due primarily to cyclical factors, rather than to a surge of investment. Consequently, unless new capacity is created, output expansion may be difficult to maintain. The increased exports required to improve the trade balance have thus induced a rate of expansion which is coming up against the limits of existing capacity and is judged by the Bank of England to be too rapid for price stability. The dilemma has been made more acute by the fact that sterling has tended to follow movements in the dollar, resulting in a roughly 5 per cent effective depreciation in the first quarter of 1995, reinforcing fears of rising inflation and leading to calls for higher interest rates.

It is difficult for the Government to cut aggregate demand by putting a break on consumption rather than investment. With real consumer expenditure rising at barely over 2.5 per cent in 1993 and 1994, and real incomes increasing by less than 1.5 per cent, there is little scope for increasing taxation to restrain consumption. Monetary tightening is thus being applied to cut back demand at the very time when investment should be increasing in order to expand capacity and increase productivity to allow the expansion to continue. If monetary policy is made too restrictive, in an attempt to reverse the modest increase in inflation which has occurred in 1995 and keep the inflation rate within the bottom half of the target range of 1-4 per cent, there is a risk of its cutting short the requisite expansion in investment.

Therefore, although the United Kingdom is grouped with the United States as leading the recovery in output and employment, the role of different components of demand is quite different; exports have been playing the leading role in the United Kingdom, and investment in the United States. A prolongation of the expansion, and a permanent reduction in the levels of structural unemployment, will require a reversal of these relative roles in both countries. The April 1995 survey of investment intentions undertaken by the Confederation of British Industry indicates that 13 per cent of manufacturing firms intend to increase expenditures on plant and equipment over the next year; that would mark a sharp departure from past patterns. Virtually all previous post-war expansions have ended in a consumer boom, leading to a wage-price spiral, growing balance-of-payments disequilibria and a sterling crisis, followed by a tight monetary policy and fiscal retrenchment.

As discussed in *TDR 1994*, the Japanese economy is still working its way out from an overinvestment bubble which accompanied the real estate and stock market bubbles at the end of the 1980s. The downturn at the beginning of the 1990s not only brought asset price deflation, but also made much of this investment redundant. The result was three years of stagnation of investment, which was only reversed in the latter half of 1994. The index of capacity utilization rose in 1994, but still remains well below the break-even point and the level at which investment is likely to revive.

The structural problems have given rise to, and in turn been aggravated by, the recent rise of the yen. Just as the economy was emerging from the adjustment of the yen to a parity of 100 to the dollar, another sharp rise in its value, to below 80, has cast a shadow over most investment plans. Investment expenditure is likely to be flat in 1995, and the effect of the strong yen has been even more pronounced for small and medium-sized firms. Much of Japanese investment continues to be in the form of foreign direct investment, which rose by around 10 per cent in 1994. It continues to be directed to East and South-East Asia, as production is shifted to countries with lower labour costs and currencies linked to the United States dollar.

This relocation of production provides a short-term solution to Japanese firms facing falling profits and loss of international market shares. But it compounds the difficulties facing the Japanese economy, as it reduces domestic employment opportunities. Already, as predicted in last year's *TDR*, unemployment has breached the traditional barrier of 3 per cent, and the Government seems helpless to stem the tide. As firms continue to shift production outside Japan it becomes increasingly difficult to hoard labour; the possibilities of moving workers around within the corporate structure diminish as domestic production falls. Eventually, labour shedding will not be avoidable any more than it has been in other advanced economies, unless the problems of demand can be overcome - problems which in Japan are structural, not cyclical; as suggested last year, unemployment may rise to 5-6 per cent in the near future.

The dilemma facing Japan is thus rather different from that facing the United Kingdom. The Japanese economy needs to rely less on exports and investment and more on domestic consump-

tion as a stimulus to domestic investment. Traditionally, it has been consumption which has passively adapted to the level of investment required to maintain the growth of export markets. The response by most large firms of relocating investment and production outside Japan is making this adjustment more difficult by reducing consumer real incomes and dampening consumer confidence. Instead of there being a consumer boom, the debt deflation is being transmitted to the retail sector, where there is widespread price cutting. However, the wealth (Pigou) effect produced by price falls has not been sufficiently strong to offset the negative influence of rising unemployment. Thus, the Japanese economy is locked in a position in which neither domestic consumption nor external demand supports expansion and stimulates domestic investment.

During 1994 Germany initiated a process of industrial restructuring; manufacturing firms have reduced employment by over 15 per cent from the peak reached in the spring of 1991. As a result of the 1993-1994 wage rounds, wages and salaries increased by only 1.5 per cent in the area of the former Federal Republic, leading to sharply lower unit labour costs. Investment to expand productive capacity started to replace residential construction, and total investment rose by 5 per cent in 1994. However, the enhanced competitiveness and higher profits of firms have largely been offset by the appreciation of the Deutsche mark and the increases in wages agreed for the current year. The German economy is thus following the path of the United States: industry is being restructured so as to increase profits and productivity, but without the benefit of stable wages. It is also facing difficulties similar to those caused in Japan by overvaluation of the currency. There has thus been an increase in investment abroad, particularly in the neighbouring Eastern European countries. Consequently, the recovery in investment is doing little to resolve the unemployment problem, and indeed may aggravate it in the short term.

Further, the recent sharp adjustments in the real value of the Deutsche mark have caused particular difficulty for small and medium-sized firms, which represent the export strength of the economy. It is not so much the appreciation against the dollar that is of importance in this respect as that relative to the currencies of the country's other European trading partners and to the Asian economies with currencies linked to the dollar. The recent decision of the Bundesbank to initiate interest rate reductions has clearly been motivated by concerns for the competitiveness of German industry; domestic inflation remains above the Bank's target.

France has assiduously followed a policy of convergence, in particular with respect to Germany. The restrictive monetary policy pursued in order to preserve a strong franc has weakened non-residential investment, which rose only by 0.5 per cent in 1994. Although growth was faster and inflation lower than in Germany in that year, much of the expansion was due to incentives provided to consumers. However, their effect had worn off by the end of the year, and in any event they were insufficient to generate investment in new productive capacity.

The Government constituted after the Presidential elections of May 1995 has announced that it will make increasing employment its major objective. However, this has created widespread fears in financial markets that budget deficits will increase and that the Government will have to abandon the policy of a strong franc. These fears have led to higher market interest rates, which discourage the investment needed to increase employment. Moreover, a strong investment surge in France alone could easily come up against a balance-of-payments constraint. The countries which have partially resolved this dilemma, such as the United Kingdom and Italy, have been able to do so only by abandoning their exchange rate link to the Deutsche mark; even then the United Kingdom has not been able to increase investment, nor Italy to resolve the problem of unemployment.

4. *Expansion without inflation*

The current recovery is distinguished by the fact that although rates of capacity utilization have risen to historically high levels in most countries, and the generalized expansion has produced a recovery in the prices of primary commodities from their historically low levels at the beginning of the decade, inflation rates have continued to decline in most of the advanced economies, to below 3 per cent during 1994.

In Japan, inflation has been replaced by "price destruction" (*kakaku hakai*), as depressed internal demand led to widespread retail price discounting; prices were 0.2 per cent lower in April 1995 than a year earlier. In countries where in the past inflation rates have generally been relatively high, such as the United Kingdom, the rate fell in 1994 to

around 2 per cent (last experienced nearly 30 years ago), while in the United States it has been below 3 per cent since 1992, as the recovery got under way. Even in countries with large currency depreciations in 1992 and 1993, such as Spain and Italy, inflation rates have declined.

This combination of rising growth rates and falling inflation can be explained by: the combined effects of an increase in global competition, producing greater competition in domestic product markets; the weak growth of wages and household incomes, which keeps down domestic demand; and industrial restructuring, which has brought about a sharp recovery in labour productivity and a fall in unit labour costs. Thus, despite weak demand conditions and low inflation, profits have been rising, providing the incentive and financing for a restructuring of production.

In the United States this process was under way for nearly three years before it started to provide a net increase in jobs, while in the United Kingdom the impact of recovery on employment has been more immediate. In other EU countries, the fact that the recovery has come so quickly after the beginning of the downturn should have implied only a minimum increase in unemployment, but in fact labour shedding persisted during the initial stages of the recovery. The European Commission has estimated that if GDP growth attains 3-3.5 per cent in the medium term and the rise in labour productivity equals the 2 per cent experienced in 1974-1994, employment in the EU will grow by 1-1.5 per cent per annum, only slightly above the rate of increase of the active labour force.[2] The assumed growth rate is higher than the rate experienced in the recovery, while the assumed productivity gain is lower, particularly for manufacturing, suggesting that a much stronger increase in growth will be needed to reduce unemployment.

The combination of accelerating GDP growth and rising unemployment rates in Europe persisted in 1995, notwithstanding growing concern that capacity shortages and rising world demand for industrial raw materials and primary commodities would lead to a return of the inflationary conditions of the 1970s.

B. Monetary policy

1. *Monetary tightening for "pre-empting" inflation*

Given the difficulties of using fiscal policy and the different cyclical behaviour of the United States and the United Kingdom, on the one hand, and continental Western European economies, on the other hand, the use of monetary policy as a tool for meeting domestic policy goals has precluded any possible coordination at the international level. After the expansion of the economy by nearly 6 per cent at an annual rate in the last quarter of 1993, the United States Federal Reserve initiated what it called a "pre-emptive" strike against potential inflationary pressures, raising the federal funds rate by a quarter of a percentage point in February 1994. It expressed concern that if expansion at such a rate continued, the economy would soon encounter limits to its productive capacity and excess demand pressures might set off a wage-price spiral. The small size of the initial interest rate increase was determined by concern that expectations of stable rates were so widespread that any reversal of policy might create market turbulence. The series of small rate adjustments spread over time was intended to provide holders of borrowed financial assets time to adjust their positions to the new conditions of rising interest rates.

With hindsight, it appears that it was not the size of the adjustment which mattered, but the uncertainty created by the fact that the Federal Reserve had reversed policy without revealing any objective target against which the market could judge the success of its tightening. In the absence of any clear signs of inflation, and with wage increases below the increase in prices, the market

had no way to judge the current success or anticipate the future stance of policy. A year later, after seven additional rounds of tightening, the federal funds rate had risen to 6.0 per cent (from 3.0 per cent), and the discount rate had been raised four times, from 3.0 per cent to 5.25 per cent.

Although the Fed suggested that it had expected the bond market to interpret its reversal of policy as an attempt to reduce the threat of future inflation, and thus reduce the inflation premium by bringing down long-term rates, it seems clear that the markets have not been dominated by similar inflationary expectations. Indeed, the bearish reaction to the policy reversal of February 1994 sent bond prices sharply downward; the increased cost of carrying securities positions on margin, due to the rise in short-term rates, combined with the sudden possibility that the market had missed the signs of inflation that the Fed had already identified, caused expectations to converge around the view that interest rates would continue to rise and bond prices to fall for the foreseeable future.

The result was not only substantial losses for individuals and financial institutions, but an estimated increase in the government deficit for the current year due to increased interest costs of over 0.3 per cent of GDP[3] - at the very moment that the Government finally appeared to have succeeded in reversing the seemingly unending rise in the ratio of the budget deficit to GDP which had started with the Reagan Administration. Paradoxically, the Fed had posed reduction of the deficit as one of the conditions for loosening monetary policy to support recovery when the new Administration took office in 1992.

The negative impact on the deficit was further increased by the decision of the Administration to reduce interest costs by concentrating its borrowing on the short end of the maturity structure. Thus, instead of borrowing long-term at less than 6 per cent in 1993, it borrowed short at 4 per cent, but within a year medium-term rates had risen to over 7 per cent. Since financial markets usually regard any increase in the government deficit as inflationary, the rise in interest rates simply reinforced the impression that had been created by the Fed that inflation was imminent and that an inflation premium should be added to interest rates.

Market conditions only stabilized in the spring of 1995, when clear signs of a slowdown and the continued absence of any indications of a rekindling of inflation reinforced the belief that the increase in interest rates had come to an end. The decline in the annual rate of growth to 2.7 per cent in the first quarter of 1995 (from 5.1 per cent in the preceding quarter) suggested that the rate had been brought down to what the Fed considered to be the sustainable growth potential of the economy. Already in his February statements to Congress, the Chairman of the Board of Governors had suggested that the period of rate increases was coming to an end. As soon as the market sensed that rates were likely to be remain stable there was a bond market rally which brought bond rates down and pushed stock prices to record levels. That this occurred even as the inflation rates were starting to edge above the 3 per cent level suggests that the rise in long-term interest rates in 1994 was more determined by the uncertainty created by the Fed's policy reversal than by any fear of higher inflation or the negative impact on the economy of higher budget deficits. As it became apparent that employment growth had been reversed and that the economy would slow further in the second quarter, fears spread of a renewed period of recession. At the end of May 1995 interest rates on bonds of up to 10 years' maturity were below the prevailing federal funds rate and 30-year bond yields had also fallen. A number of major banks had reduced their prime lending rates, implying an expectation that the official policy had become too restrictive.

The United Kingdom eventually followed the United States lead and raised the discount rate between September and February 1995, even though inflation continued to fall throughout 1994 and into the first quarter of 1995. Rather than responding to domestic monetary conditions, United Kingdom long-term rates seemed to follow upward movements in the United States. Consequently, the terms of financing for the increase in investment required for sustainable recovery have become more onerous. With long-term interest rates above 8 per cent for most of 1994 and inflation below 2 per cent, the real cost of borrowing for firms is well above 6 per cent.

In contrast to the situation in the United States, where only impressionistic and anecdotal evidence of a build-up of inflationary pressures has been presented to justify monetary tightening, in the United Kingdom the Governor of the Bank of England has stated that in the autumn of 1994 there was direct evidence of price pressure, citing commodity prices and capacity constraints in basic material sectors. Yet, commodity prices have been declining since the beginning of the year, and the World Bank has recently forecast that mineral and

metals prices will remain below those of 1990, while real prices of both agricultural and non-oil commodities are expected to return to their 1990 levels by 1998 and to remain there until 2004.[4] More recently, the Bank of England has again argued strongly in favour of further increases in interest rates to ward off inflation that it believes could result from sterling depreciation. However, the annual rate of inflation, net of the effects of government fiscal measures, was below 3 per cent in the first quarter.

2. *International transmission of the effects of monetary policy*

It was widely believed that during 1994 there would be a decoupling of interest rates from the increases which were taking place in the United States and United Kingdom to stem their vigorous recovery so as to allow lower rates in the rest of the world, which was still in the throes of recovery. However, this expectation was disappointed. The integration of the international capital market meant that the United States bond market collapse was soon transmitted to the rest of the world, and the realization in the autumn that the European economies were starting to emerge from recession meant that world interest rates followed United States rates upwards. Given the relatively low inflation rates in these countries, real interest rates quickly returned to their record high pre-recession levels in most countries even before the recovery had become well entrenched.

In Germany the reduction in official interest rates that started in September 1992 continued throughout 1994 and 1995 and both the discount rate and the Lombard rate were lowered. The Bundesbank faced particularly difficult conditions during the recession, as inflation continued to exceed the 2 per cent target and M3 rose as much as 10 per cent above its target ceiling at the beginning of 1994. All these factors led to the expectation of a rise in rates despite depressed domestic conditions. None the less, official rates were gradually reduced and inflation has fallen to the 2-2.5 per cent range. But the effects of the action by of the Federal Reserve quickly spread to German capital markets; despite the continued decline in short-term rates, the long-term rates, after dropping to 5.5 per cent in January 1994, reversed direction in February and were 2 full percentage points higher by October, giving a sharply inclined yield curve. As a result of the recovery in market sentiment in the United States, German rates again started to decline and had fallen back a full percentage point by the second quarter of 1995. The growth of the money supply also declined so rapidly at the beginning of 1995 that M3 fell below the target range, thus enabling the Bundesbank to reduce rates again in March.

Since France has continued to keep the franc within the old "narrow" exchange rate bands relative to the Deutsche mark, French interest rate policy, as that of the Dutch, Austrian and Belgian central banks, which also peg their currencies tightly to that of Germany, has been determined in the light of decisions taken by the Bundesbank. Consequently, their short rates move roughly in step with German rates plus a small risk margin (which for the guilder is now occasionally negative), while long-term rates are linked, through German rates, to movements in the United States. In this way, the Exchange Rate Mechanism (ERM) has been one means by which the rise in United States rates has been transmitted to the continental Western European countries despite their slower growth in 1994. This is one of the major factors impeding a strong recovery in these countries similar to that which has occurred in the United States and the United Kingdom. With the exception of France, the rate of inflation has been slightly higher than in those two countries, while they now run the risk of cutting short the recovery before any appreciable improvement in employment has been attained. Since they all have substantial government indebtedness, their net interest burdens have also been increased, thus narrowing the scope for fiscal policy as growth slows.

Italy and Spain represent the major exceptions to the dominance of German interest rate policy, both having severed their link with the Deutsche mark. Italy has left the ERM, while Spain has made use of both the enlarged 15 per cent fluctuation band as well as periodic realignments of its central ECU parity. The lira continued to depreciate after the 1992 ERM crisis, in particular against the dollar and the Deutsche mark. After falling during 1994, official rates were raised throughout 1995 as inflation rose; short-term rates reached 9 per cent in May 1995, an increase of 200 basis points in nine months, adding over half a percentage point to the annual government deficit.[5] Given that the political instability is partially caused by the difficulties involved in reducing the overall government deficit (composed of interest on the public debt that exceeds the deficit, set against a surplus of some 3 per cent of GDP net of interest

payments), any additional monetary tightening risks offsetting the budgetary improvements achieved and jeopardizing recovery. Exchange rate adjustment also contributed to recovery in Spain, but in contrast to Italy the improvement of the trade balance was short-lived, as imports rose in 1994 and exports declined, in large part because of a rise in domestic investment. As inflation accelerated, the Central Bank increased its intervention rate three times in 1995, by almost 2 percentage points.

Thus, in all countries where exchange rate adjustments have provided a stimulus to aggregate demand, there is now a presumption that unsustainable inflationary pressures will emerge as a result.

The experience of Japan illustrates the difficulties of monetary policy when inflation has been eliminated and prices fall. Despite the continued deterioration of the country's internal and external balances, the Bank of Japan kept official interest rates stable throughout 1994, at 1.75 per cent. The Bank found itself in a difficult position, as market rates were already below those which most insurance companies have pledged to pay on pensions and investment contracts. Most insurance companies are now reporting losses or sharply reduced earnings. Further, banks were still carrying some $500 billion of bad debts. At such low levels of interest rates, deposit and borrowing rates have reached a minimum; any further rate reductions thus simply put pressure on lending rates and reduce bank profits, which is just the opposite of what is necessary if banks are to cover their bad loans. Lower rates thus paradoxically have the effect of making banks less willing and less able to lend.

While low interest rates are usually considered favourable for the level of stock prices, the unfavourable impact on the earnings of financial institutions has led many of them to sell their investment portfolios in order to realize capital gains. This, along with sales by firms, has led to continued weakness in the stock market and a decline in stock prices below the 15,000 level of the Nikkei index. The result has been to exacerbate the weakness of the financial sector, since at these prices banks can no longer turn to capital gains for a contribution to their risk-adjusted capital requirements. Paradoxically, if insurance companies decide to meet losses by repatriating their foreign investments, particularly in the United States, there will only be a further strengthening of the yen, and increased volatility of United States interest rates and the dollar.

Under heavy pressure from the appreciation of the yen since the beginning of 1995, the Bank of Japan chose to intervene in foreign exchange markets to support the dollar, rather than act on interest rates. It was only when this policy failed because of lack of United States and German cooperation that the Bank finally acted to reduce its official intervention rates to 1.0 per cent in April 1995. There has since been some recovery in the growth of the money supply, but virtually no impact on domestic demand. Thus, the continued fall in retail prices has placed the Bank of Japan in the position where it has almost exhausted its room for manoeuvre on interest rates, while low nominal interest rates increasingly reflect tight monetary policy as the fall in prices increases real rates.

Since the government emergency budgets are generally financed through the "second budget" by the issue of bonds (see Part Three, chapter IV), there has been some concern that an excess supply of bonds will drive down prices and increase long-term interest rates. The emergency government budget allocations and earthquake reconstruction expenses for 1994 and the first half of 1995 amount to some 10 per cent of GDP. The Ministry of Finance has therefore concentrated bond issues in the short to medium range of the yield curve in order to avoid the feared negative impact on long-term rates and on the stock market. However, this policy tends to offset the efforts of the Central Bank towards monetary relaxation and reinforces monetary restriction.

This diverse behaviour of interest rates among countries in part reflects the different timing of recovery, as monetary policy is directed to the attainment of domestic objectives, and has served to increase the uncertainty of exchange rate movements. Monetary policy, in particular in Japan and the Asian NIEs, has been made particularly difficult by the decline in the dollar. The currencies of the Asian NIEs are generally linked to the dollar, although most of their foreign investment and foreign borrowing is transacted in yen. They are thus facing conditions similar to those of Latin American countries during the period of dollar appreciation of the early 1980s, and have joined Japan in trying to halt the dollar decline by intervention in the currency market. Since most of the dollars acquired in these operations are invested in United States government securities, part of the explanation of the simultaneous weakness of the dollar and strength of the United States bond market may be found in the increased currency instability in the beginning of 1995. It also demonstrates the

difficulties involved in coordinating medium-term policies of debt reduction with the requirements of short-term cyclical policy.

3. *Interest rates, capital flows and the dollar*

The tightening of monetary policy in the United States and the United Kingdom was motivated by the desire to achieve a "soft landing" whereby growth rates would smoothly decline to levels compatible with what was considered to be the long-term potential rate of expansion. However, since there was no apparent price pressure, the initial impact has been to concentrate market expectations on the spectre of future inflation, and long-term financial markets responded by abruptly reversing the fall in long-term interest rates as bond prices collapsed.

As a result of the sell-off in the United States bond market, funds were shifted to European markets, where depressed conditions of domestic demand suggested that rates would continue to be reduced. Together with a breakdown in the trade discussions between Japan and the United States which occurred almost simultaneously with the February 1994 decision to raise rates, this shift of funds led to a change in market opinion concerning the dollar and a period of dollar weakness which was to intensify during the summer of 1994 and then reappear with the Mexican crisis at the end of the year. The weakness of the dollar was further exacerbated by the emerging signs of recovery in continental Western Europe and the realization that the expected declines in interest rates would not occur, or would be reversed. This produced a weakness in international bond markets which further weakened the dollar.

Part of the response to the reduction in interest rates in the United States, and subsequently Europe, designed to reverse the decline in economic activity experienced in 1991 and 1992 was a shift of investment funds to the financial markets of developing countries, which were experiencing continued growth, high interest rates and rising equity prices. In consequence, there were sharp increases in prices on most of these emerging equity and bond markets. The change in United States monetary policy and the earlier-than-anticipated recovery in Europe played an important role in the subsequent reversal of these flows. Asian markets had already started to weaken in the beginning of 1994. They were joined by Latin American markets after the Mexican Government found itself without sufficient foreign exchange reserves to reimburse foreign holders of its domestic assets. The result of this crisis was a sharp reversal of flows of funds to Latin American markets, and a further negative impact on the dollar, as the United States Government led attempts to provide emergency lending to Mexico.

The result of the Fed's attempt to provide a soft landing by means of anticipatory interest rate tightening has thus been to create increased volatility in long-term bond markets which has spread to foreign exchange markets and prevented the recovery of the dollar. The capital losses inflicted on investors in global fixed- income markets as a result of the reversal of monetary policy in 1994 are estimated at $1,500 billion, or almost twice the destruction of private wealth in the 1987 global stock market crash. Despite interest rate increases in the United States, and reductions in Europe and Japan, the degree of exchange rate overshooting that has resulted is similar to that experienced during the mid-1980s.

Conditions in currency markets have made recovery in Japan even more difficult, as the yen-dollar rate rose by more than 20 per cent in less than a year. The Deutsche mark also moved to record levels against the dollar. Normally, the impact on the German economy would be small, since only about 10 per cent of exports are to the United States, but with both the United Kingdom and Italy outside the ERM, and successive depreciations in Spain and Portugal, the Deutsche mark has also appreciated in real terms against its European trading partners, which account for about 25 per cent of exports, and against the dollar-linked currencies of Asian developing countries. The effect on export profitability was such that in the spring of 1995 the Bundesbank moved against market expectations and reduced interest rates, even though the economy was continuing to recover and capacity utilization rates reached pre-recession levels.

C. Convergence and unemployment

By the middle of 1995, some 18 months after the alarm of the potential inflationary risk of excessively rapid growth, there were still no clear signs that inflation threatened. However, clear signs were starting to emerge that a substantial slowdown was taking place in the industrialized economies. Much of the income growth in the United States in the beginning of 1995 has been due to inventory accumulation, suggesting that demand growth has slackened. Job losses in April and May, as well as the declines in the index of leading economic indicators, tended to confirm this impression.

Recoveries in the continental European countries are far from robust or broadly sustained, and there is a risk that they may stall if monetary policy remains tight, as central banks continue to combat potential inflation of which there is no evidence in either labour markets or commodity markets. Given exchange rate developments and sluggish domestic demand, the German economy is unlikely to improve on its 1994 performance, while in the United Kingdom growth in non-oil output in the first quarter of 2.4 per cent at an annual rate suggests that the economy is now showing signs of slowing down in response to the rapid monetary tightening and sharply increased restrictiveness of the government's fiscal stance.

This levelling-off of growth performance, and the continued absence of any clear inflationary pressures, has reinforced the financial markets' hopes of a soft landing and reduced fears of further monetary tightening. Bond markets consequently recovered towards the middle of 1995, with rates again edging downwards. While a continued decline in long-term interest rates will be a positive influence, the fall in consumer expenditures and the rate of employment expansion, together with continued declines in government expenditure, mean that prospects for domestic demand growth hinge entirely on private investment. There will be little stimulus from exports, since in the two regions largely responsible for the recovery of the growth in world trade in 1994, namely the United States and Latin America, GDP growth is declining, while exchange rate turbulence continues to be a negative element for countries such as Germany and Japan.

There is a good possibility of convergence in terms of growth performance and price stability, but the convergence is towards a rate of expansion no higher than the ceiling set by the central banks' perception of the potential growth rate of 2-3 per cent (see Part Three, chapter III and box 6). At this rate of growth there is little hope of any further boost to employment in the United States and United Kingdom, or of a halt to rising unemployment in continental Western Europe or to the steady progression of unemployment in Japan to a historically high level.

Notes

1 See *TDR 1994*, Part Two, chap. II, sect. A.

2 *European Economy, Supplement A*, No.1, January 1995, p. 3.

3 This calculation is based on estimates by OECD of the impact of each percentage point increase in interest rates on all maturities on government deficits in 1995. See *OECD Economic Outlook*, December 1994, table 10.

4 *Global Economic Prospects and the Developing Countries, 1995* (Washington D.C., The World Bank, April 1995), pp. 18-19.

5 Based on estimates in OECD, *op. cit.*

Chapter II

THE INVISIBLE HAND, CAPITAL FLOWS AND STALLED RECOVERY IN LATIN AMERICA

A. Introduction

One of the most important consequences of the debt crisis in Latin America was to bring about a radical change in economic philosophy, thus laying the basis for comprehensive policy reforms. In contrast to the external shocks and crisis of the 1930s, which had led to a switch away from laissez-faire towards a strategy of import substitution, and provided for a greatly enlarged role for the State, the shocks and crisis of the 1980s led to exactly the reverse movement, towards an outward-oriented development strategy based on deregulation, liberalization, and privatization.

The aim of policy reforms was to attain microeconomic efficiency and macroeconomic stability, so as to accelerate growth and industrialization. The former required the removal of distortions, in particular with respect to exchange rates and interest rates, and to the relative prices of traded and non-traded goods and services, by deregulating markets, liberalizing trade and finance, dismantling direct controls over prices and resource allocation, and privatizing public enterprises. As regards the latter, budget deficits and monetary expansion were seen as the root causes of macroeconomic instability, and in consequence balancing the budget became a top priority, to be achieved primarily by reducing government spending and selling off public enterprises. Greater central bank autonomy was also considered essential for both monetary and fiscal discipline, and bringing inflation down to single digits was adopted as the prime objective of monetary policy in most countries.

These policy changes were expected to give a major boost to private investment as financial liberalization raised private saving and the reduction or elimination of government deficits released resources for private use. As discrimination against exports was removed and the economy allowed to exploit its comparative advantages, investment was expected to switch to export industries. Thus, domestically financed private investment in tradeable goods industries was to become the new engine for growth.

Reforms were generally implemented in a 'big bang' manner, particularly in Argentina, Mexico and Peru. This approach was considered necessary because imbalances and distortions were pervasive, and partial and gradual reform would lack credibility. However, some countries, such as Chile, had been implementing market-oriented reforms throughout the 1970s, while others, such as Brazil, had been unable to secure the political and social consensus needed for such a sharp break with the past.

In two respects the nature of liberalization and deregulation in Latin America differed sharply from that in the most successful NIEs in East Asia in the 1980s. In East Asia such reforms were not a response to stagnation and instability, but followed from a successful implementation of industrial policy.[1] Thus, while in Asia protection and other support to domestic industry were removed because they were no longer needed, in Latin America lib-

eralization was introduced as a reaction to the failure of the import-substitution development strategy based on extensive government intervention to generate rapid growth and industrialization. Moreover, East Asian liberalization was a selective, gradual and controlled process whereby the results were continuously monitored vis-à-vis their objectives, and new mechanisms and/or new areas of support and control introduced as the old ones were dismantled.

In Latin America it was recognized that a 'big bang' liberalization undertaken after failure to establish a strong industrial base through government intervention and protection would create serious adjustment problems, but these were expected to be temporary, disappearing as the economy learned to operate under the new rules of the game. Consequently, macroeconomic stability was expected to endure, provided the Government accepted fiscal and monetary discipline, and growth was expected to pick up gradually and settle at a new, higher level.

Indeed, until about a year ago optimism regarding the economic performance and prospects of Latin America was widespread. Following almost a decade of stagnation and macroeconomic instability, the region appeared to have attained durable price stability and sustained growth. In most countries, growth had picked up at the turn of the decade and was being maintained, with budget deficits and inflation under control. This optimism was intensified in the light of the apparent success of the Brazilian stabilization plan of mid-1994 in reducing inflation and lifting activity and growth, and of the very strong growth in Peru.

However, the Mexican crisis of December 1994 and its aftermath have raised questions about the policy thrust in Latin America. Mexico is not only a large economy; its economic policy had, until the crisis, also been held up as an example. Mexico had indeed taken the lead in the region in stabilization and structural reform. Not only did it provide a benchmark with regard to fiscal discipline, privatization and deregulation; its experience was also expected to lead, through NAFTA, to regional trade integration with North America. Besides, Mexico has traditionally played a leading role in the formation of expectations of international investors about Latin America as a whole. Indeed, as in the 1982 debt crisis, though not to the same extent, the recent crisis has prompted a major reassessment of the risks of investment in that region.

This chapter examines the implications, for stability and growth, of the adjustment to the sharp reversal of capital flows that is now under way, and how the various imbalances built up during the 1990s influence this process of adjustment, and in that light considers growth prospects in the coming years.

B. From recovery to crisis

The UNCTAD secretariat is among the minority of forecasters that persistently expressed doubts as to the sustainability of Mexico's external financial position. Each issue of the *TDR*, from 1991 onwards, stressed that the surge in capital flows to Latin America resembled a bandwagon, and warned that the bubble would eventually burst. These concerns were based on an analysis of the nature and effects of the inflows that differed sharply from the orthodox view. The crisis broke out broadly in the way that had been predicted on the basis of this alternative view of international finance (see box 4).

Since the outbreak of the crisis, its causes have been the subject of much discussion. There is now broad agreement (though not consensus) that it stemmed from Mexico's excessive reliance on *liquid* private capital flows to finance *large current account deficits*. But this formulation leaves a number of questions unanswered. Was the problem the *size* of the deficit or the *type* of capital

inflows that financed it? Was the external position made unsustainable by policy slippage or by the very policy reforms undertaken for stabilization and structural adjustment? Without the right answers to both these questions, the right lessons will not be drawn.

It is important to note that Mexico was not the only developing country with a large current account deficit; nor was Mexico the only one receiving large inflows of liquid capital. For instance, Malaysia and Thailand have run large current account deficits without relying on liquid capital. Chile and Brazil, on the other hand, have received relatively large amounts of liquid capital without incurring large current account deficits (see Part One, chapter II).

However, as already discussed in detail in previous issues of *TDR*, the external financial position of Mexico was unsustainable because (a) the capital inflows that financed its deficits could not last; and (b) its external deficits showed no tendency to diminish through improved export capacity and competitiveness. The inflows included large amounts of *reversible* capital attracted by arbitrage opportunities arising from high interest rates and currency appreciations, and by capital gains due to speculative bubbles in equity prices, as well as *unsustainable*, one-off flows such as those due to global portfolio diversification and receipts from privatization, also attracted by prospects of capital gain.[2] On the other hand, much of the additional external savings was used to finance consumption and investment in non-tradeables, and relatively little for investment in tradeables needed to lower external deficits. Thus, Mexico differed from Brazil and Chile because it had large and rising deficits, and from the second-tier Asian NIEs because its capital inflows consisted of portfolio investment, rather than FDI, and its used additional resources for consumption rather than productive investment.

External financial imbalances emerged in Mexico because that country succeeded all too well in following the orthodox prescription for financial liberalization and adopted an easy, popular policy of relying on capital inflows for disinflation, using the nominal exchange rate as an anchor. Blind faith in these policies explains why there was so much complacency and inaction in Latin America and the international financial community throughout the early 1990s, when exchange rates were appreciating in real terms and trade and current account deficits growing rapidly. It was believed that capital flows would continue unabated because capital markets were responding rationally to improved economic fundamentals, that investment and productivity would eventually respond to supply-side incentives, and that export capacity would increase and deficits diminish.[3] Adherence to orthodox prescriptions continued even when there were clear signs from the financial markets that capital inflows, exchange rates and external deficits could not be sustained for long.

Such signs first emerged in February 1994, when the United States Federal Reserve Board started tightening monetary policy, prices of long-term bonds fell and long-term interest rates rose with the short-term rates. Both movements had a disproportionate impact on Latin American bond prices and interest rates. Simultaneously, there was a generalized increase in the Latin American country risks spread; the margins of long-term bonds over United States Treasury bills had already increased significantly before the outbreak of the crisis. More important, individual country risk spreads rose in accordance with external fragility: less for Chile and Colombia and more for Mexico and Argentina. The latter two countries also experienced substantial declines in stock prices in dollars, while the others continued to enjoy a boom.

Governments chose to raise interest rates and, in the case of Mexico, obtain foreign official support; special swaps agreements had been signed with the United States and Canada during 1993 and 1994. While capital inflows slowed down and even showed signs of reversal, trade and current account deficits continued growing in Argentina and Mexico throughout 1994. In Argentina, reserves stagnated in the first part of the year and declined afterwards, first moderately, before the Mexican crisis, and then more rapidly. In Mexico, reserves stood at $29 billion in February 1994; by 20 December, when Mexico finally decided to devalue and let the currency float, they were down to $6 billion. For the entire year the reserve losses amounted to $20 billion, while the current account showed a $30.6 billion deficit. Thus, net capital inflows in 1994 were about $10 billion, one-third of what Mexico had received in 1993.

The way the Mexican crisis evolved stands in sharp contrast to the orthodox view that balance of payments crises occur only as a result of fiscal imbalances. Indeed, this is not the first time that

Box 4

DISCUSSION IN VARIOUS ISSUES OF *TDR* OF CAPITAL FLOWS TO LATIN AMERICA

The *Trade and Development Report* has been looking closely at the surge in capital flows to Latin America ever since it began in 1990. *TDR 1991* made the following comments about the financial situation of Mexico:

> **Many observers now believe that ... the relief provided under the restructuring of Mexico's debt to banks ... helped to create a climate of greater confidence in the country's economy. This confidence, which is also associated with the prospect of a North American Free Trade Agreement with Canada and the United States, has been associated with relaxation of the pressures on Mexico's external payments. Such confidence reflects economic expectations which, as emphasized elsewhere in this Report, can be volatile (p. 49).**

It also warned that sharply increased financial inflows can bring problems as well as benefits. Regarding debt-creating flows or borrowing, it pointed out that:

> **Circumstances can arise that encourage short-term capital inflows, pushing up the exchange rate and hence encouraging further capital inflows. This often happens when domestic inflation and interest rates are much higher than abroad. ... As short-term inflows lead to real currency appreciation, domestic financial institutions find they can borrow abroad at much lower interest rates than they can lend at home. If the process is not checked, the real exchange rate can continue to rise until the deterioration of the trade balance leads to a loss of confidence, triggering capital outflow (p. 132).**

An analogous warning was made regarding equity investment by non-residents in the capital markets of developing countries:

> **This is expected to alleviate foreign exchange shortage and to improve the efficiency of financial markets in developing countries. Many developing countries ("newly emerging capital markets") have opened up their capital markets to non-residents, and some have encouraged their participation in the privatization of public assets. Such a policy has advantages, but is not risk-free. ... Since the return on investment to the foreign investor depends partly on the movement of the exchange rate, expectations of currency depreciation can trigger both a sharp decline in equity prices and an outflow of capital if the country suffers a serious shock (e.g. a terms of trade deterioration) that makes a devaluation appear inevitable; the capital outflow can multiply the problems of adjustment. Similarly, the mood in equity markets can exert a strong influence on the exchange rate - e.g. bullish expectations can cause capital inflows, leading to overvaluation (p. 134)**

The Report went on to draw attention to the need to control capital inflows:

> **Allowing domestic firms (whether private or public) uncontrolled access to international capital markets has proved damaging in many instances; short-term, speculative capital flows have proved extremely troublesome even for industrial countries. Most developing countries need to exercise considerable control over external capital flows and the pace of accumulation of external debt (p. 137).**

TDR 1992 again cautioned that the speculative character of much of the capital inflow leaves it susceptible to sudden reversal (p. 51). In a separate annex entitled "The nature and sustainability

Box 4 (concluded)

of recent capital flows to Latin America", it presented estimates to the effect that more than half of the inflow to Latin America was short- term:

> **Such inflows usually occur when there are nominal interest rate differentials that markets do not expect to be matched by a nominal exchange rate depreciation. ... Similarly, an expectation that a rise in equity prices will more than offset domestic currency depreciation can prompt an inflow of capital. Both types of expectations can be self-fulfilling, since the inflow of funds, if large enough, can itself maintain the value of the currency and boost equity prices. ... Initially such inflows are typically a response to a favourable shift in market sentiment regarding the recipient country. ... After the initial shift in market sentiment, bandwagon-type behaviour often develops and creates a speculative bubble whereby people lend or invest simply because everybody else is doing the same. Such booms often end not with a soft landing but with a sudden capital outflow, usually associated with expectations of a sharp depreciation of the currency, which may be difficult to check with even a very large positive real interest rate differential (p. 95).**

In *TDR 1993*, to the now almost routine cautioning as to the speculative or short-term nature of much of the capital inflow to Latin America was added a warning about the difficulties which reversal could cause for macroeconomic policy:

> **To the extent that the flows take volatile forms, the possibility of their reversal represents a threat to economic stability. The threat results from the vulnerability of the country's exchange rate and external financial position to such a reversal. If a worsening of the external accounts forces a depreciation of the currency, there is a risk of a further deterioration through financial outflows as arbitrage profits, dependent in part on a high exchange rate, are eliminated. In these circumstances the Government may find that it is losing its control over key economic variables such as exchange and interest rates, and may also be confronted with a devastating loss of international creditworthiness (p. 62).**

It went on to argue that such an outcome was probable unless steps were taken to avert it:

> **The particular configuration of exchange rates, interest rates and stock prices underlying the recent surge in capital flows cannot be expected to last. An important part of the arbitrage margins has been due to currency appreciations, particularly in Argentina and Mexico, which, if continued, would eventually lead to an external payments crisis as exports fall and trade deficits mount. If, on the other hand, the currency appreciation is suddenly reversed, the arbitrage margin will disappear, possibly triggering a sharp drop in short-term capital flows. Thus, the best strategy would be to let nominal exchange rates slide gradually while controlling short-term capital flows (p. 122).**
>
> **In Argentina and Mexico growth is more fragile, and there is a much more serious trade-off between stability and competitiveness. Currency appreciations, together with trade liberalization and high interest rates, are undermining investment and export performance, resulting in large trade and current account deficits which may not be sustained over the medium term. Even though autonomous capital flows have so far been more than enough to finance external deficits, these countries need to undertake an external adjustment through higher investment and exports. If the opportunities for an expansionary adjustment are not exploited, deflationary adjustment may eventually become unavoidable (p. 125).**

In both the countries cited, deflationary adjustment is now under way.

such a crisis has occurred in Latin America despite fiscal equilibrium. The so-called Southern Cone crisis of the late 1970s and early 1980s was attributed to "fiscal deficits" and "government intervention" even though Chile had a budget surplus and liberal trade and financial policies. In short, the right lessons were not drawn from the Southern Cone experience.

Instead of assessing the costs and benefits of financial openness, there is once again a tendency to seek *post hoc ergo propter hoc* explanations. On one view the crisis occurred because there was very little information and transparency about the nature and magnitude of capital inflows; but that itself was a natural accompaniment of the "hands-off" philosophy towards external capital flows. Equally, the argument that financial markets were misinformed about the state of the Mexican economy and consequently unduly optimistic about its prospects has very little credibility. It reflects a lack of understanding of how speculative bubbles build up and 'investors' can take very high risks in return for quick, windfall profits and capital gains. There are many such episodes in both the recent and the distant history of finance, including the experience of the United States and of Japan in the 1980s.

It has also been stated that Mexico should have tightened monetary policy and raised interest rates in 1994 when the peso came under pressure and reserves were drained, so as to persuade financial markets that Mexico remained committed to a medium-term economic strategy. Timely and pragmatic measures to discourage excessive inflows of liquid funds, and a realistic exchange rate policy, rather than adjustments in macroeconomic policy designed to accommodate and prolong the surge, would have been the only sensible policy. A policy of high interest rates would have helped to stem the attack by deepening the imbalances and hence postponing the crisis, only for it to come back with greater force; for the underlying fundamentals were wrong and the external financial position was not sustainable.[4]

The crisis is also blamed on lack of transparency in macroeconomic policy, particularly in respect of the state of public finances and the pace of monetary expansion. But it is not clear how greater transparency would have averted the building up of imbalances and the outbreak of the crisis. Indeed, since the early 1990s, capital kept on flowing into countries that had much larger macroeconomic imbalances than Mexico. Brazil received large sums in the course of 1993-1994 despite its very high inflation, sluggish growth, large public deficits and rapid monetary expansion. The mounting external deficits in Mexico were not due to expansionary macroeconomic policy but, rather, to premature and rapid trade and financial liberalization and the use of the exchange rate for quick disinflation which, via reduced tariffs and appreciation, resulted in a surge of cheap imports ahead of the establishment of a sound export base. These policies were also popular because they allowed private consumption to expand. As the president of one of the top business associations is reported to have remarked, the crisis occurred because of "the 'excessively rapid' opening of the economy to external competition; the equally 'excessive' reliance on short-term, speculative capital; an also 'excessive' overvaluation of the peso; electoral considerations which led to the avoidance of opportune decisions."[5]

C. Stabilization, adjustment and macroeconomic fragility

The experience of Latin America in the past decade shows that sustainable external and fiscal positions are the most important conditions for durable macroeconomic stability and growth. Most stabilization efforts during the debt crisis were frustrated because Governments were unable to bring a lasting solution to external or fiscal imbalances or both. Although Bolivia's and Chile's stabilization programmes implemented in the 1980s succeeded and endured, these were exceptions. In most cases stability lasted for only short periods because fiscal and external adjustment relied too heavily on cuts in government spending and imports and not enough on increasing tax revenues

and exports. On the other hand, the inability to overcome the balance of payments constraint on growth often restricted the scope for fiscal adjustment and the preservation of price stability. As discussed in *TDR 1993*, the situation changed drastically in the early 1990s with the fall in international interest rates and massive capital inflows. While this allowed both external and fiscal constraints to be overcome, it also led to a build-up of large current account imbalances.

1. Capital flows, exchange rates and external imbalances

With the removal of the external constraint, the destabilizing feedbacks prevailing in the 1980s disappeared, and a virtuous circle of stability and growth emerged. Greatly increased availability of foreign currency allowed domestic absorption to expand rapidly. Indeed, the reversal of capital inflows was so abrupt and significant that many countries faced an over-abundant supply of foreign exchange, even though trade deficits widened rapidly; during 1991-1993 net capital flows to Latin America amounted to $166 billion (see table 17), while current account deficits totalled just under $100 billion. Consequently, the region as a whole accumulated international reserves and most countries appreciated their currencies. This made a major contribution to price stability both by providing an anchor to expectations and by keeping down costs and prices. Falling inflation, together with rising prices of assets, added to consumer wealth, thereby raising aggregate demand and activity.

The upturn was particularly marked in Argentina and (after 1992) in Peru. Mexico almost doubled its growth rate from 1985-1990 to 1991-1993, but the rate was still only 3 per cent in 1994 (table 17). More important, inflation slowed down everywhere, most notably in Argentina, Peru, Mexico and (after July 1994) Brazil; in Chile and Colombia this result was achieved despite continued indexation. In the former group of countries stabilization and disinflation were achieved through the instrument of the exchange rate. In Chile and Colombia, inflation had already been moderated before the surge of capital inflows, but the currency appreciation associated with these flows contributed to lowering inflation still further in the 1990s.

The dependence on capital inflows and currency appreciation has varied considerably as has the impact of this process on external imbalances. As discussed in previous issues of *TDR*, only Chile tried consistently to discourage short-term capital flows, although some others (e.g. Brazil and Colombia) also occasionally introduced measures to slow them down. During 1991-1993 Mexico received 45 per cent of net capital flows to Latin America, Argentina 18 per cent, Brazil 12 per cent, and Chile and Peru about 5 per cent each: these five countries thus accounted for 85 per cent of the total (table 17). Over the same period, foreign exchange brought in by capital flows amounted to as much as two thirds of total export earnings in Peru and Mexico and over 50 per cent in Argentina; in the other countries, they generally did not exceed 20 per cent. In 1994 the net capital flow to the region as a whole dropped, largely on account of smaller flows to Argentina and Mexico and a large outflow from Venezuela, but Brazil and Colombia both had increases of almost 50 per cent (see Part One, chapter II).

Currency appreciation has been typical of the region throughout the 1990s, although there were important differences among countries (table 18). Mexico and Argentina have had the largest appreciations. In Mexico, there was a major appreciation in 1988, one year after the stabilization programme was launched, and the peso continued to appreciate in real terms, first more slowly (until 1990) and subsequently faster. In Argentina, the currency had already appreciated in real terms before its parity was fixed against the dollar under the April 1991 Convertibility Plan. Chile and Colombia entered the 1990s with relatively competitive exchange rates; both currencies have since appreciated less than the others, but in Colombia appreciation accelerated in 1994, and Chile had to revalue by 10 per cent only a few weeks before the Mexican crisis.

In Brazil, there was a large appreciation in 1990 as a consequence of the Collor Plan for stabilization. Subsequently, the real exchange rate fell until 1993. Currency reform under the *Real* Plan in July 1994 fixed the nominal exchange rate for the new currency at parity with the dollar, supporting it with very high interest rates. This led to a nominal appreciation of about 15 per cent (with the *real* rising to about 83 centavos to a dollar) and, as prices continued to rise by 2-3 per cent per month, a real appreciation of the currency by one third in the second half of the year.

Table 17

KEY LATIN AMERICAN ECONOMIC INDICATORS, 1985-1994

Country	Real GDP growth (Per cent per annum)			Inflation[a] (Per cent per annum)			Net capital inflow ($ billion)		Trade balance ($ billion)		Exports (Annual percentage growth)[b]		Imports (Annual percentage growth)[b]		Current account balance[c]	
	1985-1990	1991-1993	1994	1985-1990	1991-1993	1994	1991-1993[d]	1994	1991-1993[d]	1994	1985-1990	1990-1994	1985-1990	1990-1994	1990	1994
Colombia	4.8	3.4	5.0	25	24	23	1.9	3.1	2.5	-2.2	14.2	6.0	6.8	21.4	6.4	-24.9
Chile	6.2	7.0	4.5	19	15	9	7.7	3.1	0.4	0.6	16.9	8.5	19.2	11.5	-7.2	-4.4
Mexico	1.4	2.3	3.0	70	13	7	75.0	10.5	-63.2	-23.6	4.4	6.2	18.8	16.6	-21.9	-61.2
Argentina	0.3	7.9	7.0	583	33	4	29.4	10.2	-8.1	-6.0	8.0	5.3	1.2	51.1	30.8	-57.7
Brazil	2.0	1.6	4.5	654	1090	55[e]	19.4	13.1	39.9	11.3	4.1	8.4	9.4	11.6	11.0	-6.4
Peru	-2.1	-2.3	11.0	824	79	18	7.5	5.9	-1.3	-1.3	1.6	7.1	9.9	17.4	-27.4	-54.3
Total Latin America	**1.9**	**3.3**	**3.7**	.	.	.	**165.9**	**47.3**	**-16.3**	**-19.2**	**5.8**	**5.8**	**10.2**	**16.0**	**-2.4**	**-25.6**

Source: UNCTAD secretariat calculations, based on data in ECLAC, *Statistical Yearbook for Latin America and the Caribbean, 1994 Edition* (United Nations publication, Sales No. E/S.95.II.G.1).

a Consumer price index.

b Derived from values (f. o. b.) in current prices.

c Percentage of exports of goods and services.

d Cumulative.

e Annualized rate for July - December.

Table 18

EXCHANGE RATES IN MAJOR LATIN AMERICAN COUNTRIES, 1986-1994

(Index numbers, 1990 = 100)

Country	*1986-1990*[a]	*1991*	*1992*	*1993*	*1994*	*1994*[b]
			Real exchange rate[c]			
Colombia	90.6	101.5	91.6	87.8	76.0	83.9
Chile	105.0	97.9	90.9	91.4	88.2	84.0
Mexico	117.9	90.5	83.4	78.7	81.8	69.4
Argentina	118.4	64.9	57.7	54.9	53.4	45.1
Brazil	132.2	115.7	126.6	126.3	103.2	78.1
			Real effective exchange rate[d]			
Colombia	87.5	101.0	89.5	83.3	76.3	87.2
Chile	96.6	98.9	94.8	96.1	95.0	98.3
Mexico	115.8	91.1	83.8	78.8	80.3	69.3
Argentina	119.1	83.3	77.5	74.4	76.3	64.1
Brazil	133.8	118.5	126.5	111.3	96.2	71.9

Source: R. Frenkel, "Macroeconomic sustainability and development prospects: The Latin American performance in the 1990s" (forthcoming *UNCTAD Discussion Paper)*.

a Annual average.

b 1986-1990=100.

c Domestic currency per dollar, adjusted for changes in United States wholesale prices and deflated by the consumer price index.

d Domestic currency per unit of foreign currency (weighted by the geographical distribution of exports).

The patterns of capital inflows and currency appreciations are also fully reflected in current account and trade balances. In the three countries with the fastest appreciations (Argentina, Mexico and Peru) current account deficits rose rapidly after 1990; in the first two countries, the deficits continued to rise in 1994 when capital inflows fell and reserves were drained. In Chile and Colombia the deficits were moderate, whereas in Brazil the current account was more or less in balance in 1994. Brazil had a cumulative trade surplus of about $40 billion during 1991-1993, and another $11 billion in 1994, despite the import boom in the second half of the year. The cumulative trade deficits of Mexico and Argentina together exceeded $100 billion over 1991-1994. For Latin America as a whole the trade balance swung from a surplus of $27 billion in 1990 to a deficit of about $19 billion in 1994; excluding Brazil, the swing was from a surplus of about $19 billion to a deficit of $30 billion.

The deterioration of current account and trade balances has been due to an unprecedented import boom. During 1991-1994, for the region as a whole, exports rose in value at an annual rate of 6 per cent, while imports rose annually by 16 per cent. While there was little change in export performance, the annual average growth rate of imports during that period exceeded that of the second half of the 1980s by more than one half. One of the few countries that had a tangible improvement in export earnings during the 1990s was Brazil. Import growth was also moderate in that country, reflecting the influence of a relatively stable real exchange rate and gradual trade liberalization. In Chile, too, where trade had already been liberalized in the 1970s, trade performance was somewhat better than the regional average. In Colombia, where the currency appreciated moderately, the import surge was mainly due to liberalization. Sharp increases in the prices of copper (19 per cent) and coffee (94 per cent) in 1994 made an impor-

tant contribution to the rapid expansion of export earnings in Chile and Colombia, respectively. Mexico had already started the decade with a large trade deficit due to liberalization; export growth subsequently accelerated a little but the trade deficit continued to widen as imports were sustained by capital inflows and currency appreciation. In Argentina, where trade had been liberalized in a 'big bang' during the Convertibility Plan, the initial large trade surplus disappeared rapidly, as imports surged and export growth was halved.

These developments are all reflected in a sharp increase in the external fragility of the region, as measured by the ratio of current account deficits to exports of goods and services. Relating the deficits to exports, rather than to GDP, provides a better indicator, because such a ratio is not influenced by exchange rates and domestic relative prices. It shows how much exports would need to rise in order to close the external gap, should there be a halt to net capital inflows. For Latin America as a whole, an increase of 2.5 per cent in exports would have been sufficient to close this gap in 1990; by 1994, this figure had risen to around 25 per cent. Clearly, vulnerability to reversal of capital flows was much greater in Argentina, Mexico and Peru, where the corresponding figure for 1994 was above 50 per cent.

2. Productivity and competitiveness

An important objective of structural adjustment reforms was to boost efficiency and productivity in tradeable goods sectors. It was expected that faster productivity growth, as well as lower tariffs and taxes, would offset the adverse effects on competitiveness of any appreciation of the currency that might occur as a result of capital inflows, and that with increased competitiveness exports would become the driving force of the economy. Labour productivity did increase considerably in Mexico and Argentina, but not enough to offset the currency appreciation. Moreover, productivity growth has generally been associated with labour shedding, cost cutting and downsizing, rather than expansion.

Table 19 compares the trend of productivity, employment and competitiveness in Mexico and Argentina since the years preceding the pegging of the nominal exchange rate (1988 in Mexico and 1991 in Argentina). The first two columns of the table show the evolution of real per capita GDP and of wages (in constant dollars) in manufacturing. Although inflation was on a downward trend in both countries after the exchange rate was pegged, it remained higher than in the United States. As depreciation of the nominal exchange rate was kept low (zero in Argentina), the real exchange rate tended to appreciate. Although nominal wages lagged behind consumer prices in Argentina - i.e. real wages fell somewhat - they rose significantly in dollar terms. In Mexico nominal wages grew even faster than consumer prices, and dollar wages rose faster than the real exchange rate.

Since the wage index is a proxy for the movement of the prices of non-tradeables, these trends implied a considerable shift in relative prices in favour of non-tradeable goods and services. The table shows that real dollar wages in manufacturing increased in both countries substantially more than productivity measured by real per capita GDP, thus leading to a deterioration in international competitiveness.

Table 19 also shows to what extent the increases in dollar wages in manufacturing were offset by increased productivity. In Mexico, labour productivity in manufacturing rose by 35 per cent from 1987 to 1993, while employment contracted by about 8 per cent. Argentina had the same decline in manufacturing employment, and a slightly larger rise in labour productivity (about 37 per cent); thus, the annual productivity growth was 5 per cent in Mexico (since 1987) and 11 per cent in Argentina (since 1990). However, it was insufficient to compensate for the rise in labour costs in dollar terms due to currency appreciations; unit labour costs in constant dollars rose in both countries, very much more in Mexico than in Argentina.

Trade liberalization and tariff reductions, together with currency appreciation, forced manufacturing firms to seek ways of improving productivity in order to survive. However, the improvements made have not been through increased investment and capacity creation (see section D below). In Argentina, where investment in machinery and equipment and industrial structures was weak, labour shedding was twice as fast as in Mexico, and manufacturing employment fell by 2.8 per cent per annum. Manufacturing output nevertheless rose, thanks to the existence of considerable underutilized capacity; manufacturing output in 1990 was some 13 per cent below the 1980 level,

Table 19

PRODUCTIVITY, EMPLOYMENT AND COMPETITIVENESS IN MANUFACTURING IN MEXICO AND ARGENTINA

(Index numbers)

Year	Real GDP per capita	Real wages[a]	Employment	Labour productivity	Competitiveness[b]
			Mexico		
			(1987=100)		
1988	99.2	123.8	100.0	103.2	119.9
1989	100.6	142.2	102.1	108.3	131.3
1990	103.0	156.8	102.2	114.9	136.5
1991	104.7	189.2	100.5	121.5	155.7
1992	105.4	232.1	96.6	129.3	179.5
1993	103.9	266.5	91.8	135.0	197.4
			Argentina		
			(1990=100)		
1991	107.1	121.5	95.5	117.2	103.7
1992	114.5	138.1	94.6	127.0	108.7
1993	119.4	147.0	91.7	136.9	107.4

Source: As for table 18

a Average dollar earnings in manufacturing, deflated by the United States index of wholesale prices

b Unit labour costs, in terms of dollars at constant prices.

and despite the impressive performance thereafter, in 1993 output was still only 10 per cent higher than in 1980. Better capacity utilization itself raised productivity: the biggest increase in productivity was in 1991 (over 17 per cent), when manufacturing output rose by almost 12 per cent; subsequently, the rate of productivity growth was halved and continued to fall throughout 1993 as the pace of expansion of manufacturing output declined, first to 7 per cent and then to 4.5 per cent. The performance of manufacturing exports was not impressive: while output in the sector increased by almost 7 per cent per annum during 1990-1993, manufacturing exports (at current prices) rose by 5.5 per cent. Indeed in some key areas, such as the car industry, output growth was due almost entirely to increased domestic demand, and higher productivity resulted from greater utilization of capacity, rather than "efficiency gains" brought about by exports.

In Mexico, by contrast, where loss of competitiveness was greater, and productivity growth slower and steadier, manufacturing exports rose by over 25 per cent per annum during 1987-1993, compared to an increase in manufacturing output of less than 4 per cent per annum. This disparity between output and export performance appears to be due to a general import desubstitution which held back manufacturing output as a whole, coexisting with increased exports from a small number of sectors, particularly the automotive industry and sectors assembling parts and components, such as electrical machinery and electronic equipment. However, export success in these areas reflected

the heavy investment made before the 1990s, rather than "efficiency gains" from policy changes.[6]

3. Fiscal adjustment and fragility

The 1990s have seen serious efforts by a number of Latin American countries, especially Argentina, to reduce budget deficits through radical tax reforms. Indeed, with the exception of Brazil, in all the major economies the government budget has been in balance or surplus in recent years; and even Brazil, which had very high inflation in most of the period, had an operational non-financial public sector deficit (i.e. a deficit excluding the nominal part of interest payments) only in 1992. Nevertheless, the removal of the external constraint has also made a major contribution to fiscal consolidation in a number ways, particularly in Mexico and Argentina. Both countries had started the decade with relatively high fiscal deficits; their subsequent fiscal adjustment occurred simultaneously with the surge in capital inflows and deterioration in external balances.

Chile and Colombia, by contrast, had already attained fiscal equilibrium before the turn of the decade, and their fiscal balances have been much less influenced by capital flows. In both countries fiscal deficits diminished throughout the second half of the 1980s, in large part due to higher revenues from their traditional exports (copper in Chile and coffee and oil in Colombia). In Colombia tax revenues also rose thanks to the introduction of a value added tax (VAT). In the 1990s fiscal consolidation continued in Colombia, where the tax base was broadened, while in Chile the newly elected Government responded to the social pressures accumulated during the earlier military regime by raising new revenues to finance additional spending, rather than resorting to deficit financing. In Chile public investment was raised in the 1980s while deficits were reduced. In Colombia there was a fall in public investment, but this was due to the completion of large infrastructure and energy projects initiated in the late 1970s. Unlike Chile and most other countries in the region, privatization has played virtually no role in the Colombian fiscal adjustment. There were increased pressures to generate a large fiscal surplus when, by pushing up interest rates, sterilization became self-defeating, but the authorities preferred to regulate capital inflows instead.

Both Mexico and Argentina leaned heavily on public investment in order to cut budget deficits: during 1988-1992 public investment averaged 4.7 per cent of GDP in Mexico and 4.1 per cent in Argentina (2.2 per cent in 1992), about half the levels of the early 1980s.[7] On the other hand, both countries have engaged in extensive privatization. In Mexico revenues from the sale of public assets reached about 3 per cent of GDP in 1991 and 1992, and were used primarily to reduce the stock of debt rather than to finance deficits. In Argentina, by contrast, they were used primarily to finance current expenditure: during 1990-1993 revenues from privatization reached $11 billion; they accounted for the entire primary budget surplus in 1991 and more than one half in 1992. Furthermore, in both countries an important part of the decline in the public sector borrowing requirement (PSBR) has been due to reduced interest payments, both at home and abroad. In Mexico, domestic interest payments fell from 13.3 per cent of GDP in 1988 to 3.4 per cent in 1991 and external payments from 3.6 per cent to 2.0 per cent.[8] In Argentina, declines in interest payments abroad were more important, although the liquidation of an important part of the domestic debt during the high inflation years was also helpful.

A number of factors contributed to reduced debt servicing. First, the Brady agreements provided some relief on external debt; Mexico's internal debt was also reduced by privatization proceeds, from 29 per cent of GDP in 1988 to 21 per cent in 1993.[9] Second, lower dollar interest rates also made an important contribution. Third, in contrast to the 1980s, when currency depreciations contributed much to "macroeconomic disorder" by enlarging the budget deficits,[10] appreciations reduced the real domestic currency value of foreign debt servicing. Finally, rapidly reduced inflation resulted in a sharp reduction in interest rates and financial deficits, particular in Mexico. Disinflation also helped fiscal adjustment by raising the real value of tax revenues, particularly in Argentina, where in a climate of rapid inflation lags in collection had constantly reduced the purchasing power of the revenues.

Even allowing for the decline in the stock of debt, Mexico, on the eve of the financial crisis, was fiscally much more vulnerable to devaluations, an acceleration of inflation and interest rate hikes than Colombia and Chile. Argentina's fiscal position was also fragile: the maintenance of the peso's parity with the dollar would have required con-

siderable deflation of the economy, which would have reduced tax revenues quite significantly.

Brazil inherited a large fiscal deficit from the 1980s due to populist policies and inconsistencies between external and fiscal adjustment. Attempts to sterilize capital flows added further to budget deficits in the early 1990s.[11] Thus, until mid-1994, in spite of a very different macroeconomic situation, capital inflows posed the same kind of problems for fiscal and monetary policies in Brazil as in Chile and Colombia. The *Real* Plan introduced tax reforms which, together with the fall in inflation and the recovery of activity, brought about important increases in revenue. Even so, the fiscal position remains fragile and further reforms are needed.

D. Capital flows, savings and investment

The coincidence of a consolidation of fiscal balances with worsening external balances implied an increased gap between private savings and private investment. According to the so-called Lawson doctrine, a current account deficit generated by private sector borrowing is not a matter for concern. This may indeed be so when the borrowing is used to finance investment. However, in Latin America, the increase in capital flows has been used for private consumption. For that reason - and contrary to expectations underlying the structural reforms - reducing the size of the public sector and eliminating budget deficits failed to "crowd in" private investment.

On the basis of IMF data for a sample of Latin American countries, it can be estimated that the contribution of the external sector to capital accumulation was negative during the second half of the 1980s when these countries were virtually cut off from international capital markets (see table 20). During 1990-1992 it was positive. Comparing the averages for these two periods, there was an increase in external savings amounting to 3 per cent of GDP (for the six countries in the sample), but gross domestic investment fell by 0.6 percentage points of GDP. Thus, the decline in domestic savings was so steep that the increase in net capital inflows was not enough to maintain the investment rate.[12] Indeed, as the data on savings in table 21 show, in Latin America average savings as a proportion of GDP declined from 23.5 per cent to 19.3 per cent between 1983/90 and 1991/93 while investment stagnated. This stands in sharp contrast with the experience of East Asian NIEs, which had exactly the same swing in capital inflows between the two periods. In the seven economies distinguished in table 20, external savings increased by 3 per cent of GDP while investment rose by 4 percentage points. In other words, as can also be seen from table 21, in Asia the increase in capital inflows has been associated with an increase, not a decrease, in domestic savings.

The contrast in investment performance between Asia and Latin America is also reflected in the differences in the types of capital inflow. As can be seen from table 21, during 1991-1993 close to 70 per cent of the total capital flow to Asian NIEs was in the form of FDI, a proportion which was twice as high as for Latin America. Furthermore, much of the flow of FDI to the latter region involved the purchase of existing assets through privatization and debt-equity swaps, rather than investment in new capacity.

There were also important differences among the Latin American countries with respect to the relationship between capital inflows and investment (see table 20). In Chile there was a relatively steep increase in the investment ratio in 1990-1992, compared with 1984-1989, though the swing was smaller than for the capital account, only half of the increase in capital inflows being translated into new investment. At the other end of the spectrum were Peru and Argentina, where investment fell by 3 per cent of GDP despite sharp increases in net capital inflows. In Mexico, there was some increase in investment, but the swing was far smaller than in the capital account: more than three quar-

Table 20

INFLOW OF FOREIGN CAPITAL AND GROSS DOMESTIC INVESTMENT IN SELECTED LATIN AMERICAN COUNTRIES AND ASIAN DEVELOPING COUNTRIES, 1984-1989 AND 1990-1992

(Percentage of GDP)

Region/country	Capital account balance[a] 1984-1989 (1)	Capital account balance[a] 1990-1992 (2)	Increase (2)-(1) = (3)	Gross domestic investment 1984-1989 (4)	Gross domestic investment 1990-1992 (5)	Increase (5)-(4) = (6)
Latin America						
Colombia	2.0	1.0	-1.0	19.7	17.7	-2.0
Chile	-1.7	5.9	7.6	16.0	20.1	4.1
Peru	-5.3	-0.3	5.0	19.4	16.4	-3.0
Argentina	-1.6	2.2	3.8	18.1	15.1	-3.0
Mexico	-0.4	6.2	6.6	20.1	21.7	1.6
Brazil	-2.3	-0.3	2.0	17.2	15.8	-1.4
Average of 6 countries	*-1.6*	*1.4*	*3.0*	*18.4*	*17.8*	*-0.6*
Asia						
Indonesia	2.2	5.0	2.8	23.8	25.4	1.6
Republic of Korea	-2.0	1.3	3.3	28.9	36.3	7.4
Malaysia	-0.4	8.7	9.1	26.0	32.8	6.8
Philippines	-3.8	1.9	5.7	18.3	20.8	2.5
Singapore	5.0	3.3	1.7	38.9	39.0	0.9
Taiwan province of China	0.1	-4.9	-5.0	19.3	22.7	3.4
Thailand	4.2	11.0	6.8	21.8	28.2	6.4
Average of 7 countries	*0.8*	*3.8*	*3.0*	*25.3*	*29.3*	*4.0*

Source: UNCTAD secretariat calculations, based on data of IMF, and G.A Calvo, "The management of capital flows: domestic policy and international cooperation", *International Monetary and Financial Issues for the 1990s,* Vol. IV - *The International Monetary and Financial System: Developing Country Perspectives* (UNCTAD/GID/G24/4), New York, 1994.

a Including errors and omissions.

ters of the increased net capital inflows went into consumption. Despite the increase in external savings, Brazil also experienced declines in investment, during a deep and prolonged recession in the early 1990s.

An analysis of the contributions of various components of demand to GDP growth also shows that demand growth in Latin America in the 1990s has been driven by private consumption, rather than investment and exports (see table 22). In none of the 5 countries did the contribution of investment spending to GDP growth exceed that of private consumption. In Argentina and Mexico, for instance, increased consumption spending added twice as much to demand growth as gross investment.

Increased private consumption was an important feature of rapid stabilization programmes based on currency appreciation, and it is not surprising to find that consumption rose most where stabilization was most rapid (i.e. in Argentina). The relationship, which was also evident during the "cruzado" and "austral" episodes in Brazil and Argentina in the mid-1980s, respectively, and, more recently, in the course of Brazil's *Real* Plan, stems from the instantaneous elimination of the inflation tax and remonetization of the economy. The surge in imports stemmed partly from the growth of de-

Table 21

COMPARATIVE SAVINGS, INVESTMENT AND FDI IN ASIAN NIEs AND LATIN AMERICA[a]

	1975-1982	*1983-1990*	*1991-1993*
Savings (per cent of GDP)			
Asia	28.1	30.8	33.1
Latin America	22.9	23.5	19.3
Gross investment (per cent of GDP)			
Asia	28.1	29.3	34.6
Latin America	23.5	19.8	20.0
Net flow of FDI ($ billion per annum)			
Asia[b]	2.1	8.3	37.9[c]
Latin America	4.4	5.9	16.5[c]
Net FDI as a percentage of total capital inflows			
Asia[b]	16.7	50.6	69.0[c]
Latin America	19.8	98.0	34.9[c]

Source: UNCTAD secretariat calculations, based on P Turner, "Capital flows in Latin America: A new phase", *BIS Economic Papers,* No. 44, May 1995, tables1, 4-6.

a Data relate to 10 countries in Latin America (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela) and 7 countries in Asia (Hong Kong, Indonesia, Malaysia, Republic of Korea, Singapore, Taiwan province of China and Thailand).

b Excluding Hong Kong

c 1991-1994.

mand. However, it was mostly due to the combined impact of currency appreciations and tariff reductions, particularly in Argentina and Mexico, where net exports made a large negative contribution to growth (see table 22).

Output cannot, of course, be sustained only on the basis of consumption; capacity, too, needs to be enlarged, if output is to continue expanding. The ratios in table 23 of gross fixed investment to GDP at constant prices provide an indication of the annual additions to capital stock. They reflect not only the proportion of current GDP spent on capital accumulation, but also changes in prices of capital goods relative to those of goods and services that comprise GDP; it is these relative prices which determine the extent to which investment spending adds to productive capacity. Since the import content of investment is generally high in developing countries, the relative prices of capital goods are greatly influenced by changes in the real exchange rate and in tariffs. Because of such changes, these relative prices showed a rising trend in the 1980s and a declining one thereafter. In the 1990s the fall has been especially marked in Colombia, Argentina and Mexico, and has thus served to increase the amount of real investment that can be financed by a given amount of savings, thereby offsetting part of the decline in the share of GDP spent on capital goods.[13] However, despite the decline in the relative prices of capital goods, real investment rates in the 1990s have been unimpressive. In Colombia and Chile they are back to their historical levels. In Mexico, Argentina and Brazil, they are not much higher than in the 1980s, when savings were drained by debt service abroad.

Not all components of investment have behaved in this average fashion. In 1992, for seven Latin American countries taken together, GDP was 21 per cent higher than in 1981 (the previous peak), but total investment was still 8.2 per cent lower. However, investment in residential construction was 27.4 per cent higher, while in machinery and

Table 22

COMPONENTS OF GDP GROWTH FROM 1991 TO 1993 IN MAJOR LATIN AMERICAN COUNTRIES

(Percentage volume change)[a]

Country	Consumption		Gross fixed investment	Net exports	GDP
	Private	Government			
Colombia	1.7	1.0	1.6	-0.9	3.4
Chile	3.2	0.4	2.3	1.1	7.0
Argentina	7.3[b]	..	3.8	-3.2	7.9
Mexico	2.2	0.3	1.2	-1 4	2.3
Brazil	1.0[b]	..	0.0	0.6	1.6

Source: As for table 17
a Annual average
b Including government consumption

equipment it was 10.6 per cent lower and in non-residential construction 24.2 per cent lower (see table 24). Furthermore, national accounts data show that investment in infrastructure was even weaker than non-residential construction as a whole. In short, the recovery of investment in the early 1990s was primarily in residential construction - something that does not add to the capacity to produce tradeable goods.

For the same group of countries the share of net investment in GDP dropped from 11.5 per cent in 1980 to a mere 4.6 per cent in 1992, without taking into account the additional depreciation of the capital stock in the tradeables sector, particularly of machinery and equipment, caused by trade liberalization.[14] Similarly, net investment in machinery and equipment declined from 2.6 per cent of GDP in 1980 to 0.4 per cent in 1992, and the corresponding figures for non-residential construction show a fall from 5.8 per cent to a mere 1.7 per cent. On the other hand, net investment in residential construction as a proportion of GDP remained much the same.

Up to 1992 Argentina registered the smallest investment ratio among the countries for which data are available: most of the recovery in investment in the early 1990s has been accounted for by recently privatized enterprises, which are mostly in services and other non-tradeables sectors; yet by 1992 net investment was negative or close to zero for all three investment components. Mexico's net investment, which reached a peak of 11.9 per cent of GDP in 1980, fell throughout most of the 1980s, to 3.2 per cent in 1987; it then began to recover, reaching 6.2 per cent in 1992; however, in that year most of it was in residential construction, with net investment in machinery and equipment absorbing only 2 per cent of GDP, and no net investment in non-residential construction. In Brazil, net investment reached 16.4 per cent of GDP in 1975 (about double the level of most other countries in the region, and about one third higher than in Mexico), falling to a mere 4.3 per cent in 1992. The fall was particularly steep for machinery and equipment (from 4.3 per cent of GDP to -1 per cent) and in non-residential construction, where there was a decline of similar size; however, the decline in residential construction was much more moderate. By contrast, in Chile the recovery of investment after the debt crisis was led by machinery and equipment, followed by non-residential and finally residential construction; after falling from 4.8 per cent of GDP to 0.6 per cent from 1980 to 1983, total net investment increased to 6.4 per cent in 1992.

A combination of strong recovery in residential investment and continued weak investment in machinery, equipment and infrastructure is not a recipe for making domestically financed private investment in tradeable goods and services the new engine of growth in Latin America. But this com-

Table 23

INVESTMENT RATIOS IN MAJOR LATIN AMERICAN COUNTRIES, 1970-1993

(Percentage of GDP at constant 1980 prices)

Country	1970	1980	1982	1985	1989	1990	1991	1992	1993
Colombia	19.8	19.1	22.0	16.7	15.6	14.9	13.3	17.9	21.7
Chile	17 8	21.0	12.6	13.9	20.0	18.8	17.4	19.5	20.8
Mexico	22.2	27.2	21.8	18.3	17.8	18.9	19.6	21.8	21.0
Argentina	23.8	25.1	19.2	16.0	14.8	13.3	15.3	18.5	19.8
Brazil	20.7	23.3	19.1	18.3	16.0	14.9	14.4	13.2	13.9

Source: As for table 18.

bination was no accident; it was the result of the policies adopted. The same factors that attracted liquid capital - namely currency appreciations, high interest rates, and cheap privatization - also deterred long-term investment, particularly in traded goods sectors.

Another important impediment to investment has been growing uncertainty in the economic environment, a legacy of the debt crisis of the 1980s, which generated an extended period of macroeconomic instability, causing lasting mutations at the microeconomic level that were prejudicial to investment and growth. Price signals became confusing because of rapid inflation and fluctuations in its rate, and because some key relative prices, in particular the real exchange rate and real wages, underwent large and abrupt swings. More-over, economic activity as a whole also fluctuated widely, as a result of external and policy shocks. These factors also led to frequent and abrupt changes in the liquidity and financial position of firms and households; especially important were the transfers of wealth induced by unexpected maxi-devaluations and accelerating rates of inflation.

The policies pursued after the debt crisis succeeded in reducing inflation, but have themselves undermined long-term investment by creating conditions that favoured investing funds in liquid financial assets rather than in physical assets for the productive sector. Sharp swings in interest rates and asset prices have not only opened up large profit opportunities from buying and selling existing assets, but have also shortened the planning horizon of enterprises, particularly in traded goods, by creating uncertainties over the long-term movement of relative prices that determine the return on investment, particularly the real interest rate and the real exchange rate; the preference for liquid assets and the advantages of keeping investment "options" open have thus increased substantially. In other words, short-term profit opportunities on financial operations, together with the increased riskiness associated with future cash flows, have seriously depressed investment in long-term, illiquid assets in manufacturing, including both machinery and equipment and business structures.[15] By contrast, investment in residential construction, which carries much greater liquidity because there are well organized real estate markets, has increased rapidly due to a speculative boom, facilitated also by easier access to credit.

Finally, the public sector has, in general, been investing very little in the infrastructure needed to develop the new tradeable activities required by the new structure of comparative advantages. As also noted by the World Bank, investment in infrastructure was seriously neglected during most of the 1980s and has continued to be neglected. It has estimated that Latin America will need annual investment in infrastructure in the next five years of about 4 per cent of GDP.[16] In Brazil and Argentina, such investment is only half this size, including privately financed investment.[17] All this obviously does not augur well for the long-term economic performance of Latin America.[18]

Table 24

REAL GDP AND GROSS FIXED INVESTMENT IN LATIN AMERICA[a], 1985-1992

(Index numbers, 1981 = 100)[b]

	1985	1989	1990	1991	1992
GDP	103.9	114.2	114.8	118.4	121.2
Investment in:					
Machinery and equipment	67.4	74.4	76.2	82.1	89.4
Non-residential construction	77.3	81.9	76.0	73.7	75.8
Residential construction	94.3	105.4	108.5	116.2	127.4

Source: A. Hofman, "Capital stock estimates in Latin America", *Cambridge Journal of Economics* (forthcoming issue).
a Argentina, Brazil, Chile, Colombia, Ecuador, Mexico and Venezuela.
b Derived from data in constant 1980 prices.

E. Prospects

The preceding discussion shows that the consequences of the sharp reversal in capital flows and the emergence of the external constraint on macroeconomic stability vary widely among countries of the region. The three largest economies, accounting for almost three quarters of regional output, all face serious adjustment problems. Nevertheless, the type of adjustment needed, the trade-offs faced and the policy options are not always identical.

Both Argentina and Mexico have had to embark on a sizeable external adjustment process: the question is whether they can succeed without rekindling inflation or going into a deep and prolonged recession. Sharp currency devaluation in Mexico facilitates balance of payments adjustment, but endangers price stability. By contrast, the main question for Argentina is how much unemployment will be needed to improve competitiveness, given that it has excluded the possibility of using what is normally the most potent instrument of policy to that end, namely the exchange rate, and whether such a level of unemployment will be politically acceptable.

The immediate problem in the aftermath of the December 1994 devaluation in Mexico was how to stabilize the country's reserves and the peso. Thanks to an unprecedented international rescue package and the monetary measures taken, these objectives have been accomplished, with the peso falling to less than half its previous value. The fact that stock prices, yields on government debt and the exchange rate of the peso have been stabilized, and the emergence of a trade surplus in the first quarter of 1995, have caused official circles, in Mexico and abroad, to regard the crisis as virtually over. However, current projections for 1995 are for a decline in output of around 5 per cent; this is greater than the decline that followed the debt crisis in 1982. Although the manufacturing sector is currently working at about 40 per cent capacity, inflation can be expected to be as high as 70 per cent.[19] Export growth has been quite strong, but much of it originates in highly import-intensive assembly plants that have little backward linkages with the rest of the economy; increased exports are associated with a falling level of industrial production;[20] and imports have fallen little despite the sharp contraction of economic activity

and devaluation of the peso. For these reasons, and because of the slowdown in the United States, it is most unlikely that the planned reduction in the current account deficit from $25 billion to $2 billion will be achieved without large import cuts.

The large stock of dollar or dollar-denominated debt incurred by households and financial and non-financial corporations during the last few years has greatly compounded the deflationary consequences of the devaluation. The increase in the peso value of these liabilities, the sharp decline in the prices of assets, including equities and real estate, together with the fourfold increase in interest rates, could result in a debt-deflation-*cum*-recession process as serious as that experienced in the United States and Japan in the late 1980s and early 1990s. Indeed, the banking system's bad loans have been mounting rapidly, with mortgages accounting for 25 per cent of the total. There is a real danger of a private sector debt crisis and widespread bank failures; early in the year the Government secured a credit line of $3.2 billion from the World Bank and $2 billion from the Inter-American Development Bank to help overcome possible banking problems. Already in June 1995, one of the largest banks had to be taken over by the Government. As discussed in *TDR 1992* and *TDR 1993*, such a process tends to produce drastic cuts in spending and impairs both the ability and the willingness of banks to lend, thereby prolonging the recession until balance sheets are restored.

In the United States overcoming debt deflation was greatly facilitated by monetary expansion and lower interest rates. However, since Mexico faces not only a balance sheet adjustment, but also an external adjustment, monetary policy is expected to remain very tight until inflation is brought under control and confidence restored. As already noted, the rapid increase of inflation and of nominal and real interest rates will add considerably to the interest burden on government domestic debt. The yields on *tesebonos* (dollar-indexed government securities held primarily by non-residents) shot up to 20 per cent early in the year. On the other hand, the decline of the peso is expected to cause additional interest payments on external debt of an amount equivalent to 1.4 per cent of GDP in 1995.[21] In January-March 1995, interest payments by the non-financial public sector grew in real terms (i.e. after deflation by the consumer price index) by 44.5 per cent compared to the same quarter of 1994.[22] Tax revenues also fell by 13 per cent in the first quarter. The Government is trying not only to offset the budget deficits triggered by "stagflation", but also to generate the savings needed to close the current account deficit: thus it raised the VAT rate by 50 per cent, increased the prices of public goods and services, and announced a plan to cut public spending by 10 per cent. Given that there are already strong contractionary influences stemming from debt deflation, the very tight monetary and fiscal policies in place may well result in a deflationary overkill (if they have not already done so).

Contraction of economic activity also depends on what happens to inflation. High interest rates, by adding to costs, can make it difficult to reduce inflation. If, on the other hand, a tendency for a wage-price spiral emerges, recession may be deeper and longer as the Government tries to overcome it by cutting demand further. That is why another "pact" was sought; but it is not easy to ask for further sacrifices after so many years of "adjustment" based on retrenchment, particularly from those who gained nothing from the earlier boom. Nevertheless, success may bring with it the temptation to repeat the story. Policy credibility depends, more than ever, on receiving a vote of confidence from financial markets in the form of a recovery of asset prices and the continued stability of the peso - i.e. on the restoration of capital flows. The possibility of this happening cannot be dismissed, for the current situation of very low dollar prices for physical assets ranging from hotels to banks, from "fast food chains, clothes stores, video outlets" to property again presents highly attractive opportunities for windfall profits.[23] If the exchange rate can be held at the target level of 6-6.5 pesos to the dollar and inflation turns out to be 70 per cent, the real exchange rate will have returned to its previous level within a year. If interest rates track the inflation rate, there will be considerable profit opportunities in the market for liquid funds, particularly since prospects are for lower United States interest rates. The more the Government succeeds in stabilizing the peso and thus gaining the financial markets' confidence, the more there will be opportunities for short-term profits. Under these circumstances, a bandwagon may emerge once more - unless controls are introduced to limit capital inflows.

Even if the necessary adjustment is made in an orderly way, through a combination of import cuts and export expansion, and inflation is brought under control, the question is how to restore growth without coming up against the payments constraint and rekindling inflation through successive devalu-

ations. Achieving this objective depends, of course, on the level of capital inflows that may be sustained over the medium term. But it also depends crucially on the ability of industry to sustain an export expansion that can match the rise in imports that is bound to occur; there is almost no scope to use trade policy measures to curb imports. Sustained export expansion will not be possible without a significant increase in investment.

The situation also poses difficult challenges for economic policy making in Argentina. A trade surplus was achieved during the first quarter of 1995, as a result of high prices for commodity exports and substantially increased exports to Brazil; in that period, almost one half of Argentina's exports were to Brazil. Nevertheless, GDP in 1995 is not expected to rise, after an impressive growth of 6 per cent in both 1993 and 1994. Inflation, having fallen to under 4 per cent in 1994, accelerated in the early months of 1995. Its future course will depend on the tightness of policy; it will be lower the greater the contraction of the economy.

As in Mexico, the Government is trying to generate the savings needed to close the current account deficit, but there are difficulties. According to the Minister of Finance, the adverse fiscal effects on the country of the Mexican financial crisis amounted to $4,550 million (some 1.8 per cent of GNP), made up of $3,750 million due to losses from anticipated tax revenues, $500 million due to increases in interest rates, and $300 million due to revenues forgone from privatization.[24] With the slowdown of the economy, receipts from VAT in April 1995 were 11 per cent lower than in the same month of 1994, despite the increase in rates, and fiscal revenues were down in every month except February. The Government is finding it difficult to meet the fiscal target agreed with IMF (i.e. a surplus of $4.4 billion).

Moreover, the banking system is confronted by a number of problems. The financial sector is always the most fragile element in a deflationary adjustment, and Argentina is no exception. Bank deposits were drained early in the year, and the Government introduced deposit guarantees to restore confidence - a move which was widely interpreted as a retreat from free-market philosophy. However, dollar-denominated deposits, particularly those which were fixed-term, continued to fall. Moreover, the deposit insurance fund does not appear to be sufficiently large to meet all claims in the event of another run. According to the President of the Central Bank, early this year "between 25 per cent and 30 per cent of the country's deposits were held in insolvent banks".[25] The Government has secured $1 billion from the World Bank and the Inter-American Development Bank, and a credit line of $1 billion from BIS (against a collateral of the public shares in the oil company YPC) to help overcome banking insolvency. The current difficulties are expected to give rise to widespread mergers and closures before the end of the year; even so, a serious banking crisis cannot be entirely ruled out.

If confidence cannot be restored and deposits do not return to the banking system, the maintenance of the parity would require further tightening of monetary policy and another hike in interest rates. These could well result a deflationary overkill, with social and political consequences. By contrast, a massive return of deposits to banks would enable the pace of external adjustment to slow down; but competitiveness could remain insufficient to avoid future crises of confidence.

In short, Argentina, with its fixed exchange rate, faces a number of policy dilemmas in making external adjustment. Given the importance of its trade with Brazil, a continued appreciation of the *real* would be most helpful, but, as explained below, this is not a viable option for Brazil. Consequently, the only way to restore export competitiveness is through a fall in nominal wages and in prices of non-tradeables or an investment-led rise in productivity. A fast and significant nominal deflation of prices and wages is implausible and would, in any case, cause serious financial difficulties for firms and banks. There is also little prospect of increased investment in tradeables without an improvement in the real exchange rate and a fall in interest rates from the current level of over 20 per cent.

Therefore, the burden of adjustment will eventually have to fall on imports. The Government has decided to increase tariffs on the 15 per cent of items that are not covered by MERCOSUR, but that will have only a limited impact. A more generalized increase in tariffs is not feasible; besides, it would go right against the Government's underlying free-market philosophy, and, possibly lead to a loss of confidence. Consequently, import cuts will have to be effected essentially by reducing domestic demand. Given the size and the speed of the adjustment to be made, and weak response of imports to cuts in demand, a deep and prolonged recession could set in.

Although external financial support for adjustment is now much greater, the adjustment could be as painful as in the 1980s.

On the other hand, devaluation - which markets might force on the country if cutting demand so much is politically intolerable - would not necessarily provide an easy escape route, as has been shown by the example of Mexico. Since most of the credits, including consumer and mortgage loans, contracted in the 1990s are dollar-denominated or dollar-linked, devaluation would create serious problems of overindebtedness. The exchange rate risk that banks had passed onto borrowers could then rebound to them in the form of credit risk, threatening the solvency of the already troubled banking system. Moreover, since the economy is effectively indexed to the dollar, devaluation would be likely to result in prices and wages rising in tandem, possibly triggering another hyperinflation.

In brief, the challenge is how to restore external equilibrium and a competitive exchange rate while avoiding a runaway inflation; that had only been overcome in the first place by sacrificing external equilibrium and a competitive exchange rate. Stabilization from very high inflation generally requires using the nominal exchange rate as an anchor for inflationary expectations, pricing decisions and wage setting, which leads to the appreciation of the currency. The main challenge is to manage a quick and smooth transition to a stable and sustainable real exchange rate regime, so as to restore competitiveness without rekindling inflation and disrupting price stability. Israel and Bolivia, for instance, have managed that transition more or less successfully. Mexico and Argentina have not been able to do so, in large part because they took advantage of capital inflows to raise absorption rapidly while disinflating; heterodox stabilization policies merely sought to avoid large output and welfare losses during disinflation.

Brazil is also facing this challenge. The indication in the second half of 1994 was that the economy was on much the same course as in Mexico and Argentina. The currency was fixed in nominal terms, occasionally supported by official intervention. Little attention was paid to rapid overvaluation of the currency and to the worsening external balance in the second half of 1994 because pressures stemming from the real side of the economy did not seem particularly menacing. The *Real* Plan had generated an impressive expansion of demand that allowed firms to increase production and sales in spite of the surge in imports fuelled by currency appreciation and tariff reductions. Besides, the surge in imports was deemed positive because it helped to lessen the demand pressures on prices. Although the trade balance began to show a deficit at the end of the year, reserves were still high and the import boom was expected to weaken in the near future. Furthermore, there were political difficulties in the way of fiscal consolidation and deindexation.

The scene changed abruptly with the Mexican crisis. The capital account turned negative just as the trade deficit was widening rapidly because imports continued to surge. In response, the new Administration appears to have made a major shift in policy, towards paying full attention to the real exchange rate and the trade balance. First, in early March it was announced that central bank interventions would be conducted within a flotation band, with a fixed upper bound and a progressively declining lower one. The announcement was followed by a big increase in the demand for dollars. The Central Bank sustained the exchange rate near the preannounced lower bound and the run was curbed after the rules were again changed. An exchange rate policy was finally adopted consisting of a flotation band with fixed nominal upper and lower bounds. There resulted a 10 per cent devaluation of the nominal exchange rate. At the end of June 1995, when the dollar was trading at 92.5 centavos (just under the upper bound of the existing band of 88-93), the Government paved the way for another devaluation by ceding to market pressure and allowing the *real* to fluctuate between 91 and 99 centavos. However, the currency is still 25 per cent higher in real terms than when it was introduced in July 1994.

Second, the Government seems to have reversed its policy of rapid trade liberalization, and indeed started to use trade measures to curb imports. In February 1995 the tariff on imported cars was increased by more than one half. In late March there was a further 70 per cent increase on extra-MERCOSUR imports of 100 items, largely cars and consumer durables. It has also introduced import deposits of 20 per cent, and forbidden importers to pay for imports with borrowed dollars. When the trade deficit increased in May, a decision was taken to introduce quotas for car imports.

Finally, an attempt has been made to slow the economy so as to reduce inflationary pressures and check the deterioration of the trade balance. GDP

growth in the first quarter was at an annual rate of 9 per cent, but for 1995 as a whole it is expected to be 5-6 per cent. Interest rates have been raised substantially, particularly on consumer loans. Tariffs have also been lowered selectively on basic consumption items, including food, clothing and other wage goods, in order to relieve pressures on prices and avoid further wage increases.

So far the results are mixed. Since the beginning of 1995 there has been a trade deficit every month (more recently due to a sharp increase in imports caused by expectations that imports will be curbed through devaluations and other trade measures), and reserves are down by some $10 billion from their end-1994 level. However, exports have more recently shown considerable dynamism and inflation has been reduced to below 2 per cent per month. Nevertheless, the very high real interest rates (over 30 per cent per annum) could choke industry if maintained for long. Fiscal measures need to be introduced rapidly to ease the burden on monetary policy.

The new conditions in international financial markets caught the Brazilian economy in a particularly vulnerable situation: the external accounts became unsustainable in the first months of the new Administration, when the stabilization programme was still in its early phase and required additional severe measures to be consolidated. But the Government also brought greater realism to policy making before it was too late.

Whether Brazil will be able to maintain stability and growth despite adverse external financial conditions will depend how far it is able to exploit the advantages of being "late" in "structural adjustment reforms". First, given the parameters within which economic policy in different countries is operating, Brazil has greater scope than the other major countries in the region to use trade measures to deal with external and domestic imbalances; as already noted, these have indeed been used selectively to curb imports and reduce inflationary pressures. Second, its economy is not dollarized, which means that devaluations would not have the same financial implications as in Mexico and Argentina. Third, it has considerable scope for privatization to help reduce government deficits and debt, which constitute the Achilles heel of its stabilization programme.

Developments in these three largest economies will have important consequences for the smaller economies of the region - not only for countries with large current account deficits, and hence similar potential adjustment problems (e.g. Peru), but also for others in much more comfortable positions (e.g. Chile and Colombia). This is not only because of the well-known contagion effect, but also because of the growing interdependence of countries through intra-regional trade. One consequence of this growing interdependence is that changes in the regional pattern of exchange rates now play a greater role by redistributing growth impulses among the countries. For instance, an important factor behind the increases in Chilean exports to the region during the 1990s was that its currency appreciated less than others. Regional exchange rate patterns are now changing rapidly again. Compared to a year ago, Mexico has depreciated, and Argentina appreciated, vis-à-vis almost all other Latin American economies (except that the Argentinean peso fell against the Brazilian *real*). However, since the markets of both Mexico and Argentina will be shrinking, the net effect on the other economies is certain to be negative.

The appreciation of the *real* and fast growth in Brazil after July 1994 have also helped its partners in MERCOSUR. Uruguay's exports to Brazil, its largest trading partner in that arrangement, doubled within the first few months of 1995, lowering sharply its bilateral trade deficit. The recent devaluation of the *real* has thus caused considerable concern in Uruguay, as well as in Argentina.

As countries increasingly try to bring down their trade deficits to sustainable levels through exchange rate or trade policy actions, tensions are building up in regional trade relations, including in MERCOSUR: for instance, even though Argentina accounts for only a fraction of Brazil's total imports of cars, Brazilian restrictions on car imports are a source of friction with that country. A leading business periodical on Latin America has characterized these developments as "back to beggar-my-neighbour".[26]

F. Conclusions

The new situation in 1995 means that in the larger Latin American economies the savings and the foreign exchange constraints on growth are once again binding. The decline in net capital inflows will restrict growth by reducing both the savings and the supply of foreign exchange needed to finance capital goods imports for investment as well as imports associated with rising incomes. Furthermore, fiscal imbalances and price instability that arise from external adjustment will constrain policies, which may, in turn, further depress growth.

Overcoming these constraints calls for raising domestic savings rapidly and directing investment to traded goods. The crucial question is whether current policy is capable of achieving these objectives. Recent experience shows that it has serious shortcomings; the policy reforms designed to raise savings, investment and competitiveness have played an important part in the crisis by promoting consumption, rather than savings, and diverting investment from traded goods sectors. There is thus a need to review policy reforms adopted in response to the crisis of the 1980s so as to determine what needs to be done. The discussion above shows that attention needs to focus on finance, trade, and the public sector.

It was expected that once the macroeconomic fundamentals were put right, inflation brought under control, and "financial repression" eliminated, household savings would rise and relax the constraint on capital accumulation. However, as discussed in *TDR 1994*, in almost all examples of successful modern industrialization, from Japan to the Republic of Korea, the main source of capital accumulation in private industry was profits; profits were retained because of the drive to maintain a high pace of accumulation, and government intervention played a major role in this process. Although historically profits have been just as high in Latin America, the propensity to reinvest them has not been very strong. An important reason has been the opportunities to earn high rents from various unproductive channels. While liberalization and deregulation have closed the old channels of unproductive rent creation, they have opened up new ones, particularly in the sphere of finance, diverting resources from investment. Regulations and control over financial transactions to close these new channels for rent-seeking may therefore be needed in order to raise savings and accumulation; they could also serve to reduce instability and uncertainty.

Control over short-term capital flows should be a permanent feature of the financial system, since such flows are an important source of speculative rent seeking and also because exchange rate stability is important for the success of outward-oriented development. Experience shows that, provided that macroeconomic fundamentals are correct, such controls can be quite effective. The issue has been explained by the Governor of the Central Bank of Colombia, a country that has applied such measures quite successfully:

> At the present time, the accepted theory is that all capital controls are useless, because they become, quite quickly, ineffective. I think this is a half-truth. One could argue that a large portion of capital flows can be controlled. In that case, rules and regulations could be helpful.
>
> Experience clearly shows that regulations are ineffective in keeping nationals from exporting capital when they lose confidence in their local currencies. In a similar fashion, it can also be extremely difficult to avoid capital repatriation by nationals. ...
>
> Nevertheless, it is clearly possible to avoid market failures that involve destabilizing flows from regulated financial institutions. Moreover, these are the agents that can make the largest short-term capital transfers. In this case controls are effective.[27]

There is no doubt that there were limits to the extent to which high trade barriers were capable

of accelerating industrialization in Latin America and that a considerable degree of trade liberalization was called for. However, in this respect, too, the pendulum has swung too far; the average and maximum tariff rates in Latin American countries today are considerably lower, and their dispersion smaller, than in the most successful East Asian countries with much more solid industrial bases and developed and efficient manufacturing exports.[28] In all successful examples of modern industrialization, import liberalization followed, rather than preceded, export success. As discussed in detail in the last year's *TDR*,[29] and further pointed out in Part Three, chapter 2, below, this sequence would necessitate breaking through the limits of static comparative advantages based on abundant unskilled labour and/or natural resources and promoting industrialization based on establishing dynamic comparative advantage. It is thus necessary to reconsider trade policy in Latin America, within the bounds of international commitments already made, and to seek trade-equivalent fiscal measures to help promote rapid industrialization based on the exploitation of dynamic comparative advantage in high-technology, high-skill industries.

Again, considerable efforts have been made to restructure the public sector, bring fiscal discipline and reduce inefficiency. However, in the three major economies (Argentina, Brazil and Mexico) the public sector is still not fully geared towards economic stability and growth. Tax revenues are inadequate, and taxation has become more regressive. A significant part of the spending cuts in the 1980s and the 1990s fell on public investment in human capital and physical infrastructure. Present levels of spending in these areas are too low to sustain rapid growth and industrialization.

There is no disagreement over what are the key variables for the purpose of accelerating growth and industrialization in Latin America. As put by the authors of a recent World Bank report on Latin America after the Mexican crisis: "If Latin America achieves improvements in three key areas - export competitiveness, domestic savings, and investment in infrastructure - its average annual rate of growth could increase substantially by the end of the decade".[30] What is at issue is the policies which will improve performance under these headings. In this respect, a rethinking of economic policy appears to be called for.

Notes

1 See *TDR 1994*, Part Two, chap. I, "The Visible Hand and the Industrialization of East Asia".

2 It is true that privatization may give rise to subsequent FDI, but the amounts involved are usually small compared to the initial sale of the assets. More important, FDI used to create new productive assets particularly in manufacturing, rather than acquire existing assets typically gives rise to additional imports of capital goods, thereby generating additional demand for foreign exchange. Thus pressures on the exchange rates arising from such capital inflows are much smaller than those from portfolio investment or FDI attracted by privatization.

3 It is worthy of note that in the May 1995 issue of *World Economic Outlook*, prepared by the staff of IMF, the discussion of "factors behind the crisis" does not allow for the possibility that there was a speculative bandwagon. There is indeed no reference to *speculative* capital flows in the discussion of the sustainability of the external financial position of Mexico. Similarly, it is argued that the optimistic interpretation that "the ensuing external deficit would subside over time, as improvements in productivity lead to gradual increases in competitiveness and exports, with no need for a devaluation ... receives some support from the behaviour of investment and exports" (annex I, p.42). While it is true that there was some increase in investment, this was *before* rather than *after* the capital flows picked up (*ibid.*, table 1). More important, as discussed below, much of the increase was in non-traded goods and services. Furthermore, while total exports increased, imports rose much faster and there was no tendency for the external deficit to fall (*ibid.*). It is also suggested that "manufacturing exports grew at a fairly rapid pace during 1988-94,

while the peso was appreciating in real terms, owing in part to the increases in total factor productivity resulting from the rapid trade liberalization and wide-ranging deregulation of previous years" (p. 42). However, as shown in section C below, the productivity growth was insufficient to compensate for the rise in unit labour costs in dollar terms, and there was a substantial decline in the international competitiveness of manufacturing in Mexico.

4 As the IMF staff also admit, the effects of "a much earlier tightening of credit supported by a more restrictive fiscal stance ... on output and on the solvency of the banking system may not have been qualitatively different from those that seem to have arisen in the aftermath of the December crisis" (*ibid,* p.43).

5 *Latin American Weekly Report*, 15 June 1995, p. 262.

6 See M. Mortimore, "Paths towards international competitiveness", Santiago, Chile, January 1995 (mimeo).

7 M. Agosin, "Saving and investment in Latin America", *UNCTAD Discussion Paper*, No. 90, October 1994, table 3, p. 12.

8 J. Carlos de Souza Braga, M.A.M. Cintra, and S. Danis, " Financing the Public Sector in Latin America", *UNCTAD Discussion Paper* (forthcoming), table 4.

9 *Ibid.*, table 3.

10 See *TDR 1989*, Part One, chap. IV, "Macroeconomic Disorder in Developing Countries".

11 See *TDR 1993*, Part Two, chap. III, sect. C.4, and box 12.

12 It should be noted that the capital account in table 20 includes errors and omissions, which are usually taken as a proxy for capital flight (or unrecorded capital inflows). External savings, as defined by the capital account balance, do not allow for net factor payments abroad; these are accounted for in the calculation of national savings, defined as domestic savings (i.e. GDP minus consumption) minus net factor income and in the calculation of the net transfer of resources (i.e. capital account balance, including errors and omissions, minus net profits and interest). Clearly, since net interest payments generally fell in the 1990s compared to the 1980s, the swing in the net transfer of resources between the two periods was greater than the swing in the capital account balance, implying that domestic savings fell even more than national savings. However, it should also be noted that part of capital inflows was added to reserves, so that the portion of external savings used for consumption was somewhat less than indicated in table 20.

13 This also points to a potential problem. A positive adjustment to the turnaround in external capital flows would require a faster rate of capital accumulation to generate the necessary expansion in exports. Since currency devaluations necessitated by external adjustment raise the relative prices of capital goods, a much greater proportion of GDP would need to be spent than in the early 1990s to attain the same rate of addition to capital stock.

14 These net investment figures are from the same source as the gross figures in table 24. They have been generated using the perpetual inventory method, assuming a straight-line depreciation over 15 years for machinery and equipment, 40 years for non-residential construction, and 50 years for residential construction.

15 On the relation between macroeconomic instability and the "option" to delay investment decisions see, for example, A. Dixit and R. S. Pindyck, *Investment Under Uncertainty* (Princeton, N.J.: Princeton University Press, 1994).

16 S.J. Burki and S. Edwards, "Consolidating Economic Reforms in Latin America and the Caribbean", *Finance and Development*, March 1995, pp. 7-8.

17 For a discussion of infrastructure needs in Latin America and the role of the private sector see J.C. de Souza Braga *et al.*, *op.cit.*

18 It should be noted that the factors discussed above have had much less influence on investment in Chile: the extent of currency appreciation has been limited; the current account has been sustainable; economic activity has not been subject to large fluctuations; and public investment has increased. Moreover, in Chile investment has been concentrated in sectors with a large primary input content, rather than in manufacturing, where it is much more susceptible to changes in relative prices.

19 For the most recent developments, policies and prospects in Mexico, Argentina and Brazil see *Latin American Economy and Business*, April-June 1995; and *ibid., Quarterly Update*, No. 2, June 1995.

20 See "Trade balance up, production falling", *Latin American Weekly Report*, 22 June 1995, p.272.

21 *Latin American Weekly Report*, 8 June 1995, p.242.

22 Information provided by the Mexican Ministry of Finance.

23 See L. Crawford and L. Bransten, "Bargain Time in Mexico", *Financial Times*, 14 June 1995.

24 J. Carlos de Souza Braga *et al.*, *op. cit.*, pp. 8-9.

25 *Latin American Economy and Business*, May 1995, p. 6.

26 *Latin American Economy and Business*, April 1995, p.1.

27 Miguel Urrutia Montoya, remarks made at the session on "International Liquidity, Capital Mobility and the Developing Countries" of the Conference sponsored by the Group of Twenty-Four on the Occasion of the Fiftieth Anniversary of the Bretton Woods Conference, Cartagena, Colombia, 18-20 April 1994 (*International Monetary and Financial Issues for the 1990s*, vol.IV - *The International Monetary and Financial System: Developing Country Prospects* (UNCTAD/GID/G24/4)), pp. 85-86.

28 See *TDR 1993*, Part Two, chap. III, sect. B.

29 *TDR 1994*, Part Two, chap. I.

30 S.J. Burki and S. Edwards, *op. cit.*, p.7.

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Chapter III

SYSTEMIC RISK AND DERIVATIVES MARKETS: SELECTED ISSUES

A. Introduction

Attention to the growing use of derivatives in recent years has been associated with forebodings as to their potential in certain circumstances for causing systemic destabilization. These forebodings are not always well defined but reflect the fear that the consequences of default in derivatives markets are capable of spreading quickly, and that the resulting difficulties may endanger not only participants in these markets but also other financial institutions. The discussion which follows focuses on this systemic threat and takes up other risks related to derivatives, mainly to the extent that they have possible systemic implications.

The connection between threatened or actual defaults and systemic risks is illustrated here through a number of examples involving both organized exchanges for derivatives and institutions with positions in derivatives issued over the counter (OTC).[1] The global crash on equity markets in October 1987 is of special interest in this context, since it not only led to defaults on Hong Kong's stock futures exchange but also severely tested the defences of certain other derivatives markets. The dangers resulting from defaulting by firms with positions in OTC derivatives are different from those due to failures on organized exchanges, regulatory concerns here focusing on such issues as the frequent lack of transparency regarding firms' positions, which may result in inter-firm and inter-market linkages that are difficult to identify.

Policies and policy proposals described below are directed not only at systemic risk as such but also at other subjects. The initiatives most immediately connected to the former have involved strengthening the defences of organized exchanges and otherwise reducing the likelihood of the spread of initially localized problems. Another category of measures is directed in the first instance at individual firms, in particular their internal controls. However, owing to the relations between firms and the system of which they are constituent parts such measures also have wider effects. The objectives of prudential regulations are both microeconomic and macroeconomic. Particular measures under this heading may emphasize one set of considerations rather than the other, but each measure generally makes some contribution to the functioning of the system as a whole.

B. Systemic and other risks

In a 1992 report prepared for the central banks of the Group of Ten, systemic risks are defined as those which have the potential to cause a systemic crisis. Such a crisis is "a disturbance that severely impairs the working of the financial system and, at the extreme, causes a complete breakdown in it.... Systemic crises can originate in a variety of ways but ultimately they will impair at least one

of three key functions of the financial system: credit allocation, payments, and the pricing of financial assets. A given financial disturbance may grow into a systemic crisis at one point in time but not another, depending on the financial and economic circumstances when the shock occurs".[2] The following useful extension of this characterization was provided in a recent speech by an official of the Bank for International Settlements (BIS) as follows: "By way of illustration, consider the framework of a flow-of-funds matrix, with columns comprising individual market *players* and rows representing the instruments in which they deal. Lurking behind the matrix are *market clearing* conditions, as well as the *institutional* structure (back offices, the legal framework, and payment systems) which allow the markets to function. Systemic risk arises whenever a problem at any of these four levels threatens to cause sudden and widespread difficulties in other parts of the financial system, difficulties serious enough to have macroeconomic consequences".[3]

These quotations make clear the relevance to systemic risk of the context in which a disturbance takes place. Thus, for example, as illustrated below, the threat posed by a default on an organized derivatives exchange can depend on its framework of regulations and the rigour with which they are enforced. Likewise, the possibility that initially localized difficulties become a source of systemic risk depends on the nature and scale of the exposure of other firms to those affected in the first instance. Moreover, the impact of defaulting differs according to conditions in financial markets at the time when it occurs. Systemic risk is more likely to arise if these conditions are fast-moving and disorderly. In such circumstances the disturbing effects of default on market psychology are likely to be greater. Furthermore, the resulting failure to meet obligations is imposed on systems of settlement and short-term financing which may already be overloaded and under strain.

The main risks other than systemic which are associated with derivatives positions are credit, market, settlement, liquidity, operational, and legal risks. Credit risk is due to the possibility that a counterparty will default on obligations. Market risk is that of loss due to changes in the market value of a position before it can be offset or liquidated. Settlement risk relates to the possibility that a party which has fulfilled its obligations regarding the delivery of funds or property may not receive according to the agreed timetable the funds or property owed by its counterparty. This risk is clearly especially important for transactions involving transfers at different times or in different time zones. Liquidity risk is usually defined as having two dimensions - cash liquidity or funding risk and market liquidity risk. The latter is the risk to participants in derivatives markets that their own transactions will (at least on occasion) affect prices. This risk has an impact on both the cost and effectiveness of various hedging strategies, including portfolio insurance (a subject taken up below). Cash liquidity or funding risk affects many of financial firms' operations and not just those involving derivatives. It results from periodic needs for liquid funds which cannot be precisely forecast in advance. With respect to derivatives such needs can arise suddenly and for large amounts owing to changes in market conditions or shifts in credit standing which necessitate additional margin payments on organized exchanges or the adjustment of positions. Operational risk is that of loss due to inadequate systems and controls or to management failure and human error. Legal risks are due to uncertainties as to the enforceability and other legal aspects of the performance of derivatives contracts.

The inclusion of market risk as one of the major risks in connection with derivatives deserves further comment owing to the role of such contracts as an instrument for hedging risks due to price fluctuations. The perfect hedging of a position with a derivative instrument is not always possible (for example, because of imperfect correlation of its price and that of the position being hedged), so that the institution in question can still be faced with residual basis risk.[4] Furthermore, derivatives can be subject to market risk because of their use for speculation as well as for hedging.

Even though the risks described above are not themselves systemic, they can cause problems capable of posing a systemic threat, especially owing to ways in which they may interact. Credit risk in particular has close connections to many other non-systemic risks. For example, price volatility, the source of market risk, by causing losses or otherwise threatening parties' ability to meet their obligations can increase credit risk. Similarly, the short-term exposures associated with settlement risk are closely linked to credit risk, as are disruptions of the fulfilment of obligations due to problems under the heading of operational and legal risk. These relations are not one-way, since defaults and even temporary failures to meet obli-

gations can cause sharp movements in the prices of financial assets, thus acting as a source of market risk.

The likelihood that such interaction will result in systemic threats depends on the scale of default attributable in the first instance to a risk or risks of a non-systemic character, the impact on the functioning of financial markets, and the size and nature of other firms' exposure both to the defaulting institution or institutions and to the markets affected. As illustrated below, a single large failure on an organized exchange can seriously disrupt or even halt its operations, though appropriately designed legal frameworks and rigorous supervision should now make such an event extremely unlikely. More generally, regardless of its initial character, any disruption of financing and payments can be magnified owing to the mutual relations underlying financial firms' liquidity and solvency, and to their exposure to the same asset markets. As elaborated below, the potential of non-systemic risks to generate systemic problems in certain circumstances has important implications for prevention. Measures directed at non-systemic risks, as a by-product, have the effect of rendering systemic threats less likely.

C. Difficulties involving derivatives markets in practice

1. *The 1985 default on the tin market*

Defaults posing serious threats to the organized exchanges on which they took place have historically been very rare. One such threat arose in October 1985 with the announcement by the buffer stock manager of the International Tin Council (ITC) that the Organization was unable to meet obligations estimated at approximately £900 million in the form of futures contracts to buy tin on the London Metal Exchange (LME) and of loans from banks.[5] At that time, trading on the LME was on a principal-to-principal basis. In other words, there was no clearinghouse to guarantee the performance of contracts through its interposition as counterparty to every transaction, as is usual on organized futures and options exchanges. The absence of a clearinghouse not only increased the risks associated with transactions on the LME, but probably also contributed to the lack of transparency which surrounded the build-up of ITC's eventually unsustainable position.[6]

The response of the LME was to suspend its tin market, since the free fall of prices which, it was feared, would have resulted from continued trading threatened the solvency of dealers holding positions in tin and, more broadly, that of firms operating in other LME markets. Such a collapse might well have led to the end of the LME as an institution. The companies most directly affected were mostly subsidiaries of transnational enterprises, mining, metals or trading companies, but their capitalization was relatively small (on average less than £10 million) and the willingness of their parent companies to meet their losses uncertain. The effects of a widespread breakdown of the interlocking commitments among brokers, producers, consumers and bankers were unsurprisingly difficult to estimate at all precisely. However, a survey by the Bank of England in early 1986 suggested that under a so-called Armageddon scenario[7] the total liabilities to the banks of LME members might have reached £6.2 billion[8]. Although the Armageddon scenario was hypothetical, contagion effects of the tin crisis were actually observed in other LME markets in the form of unwillingness by some firms to engage in transactions with brokers known to be at risk owing to their positions in tin.[9]

Eventually, in March 1986, a decision was taken to conduct a "ringout" under which all outstanding LME tin contracts were settled at a single fixed price (based on the prevailing free-market price). This procedure resulted in losses for those affected which depended on the nature and size of their tin positions and the differences between the ringout price and prices at which they were to buy or sell under the terms of their contracts. After long negotiations ITC and its creditors reached an agreement concerning outstanding obligations which led to a payment by the former in early 1990. The suspension of tin trading was

also lifted in 1989. By the time of this reopening the LME was operating with a clearinghouse established in May 1987 under the new regulatory framework for financial markets in the United Kingdom resulting from the Financial Services Act of 1986.

2. *The threatened melt-down of the Hong Kong financial futures market*

The stock market crash of October 1987 had reverberations throughout the world's financial markets. Hong Kong's stock market was one of those most severely affected, and only a large rescue package saved the stock futures exchange from complete collapse. A stock futures contract based on the Hang Seng Index had been introduced on a reorganized Hong Kong Futures Exchange (HKFE) in May 1986. From the first, trading had attracted strong speculative interest, features of Hong Kong's stock futures contract especially conducive to its use for speculation being its relative cheapness by international standards and the short maturities (one, two and three months) for which it was available. The market break of October 1987 ruthlessly exposed the weaknesses of the futures exchange's legal and institutional framework and of its supervision.

The initial price decline in Hong Kong's stock market (11 per cent in the Hang Seng Index) took place before the opening of markets in the United States on Monday, 19 October. The governing committee of the stock exchange reacted with a decision to close the exchange for the rest of the week, the reasons given being the threat of panic selling and a disorderly market, brokers' potentially precarious liquidity positions, and the possibility of runs on banks. Special attention was also drawn to the overwhelming of the exchange's settlement system (supposed to operate on the basis of a 24-hour settlement period), which had left a backlog of 250,000 unsettled deals, equivalent to one week's trading.

Closure of the stock exchange was followed by the suspension of trading in stock futures. During the days which followed the authorities were made aware that the resources of the Hong Kong Futures Guarantee Corporation (HKFGC) would be insufficient to meet widespread defaults on the Hong Kong Futures Exchange (HKFE), and that a collapse of the HKFE could lead to massive selling of stocks hedged with futures contracts or held as part of arbitrage operations; figures as high as HK$ 5-6 billion were mentioned (roughly 1.25 per cent of the market's capitalization in December 1987). As a result, a rescue plan was put together for the HKFGC. This involved a loan of HK$ 2 billion, half of which was provided by the Government and half by various financial institutions. On Monday, 26 October prices on the stock market plunged again, this time by no less than 33 per cent. Most of the loan was quickly used to cover defaults on the futures exchange, and the Government was forced to assemble another rescue package of the same amount (which in the event was not drawn down). The aftermath of this harrowing experience included the establishment of a Securities Review Committee under Ian Hay Davison, a former Chief Executive of Lloyds insurance market, to examine both the stock and the stock futures markets, followed by the putting in place of sturdier frameworks for both.

How did the HKFGC get into a situation where the imminent exhaustion of its resources threatened the continued functioning of the HKFE? The character of clearing and guarantee arrangements differs among futures exchanges but their general nature tends to be similar. Usually the heart of these arrangements is a clearinghouse which, as noted in the previous section, interposes itself between buyers and sellers as the counterparty in all transactions. The long and short positions of clearinghouse members are marked to market on a daily basis, and the accounts which they maintain with the clearinghouse are credited and debited accordingly, the sums required in response to such margin calls being due for prompt payment. Clearinghouse members can trade on their own account but are also responsible for all trading by non-members, firms and individuals, who in turn maintain margin accounts with members. Clearinghouses are typically empowered to increase the monies in margin accounts if this is considered necessary to protect the exchange's financial integrity, an action which may be taken, for example, during periods of particularly volatile trading. In the event of failures of clearinghouse members to meet their obligations (triggered, for example, by corresponding failures by their customers) the clearinghouse can draw on resources which include its reserves, borrowings, sums available under insurance policies, and funds contributed by members of the clearing house (or its shareholders, if these are different).

If a clearinghouse (and thus the futures exchange it serves) is to function properly, it is essential both that the arrangements for margin payments are in good working order and that the back-up resources should be large enough to meet obligations caused by the defaults of its members. Neither condition was met by the HKFE in the autumn of 1987. The amount available to meet a drain on the HKFGC amounted to only HK$ 22 million, a wholly inadequate sum consisting of its initial capital endowment and accumulated reserves. The inadequacy of this amount is evident from a comparison with the outstanding open interest of more than 35,000 contracts, which was equivalent to about HK$ 7 billion worth of stock.[10] Under the framework of the HKFE the funding of the HKFGC, a company owned by six banks and the clearinghouse itself, was not the collective responsibility of clearinghouse members, the assumption being that ownership of the HKFGC by large Hong Kong banks would ensure their support for preserving the integrity of the HKFE.

Of the outstanding stock futures contracts in October 1987 short positions for hedging and arbitrage were held mostly by large institutions, mainly of overseas origin. The long side consisted mostly of speculators and was of a character likely to be highly vulnerable to a sharp fall in share prices. About 50 per cent of the long positions were held by a single client (an expatriate property magnate) and his business associates. A significant part of the remainder of the long positions was held by small-scale actors, apparently including taxi-drivers and *amahs* (Chinese nursemaids).[11] The vulnerability of the market to a sharp movement in prices was increased by the failure of many futures brokers to enforce their customers' margin requirements. The Hay Davison Committee does not provide a precise account of how the clearing members financed the payment of their own obligations to the clearing house which corresponded to these unenforced customers' margin requirements. It does, however, refer in this context to "tax credit extensions and increasing confidence that the bull market would continue"[12] - which suggests that the obligations in question were financed with credit. The crash caused widespread defaults among brokers, which led eventually to the liquidation of more than 30 per cent of the clearinghouse's member firms.[13]

The first of the packages of financial support for the futures market described above was put together in the absence of assurances that its owners would stand behind the HKFGC. The second package was a response to a message on 26 October to Hong Kong's Financial Secretary from the Chairman of the HKFGC to the effect that unless additional resources were forthcoming, the HKFGC would cease writing guarantees (an action which would have led to the closure of the futures exchange). All the companies owning the HKFGC participated in the first support package, their contribution coming to 25 per cent of the total amount, but only two of them to the second. In other words, their commitment fell far short of that which had been assumed at the time of the opening of trading in the Hang Seng Index contract in 1986.

This experience demonstrates the dangers of shortcomings in legal and institutional frameworks or in supervision for other countries, including developing ones, contemplating the establishment of exchanges for financial futures. One account of the crash by a person with long firsthand experience of Hong Kong's financial markets highlights the way in which key decision takers in October 1987 had not fully grasped the risks associated with the huge increase in share trading and of the expanded foreign participation in both stock and futures markets.[14] The report of the Hay Davison Committee brings out the way in which diffusion of functions and obligations adversely affected the working of the Exchange.[15] Clearing members, for example, had no rights in respect of management and control of the clearinghouse. The legal relationship between the HKFE and the HKFGC was not well defined - indeed, it was unclear whether any institution actually was interposed as a counterparty to transactions by clearing members. The result was a blurring of the collective responsibility of clearing members for the markets' integrity. The reforms subsequently adopted by Hong Kong's authorities were designed to remedy these deficiencies, and included a clarification of the position of the clearinghouse, now a wholly-owned subsidiary of HKFE and, as an integral part of it, a Reserve Fund able to call on large resources for meeting the consequences of defaults.

3. *Strains in United States markets during the October 1987 crash*

The behaviour of markets for stocks, stock futures and stock options in the United States during the crash of October 1987 throws interesting light on many of the risks associated with deriva-

tives owing to the integration of these markets through arbitrage, asset reallocation strategies and portfolio insurance.[16] Increased risks during the crash have been extensively analysed in studies by official bodies and others.[17] Here the discussion will be limited to two subjects with a special bearing on systemic risk: firstly, the performance of clearance and settlement during a period of greatly increased trading volumes and fast-moving markets, and, secondly, effects of the large shifts in buying and selling pressures between the markets for stocks and derivatives. The first topic is of interest not only owing to the contrast with the experience of Hong Kong described in the previous subsection but also because many features of the institutional and regulatory frameworks of United States futures and options exchanges increasingly serve as a model for those of other countries. The second is noteworthy because intermarket shifts in buying and selling pressures are potentially destabilizing, and the trading strategies to which they are a response may become increasingly important in countries other than the United States.[18]

The functioning of clearance and settlement arrangements for financial futures and options exchanges in the United States during the crash was in sharp contrast to that in Hong Kong. Clearing and settlement on 19 October in the markets for stock futures, in spite of the largest ever one-day change in the Standard and Poor's (S&P) index of 500 stocks (which underlies the most widely traded futures contract), took place without the failure of a single clearinghouse firm. On the Chicago Mercantile Exchange, on which the S&P futures contract is traded, margin calls reached $2 billion, a level 20 times greater than the 1987 average for months prior to October.[19] Unsurprisingly, the market break was accompanied by signs of strain. Rumours circulated concerning impending failures of particular brokers and clearing firms, and there were disruptions of information flows among market participants. More importantly from the regulatory perspective, lags in payments did threaten increases in the short-term exposures of clearinghouses to clearing banks (through which clearing members' margin payments are received by clearinghouses) and in those of clearinghouses to their customers.[20] Such lags are an abiding source of concern to financial regulators owing to the fear that sharp rises in short-term exposure during fast-moving markets can adversely affect perceptions of creditworthiness, with potentially serious consequences for the entire process of settling margin obligations. As discussed below in section D.1, owing to the lags observed during the crash, steps were subsequently taken to reduce further the likelihood of hitches in clearing and settlement in United States futures markets.

Stresses resulting from the crash were more evident in the case of the Options Clearing Corporation (OCC), which clears and settles stock options traded on major United States exchanges. Although the calculation of margin payments is different from that on futures exchanges, in other respects the settlement processes for options and futures have several common features. On the OCC also the crash led to an enormous increase in obligations to meet margin payments. One clearing member (H.B. Shaine and Co.) failed on 19 October with the result that a charge was made on the OCC's fund for losses of $6.8 million (or 2.45 per cent of the money available).[21] A number of other member firms experienced difficulties in meeting their margin obligations. The response of the OCC included flexible interpretation of its rules for settlement combined with the imposition of restrictions on the operations of the firms in question. This approach, which made possible the avoidance of further defaults, posed no threat to the OCC's own financial position, which was protected by holdings of margin deposits largely in excess of margin requirements.[22]

Empirical research has not produced a consensus as to the effects of derivative markets on the volatility of stock prices. Work summarized by the United States Securities and Exchange Commission in its study of the 1987 crash pointed to an increase in intra-day, but not inter-day, volatility resulting from the introduction of futures.[23] However, as that study put it, "the availability of the futures market has spawned trading strategies that have greatly increased the velocity and concentration of stock trading", in the process making more difficult the maintenance of an orderly market in stocks.[24] Two of the official studies of the crash attribute special importance to selling pressures generated by the implementation of such strategies at particular times during the large movements of prices.[25] These and other studies also bring out the way in which during fast-moving, disorderly markets the multiplication of the channels for the transmission of buying and selling pressures and resulting discrepancies between spot and futures prices can make information about market conditions harder to interpret. Moreover, the belief that portfolio insurance was the source of an

overhang of selling pressures was found to have had a negative impact on market psychology. Such effects on transparency and expectations reduced market liquidity, thus giving a further stimulus to price volatility.

As already mentioned, steps were taken by United States regulators in response to the lessons drawn from the 1987 crash. In spite of the much greater robustness of the legal and institutional framework in the United States than in Hong Kong, the events just described none the less provide additional evidence of the strain which can be exerted by large, concentrated movements of funds due to interactions between the stock market and markets for derivatives. During such periods flaws or weaknesses in these frameworks can put at risk the very existence of the exchanges affected.

4. *Handling the failures of institutions with portfolios of OTC derivatives*

The examples so far in this section have all concerned defaults and other strains associated with derivatives activities on organized exchanges. As already indicated, such exchanges have rules designed to minimize the losses due to defaults by clearing members and their clients, as well as for meeting any losses which do none the less arise. During recent years there have been a number of bankruptcies of financial institutions with portfolios of OTC derivatives. The unwinding of these portfolios was achieved without major disruptions. But the question arises what general conclusions about the containment of systemic risk can be drawn from these cases.

Examples cited in this context include the bankruptcies of the British and Commonwealth Merchant Bank (BCMB), the Development Finance Corporation of New Zealand (DFC), the Bank of New England (BNE) and Drexel Burnham Lambert (DBL). At the time of default the notional principal value of the DFC's swap portfolio was $3-4 billion, while BCMB's derivatives portfolio contained swaps and other OTC interest-rate-related instruments with a value of about £2 billion.[26] In neither case were the portfolios large enough for the institution in question to be classified as a major participant in derivatives markets. At the time of BNE's insolvency in early 1991 the notional value of its portfolio of OTC derivatives was $6.6 billion. However, one year earlier when BNE became an "officially troubled bank" subject to enhanced scrutiny by its regulators, namely the Federal Reserve and the Office of the Controller of the Currency, the notional value of its portfolio was $30 billion.[27] In February 1990, the date of bankruptcy of the DBL Group, the derivatives portfolio of its subsidiary, DBL Products, which consisted of swaps and other interest-rate-related instruments, had a notional value of $30 billion, an amount which would have left it with a rank of about twentieth among more than 800 United States entities reporting the notional values of their swaps positions in 1990.

The attribution to BNE of the status of an "officially troubled bank" followed its announcement in January 1990 of a loss of more than $1 billion for 1989 (to a great extent due to defaults on loans related to real estate). During 1990 counterparties were unwilling to enter into new swaps with BNE, since they did not want exposures to a bank in difficulties during extended periods, but there was a continuation of the bank's business in forward exchange (on terms which became increasingly stringent). BNE was able to reduce its OTC derivatives portfolio by almost 80 per cent in a relatively orderly way before the declaration of its insolvency in January 1991. The unwinding of derivatives contracts continued after the Federal Deposit Insurance Corporation took control, but there remained a portfolio with a market value of about $80 million in July 1990 which was purchased as part of the bank by Fleet/Norstar Financial Group.

DBL Products did not begin bankruptcy proceedings at the same time as its parent, DBL Group, thus making possible a winding-down of its operations under which asset values were as far as possible maximized and losses minimized. Although the great majority of the swap agreements of DBL Products would have permitted its counterparties to walk away from their obligations after the bankruptcy of DBL Group, few did so.[28] During the following three and a half months before its own filing for bankruptcy at the end of May, DBL Products unwound virtually its entire swaps portfolio, aggressively using in negotiations with counterparties the threat of expensive litigation to challenge their right to walk away as well as exploiting their fear that walking away would make other participants in the swap markets less willing to do business with them in future. DBL Products recovered the full amounts owed it under most of its contracts, while paying out 70-75 per cent of the sums which it owed.

Although both BNE and DBL Products participated in derivatives markets on a substantial scale, the community of financial regulators seems reluctant to draw conclusions from the two cases about the relationship between the defaults of particular institutions and systemic risk. One reason for this reluctance is that there are many firms whose OTC derivatives portfolios are more extensive in terms of the number of both markets and countries than those of BNE and DBL Products. Moreover, in both cases regulators themselves "were heavily involved as managers or facilitators in ensuring that the demise of both institutions caused as little disruption as possible".[29] Another reason for regulators' attitude is that the resulting problems would be likely to be much more serious if there were defaulting at a time of stress owing, for example, to a high degree of price volatility on organized exchanges. In such circumstances difficulties due to defaults on obligations on OTC derivative instruments could be compounded by others on exchange-traded futures and options. Moreover, the defaulting might well be sudden and unexpected, and regulators seem fearful that owing to lack of transparency the nature of the exposures of the firm or firms involved might initially be poorly understood. This fear is clearly due in part to the proliferation of relations among different derivatives markets, those for OTC instruments and organized exchanges.[30]

D. Regulation and control

Derivatives have a long history. Futures evolved from forward contracting, which involves agreement between two parties to make and take delivery of a specified amount of a commodity or foreign exchange at a set price or exchange rate. As forward trading developed in the context of organized markets such as those of medieval and renaissance Europe, progressive standardization of contract terms became possible and with it greater transferability of contracts and ease of settlement.[31] Rice trading in seventeenth-century Japan is often cited as furnishing the first historical example of a futures market in the modern sense.[32] OTC foreign exchange options were available in nineteenth-century Germany.[33] But the current gamut of financial futures, options and swaps is a relatively recent development. Unsurprisingly, therefore, regulatory frameworks for derivatives are still underdeveloped in several ways, and despite recent tendencies in the direction of convergence there remain significant differences among them (which reflect not only countries' different traditions of financial law and supervision but also variations in the availability of such instruments and in their firms' involvement in this business).

As suggested in the introduction to this chapter, subjects to be considered under the heading of regulation and control bear on systemic risks to varying degrees. Financial regulation and supervision is traditionally concerned with a broad range of issues, some having a direct relation to the functioning of the financial system, while others concern in the first instance the working of individual firms and their relationships with customers. However, since the functioning of the system cannot be considered in abstraction from the positions of its individual participants, the latter set of issues ultimately has implications for the former, though the links are more immediate in some cases than in others.

Regulatory regimes for derivatives still reflect to a large extent national origins, though many of their constituent measures show the influence of lessons drawn from the experience of other countries. But as in international banking more generally, not only these regimes but also the management practices of firms are increasingly the subject of initiatives of supranational institutions and bodies. What follows is not a comprehensive discussion of regulation and control but a partial survey designed to exemplify significant trends in this area. The first set of measures taken up here are ones having major objectives of a clearly systemic nature. This is followed by a discussion of initiatives directed at firms' internal controls, whose relevance to systemic risk is more indirect. The third group of measures discussed concern various aspects of the regular functioning of derivatives markets and not necessarily systemic risk as such. But as should be clear from preceding re-

marks, these two subjects are never completely separate in practice.

1. Improvements to exchanges

Reference has already been made to a number of reforms of organized exchanges which clearly had the reduction of systemic risk as a major objective. The establishment of a clearinghouse for the LME falls into this category, as does the overhaul of the legal and institutional framework of the HKFE after the crash of 1987. The lessons drawn from the crash also led to measures elsewhere designed to strengthen exchanges for periods of stress. For example, in February 1988 a guarantee fund of £100 million was set up to back futures and options contracts cleared by the clearinghouse of the London International Financial Futures Exchange (LIFFE), whose backing had earlier consisted only of the relatively small equity of the firm owning the clearinghouse and the moral obligation of its shareholders (an arrangement similar to that before the crash in Hong Kong).[34] In the United States much regulatory attention was paid to ways of reducing short-term exposures during the clearing and settlement process. For example, agreement was reached in 1988 between the (Chicago) Board of Trade Clearing Corporation, the Chicago Mercantile Exchange and their settlement banks under which transfers by clearing banks to the clearinghouse to meet margin payments became final and irrevocable, regardless of the position vis-à-vis the clearing bank of the clearing member from which the payments were due.[35]

In spite of the series of improvements in the legal and institutional frameworks of major futures and options exchanges and the adoption by many of them of similar rules in certain areas, differences in these frameworks and in the rigour of supervision remain a potential source of regulatory arbitrage. Moreover, rules for exchanges of information among regulators remain underdeveloped in comparison with those in force for international banking. Indeed, the arrangements in this area covering international banks (which have been one of the subjects of guidelines issued by the Basle Committee on Banking Supervision)[36] are probably at present in most cases the main vehicle for such information exchanges but are presumably subject to lacunae to the extent that countries' regulation of banking and of futures markets are separate.[37]

2. Internal controls

Internal controls for dealers in and users of derivatives have recently been the subject of recommendations by various bodies. The study of global derivatives published in 1993 by the Group of Thirty (referred to in section C.4 above) has attracted particular attention in this context. The Group's summary of its detailed recommendations[38] is as follows: that firms which deal in or use these instruments (1) should determine at the highest level of policy and decision making the scope of their involvement in derivative activities and the policies to be applied; (2) should value derivatives positions at market, at least for risk-management purposes; (3) should quantify their market risks under adverse market conditions against limits, perform stress simulations and forecast cash-investing and funding needs; (4) should assess the credit risks arising from derivatives activities on the basis of frequent measures of current and potential exposure against credit limits; (5) should reduce credit risks by broadening the use of multi-product master agreements with close-out netting provisions,[39] and by working to ensure legal enforceability of derivative transactions within and across jurisdictions; (6) should establish market- and credit-risk management functions with clear authority, independent of the dealing function;[40] (7) should authorize only professionals with the requisite skills and experience to transact and manage the risks of, as well as to process, report on, control, and audit, derivatives activities; (8) should establish management information systems sophisticated enough to measure, manage, and report the risks of derivatives activities in a timely and precise manner; and (9) should adopt accounting and disclosure practices for international harmonization and greater transparency, pending the arrival of international standards.

Similar ground was covered in papers issued simultaneously by the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (IOSCO).[41] Both of these documents were designed to furnish guidance to regulatory authorities for the development of approaches to the supervision of the derivatives activities of financial firms. But they were also clearly of interest to dealers and end-users.

As was noted earlier, some of the subjects covered by microeconomic guidelines as to man-

agement and internal control have a more direct connection to problems of systemic risk than others. One of these areas is liquidity risk and stress testing. Liquidity risk (described above in section B) concerns both the possible effects on asset prices of market participants' own transactions and difficulties regarding access to liquid funds. Both these dimensions of liquidity risk can become especially important during fast-moving, disorderly markets. Stress simulations can provide guidance as to how firms' portfolios are likely to perform in such conditions, thus making possible a reduction of risks of failure at the very time when such risks will also be greatest for most other market participants.[42]

There is now a trend towards according banks' internal controls an explicit role in standards used in prudential supervision, and towards greater reliance on data generated in connection with these controls for supervisors' information requirements.[43] Among the advantages of this trend is a reduction in the cost of meeting these requirements for reporting institutions. The trend has also been promoted by those who view the models used as part of banks' internal controls as the most appropriate vehicle for setting capital charges for financial risks. Such an approach is advocated as a way of facilitating the adaptation of capital standards to the frequently rapid changes in instruments and risk-management systems associated with financial innovation.[44] In its most recent proposals on capital changes for market risks (discussed in the next subsection) the Basle Committee on Banking Supervision accepts the use of in-house models for the measurement of such risks, subject to certain conditions.

3. *Prudential standards and transparency*

The major focus of ongoing initiatives regarding prudential supervision of derivatives is currently OTC instruments. In the countries with the most important financial markets the major OTC dealers are in most cases subject to some form of regulation.[45] Moreover, the OTC derivatives business is fairly concentrated; for example, in the United States, a mere eight banks account for more than 85 per cent of OTC interest-rate and currency derivatives outstanding among 50 of the country's largest banks at the end of 1991, and the top eight firms accounted for 56 per cent of worldwide activity in interest-rate and currency swaps at about the same date according to the afore-mentioned study by the Group of Thirty.[46] Such concentration can be expected to facilitate the task of supervision to some extent (although, owing to the scale of inter-firm linkages which it implies, it might result in greater systemic risks in certain circumstances). However, regulations in these countries differ and the transparency of financial firms' derivatives activities is still considered deficient. Moreover, the process of agreeing on internationally harmonized capital standards for the derivatives positions of such firms is far from complete.

Improvements in national prudential regimes for derivatives are increasingly being shaped by initiatives at the international level. These initiatives were initially directed at derivatives as part of proposals and measures designed to reduce or control the broad categories of financial risk associated with banking and the securities business generally. For this purpose derivatives were singled out only to the extent that their features required special treatment. More recently, however, as already noted above in the discussion of internal controls, guidelines put forward by international bodies have also been concerned with certain aspects of derivatives as such.

Credit risk associated with derivatives is now covered by EU directives on capital standards for banks[47] and by the 1988 agreement, "International Convergence of Capital Measurement and Capital Standards", reached by the Basle Committee on Banking Supervision. Since the Basle Committee is increasingly accepted as the main source of standards for international banking, its guidelines on this subject are likely to serve as a model for banking regimes worldwide. Market risks are covered by EU's Capital Adequacy Directive (CAD), due to come into force in 1996.[48] Initial proposals of the Basle Committee on this subject in April 1993[49] (which followed lines similar to those embodied in the CAD) were criticized by banks. These proposals would have applied capital charges to the current market value of banks' open positions in debt securities and equities and to currency positions involving foreign-exchange risk. The basis of the charges would have been standardized approaches to the different risks covered. Comments received during the subsequent consultation process drew special attention to the proposals' failure to provide incentives for the improvement

of risk-management systems, the insufficient account taken of correlations and portfolio effects across instruments and markets and thus the inadequate rewards to risk diversification, and the probable incompatibility of many of the proposals' features with banks' own risk-management systems (which could lead to costly overlaps to the extent that institutions had to estimate market risks in two different ways).[50]

As a result, in revised consultative proposals of April 1995, the Basle Committee has now put forward the alternative of using banks' internal models for measuring market risks for the purpose of calculating capital charges. This alternative would be subject to supervisors' satisfaction concerning qualitative standards regarding a banks' organization of its risk-management function and quantitative standards for the way in which its value at risk is calculated.[51] The multiplication factor applied to the value at risk for calculating capital charges would be set by supervisors on the basis of their assessment of banks' risk management systems and their recent experience of volatility, but would not be less than three. For banks not using comprehensive risk-management models supervisors would use a slightly revised version of the Basle Committee's standardized approach to the measurement of capital charges for market risk proposed in April 1993.

Thus the outcome of initiatives so far is only the beginnings of a harmonized regime of international standards for the regulation of derivatives activities, with a coverage of both subjects and financial firms that is incomplete. The EU directives apply to both banks and securities firms throughout member countries of the Union. However, the capital standards of the Basle Committee are directed only at internationally active banks; countries are granted some latitude as to the scope of the standards' application at national level. Since the remit of banking supervisors covers securities business to varying degrees in different countries, much of the Basle Committee's work on market risk was undertaken jointly with the Technical Committee of IOSCO. Owing to disagreements within its own group, IOSCO was unable to endorse the Basle Committee's proposals concerning capital charges for market risk of April 1993.[52] IOSCO's reaction to the new proposals of April 1995 was not available at the time of writing. The consultation period for these proposals is supposed to close at the end of July 1995, and the date for their implementation by member countries of the Basle Committee would be the end of 1997. Even if this schedule is achieved, the task would remain of harmonizing the EU rules on capital charges embodied in the CAD with the Basle Committee's revisions to its capital accord to include market risks. An internationally agreed framework for major aspects of the supervision of financial firms' derivatives activities is therefore still some way off.

Consensus seems easier to achieve regarding reporting and transparency. Here the objectives are improvements in the information available not only to regulators but also to counterparties and investors in the shares of financial firms. Public disclosure regarding derivatives portfolios and associated capital positions, accounting practices and other more qualitative dimensions of the use of, and dealing in, derivatives would permit better decisions regarding a firm by both counterparties and investors, thus serving as a useful discipline on its management. With such objectives in mind, in September 1994 a task force of the Euro-currency Standing Committee of the Central Banks of the Group of Ten issued a paper ("Fisher Report") which, unsurprisingly in view of the Committee's close relationship to the Basle Committee, recommended a framework of disclosure for financial firms' risk exposures and risk-management procedures based on their own internal systems.[53] Analogous guidelines were proposed by the Institute of International Finance in a paper of August 1994.[54] In May 1995 the Basle Committee and IOSCO issued a joint report on a framework for information useful to supervisors concerning the derivatives activities of financial firms.[55] Information is classified in connection with major categories of non-systemic risk described above in section B and the impact of derivatives on firms' earnings. The proposed minimum framework covers only some information requirements, the principal focus being on the outstanding notional amounts of derivatives in financial firms' exposures, the creditworthiness of counterparties, maturities, and losses on derivatives positions. Other subjects pertinent to a minimum framework are to be covered in later work. The impact of improved information at supervisors' disposal depends on the scope of the regulatory regimes in force, so that its usefulness will be enhanced as more complete sets of internationally harmonized prudential guidelines are put in place and their geographical coverage is extended.

4. Some other approaches

Various other ideas have recently been floated for improving the functioning of, and reducing risks in, derivatives markets. One suggestion is to change the regulatory framework within which financial firms operate in such a way that activities involving derivatives and certain other instruments which were not for the purpose of hedging or linked to a purely intermediary role would have to be carried out in separate legal entities created for the purpose. This idea builds on a conception for the design of financial systems in which much clearer legal distinctions would be drawn among different entities, according to the level of risk carried by their assets. Its adoption would be likely to meet resistance from financial firms, for which the provision of various services is often closely linked to efforts to generate profits through the taking of positions in markets used in connection with these services. While such delineation of financial firms' activities according to their risks could increase transparency, and thereby, it is hoped, reduce incentives to speculation, the effects on systemic risk would not necessarily be large.

Another proposal is to establish a clearinghouse for exchange-traded swaps and other OTC contracts. The arrangement would apply to a limited number of standardized contracts.[56] Exchanges with appropriately designed clearinghouses can reduce risks, as is evident from the description of their role above in section C. Other potential benefits are improvements in the transparency of positions and transactions, the likelihood of participation in the business by a wider range of financial firms than at present (with the result that competition would be increased), and greater liquidity. However, doubts have been expressed as to the magnitude of these benefits.[57] Indeed, an attempt by the Chicago Board of Trade in 1991 to introduce trading in standardized three- and five-year interest-rate swaps failed owing to lack of investor interest.[58] More recently there has been some spontaneous movement in this direction. For example, the Chicago Board Options Exchange and the Philadelphia Stock Exchange now provide facilities for trading non-standardized option contracts. The advantage of this approach is that use of these facilities is determined by the supply and demand of those who wish to combine flexibility as to contract terms with the security provided by a clearinghouse, and who are willing to take the risk that the market for any particular contract may prove illiquid. Pressure for widespread standardization of contracts, which is a source of concern to OTC dealers, is thus avoided.

Another recent proposal is directed at the incentive structure embodied in typical remuneration packages for the traders of financial firms.[59] These consist of a basic salary together with a profits-linked bonus which can be very large and thus can provide an incentive to sometimes undesirably high risk taking. Under the proposal bonuses would depend not only on the levels but also on the variability of profits, being positively related to the former and negatively to the latter. The effect of such a change on systemic risk is difficult to judge in abstraction from other features of the risk management of financial firms such as their internal controls.[60] Some firms have already moved towards basing traders' remuneration on a formula under which the profits made by units in excess of those on a risk-free portfolio are compared with an aggregate benchmark reflecting those which could have been expected from the movement of the market as a whole. This formula seems designed to achieve the same objective as the proposal described above.[61]

There would thus appear to be no easy or simple alternative to a continuing drawn-out process of developing harmonized international standards for the regulation of derivatives markets alongside of piecemeal efforts to improve existing national regulatory regimes. Derivatives markets will continue to be subject to systemic risk owing to instances of exceptionally high volatility in the markets for their underlying assets and defaults by financial firms with large portfolios of derivative instruments (particularly if these events occur in combination). Better harmonized standards would provide greater defences against such risk but would be unlikely to eliminate it. In the meantime the successful withstanding of periods of stress remains dependent on financial firms' own risk management and the quality and scope of national supervision.

5. Concluding remarks

Although futures and options have been around for a long time, until the 1970s they were, outside the field of commodity trading, a rather esoteric subject. But since the introduction of exchange-traded futures and options on financial in-

struments, derivatives have progressively become part and parcel of the management of their assets and liabilities by banks and institutional investors. With their growing penetration of the operations of financial institutions, derivatives have featured with increasing prominence on the regulatory agenda. With a few exceptions, use of derivatives remains relatively limited in the developing world and the economies in transition, despite long-standing recourse to futures and options by those involved in the trading of their exports of primary commodities. But hedging and speculation with derivatives by domestic and portfolio investors in developing countries is growing even in the absence of well-established markets for futures and options on financial instruments, and can be expected to accelerate in step with the liberalization of their financial markets.[62]

Historical experience suggests that expansion of the use and trading of derivatives should be an organic extension of hedging and of other operations of financial firms for the purpose of balance-sheet management. Initiatives involving artificial incentives to trading in derivatives - for example, through the establishment of exchanges intended purely to attract business to nascent financial centres in developing countries - are likely to lead to markets where speculation predominates, and that are capable of posing a threat to the stability of the financial systems of which they are a part. Moreover, expanded use of derivatives should be accompanied by the development of solid frameworks of regulation and supervision, an integral part of which consists of ensuring that stringent internal controls are in place at enterprise level. As the use of derivatives spreads, links between the firms and exchanges involved can be expected to lead to pressure for more comprehensive agreements on prudential standards, involving developing countries as well as OECD countries, which will build on the ongoing work of the EU, the Basle Committee on Banking Supervision, and IOSCO.

Notes

1 Several futures and options contracts are traded on organized exchanges. Futures specify delivery of commodities or financial instruments at a specified price and future date. Options give the purchaser the right (but without any obligation) to buy or sell commodities or financial instruments in the future at a pre-set price. In the case of exchange-traded derivatives the contracts are standardized. Derivatives are also sold by financial firms over the counter (OTC), in which case the contracts may be customized. OTC derivatives include options, forward contracts (similar to futures but not tradable on an exchange), swaps (which involve the exchange of periodic payments in the same or different currencies according to a specified timetable), and other contracts specifying rights and obligations linked to the performance of an underlying financial instrument or currency, price index or interest rate.

2 Bank for International Settlements, *Recent Developments in International Interbank Relations*, Report prepared by a Working Group established by the Central Banks of the Group of Ten countries ("Promisel Report") (Basle, 1992), p. 25.

3 Keynote address delivered by Dr. William R. Whyte at the Conference, "The Implications of Derivatives for Regulation", organized by the London School of Economics and held at the University of London, 2 December 1994 (reprinted in *BIS Review*, 22 December 1994).

4 Basis risk is that which results from such imperfect correlations.

5 This account is based mostly on Rudolf Wolff & Co. Limited, *Wolff's Guide to the London Metal Exchange*, 3rd edition (London, etc.: Metal Bulletin Books, 1987), chap. 11, and R. Kestenbaum, *The Tin Men. A Chronicle of Crisis* (London, etc.: Metal Bulletin Books, 1991). (Ralph Kestenbaum was spokesman and representative for broker creditors during the negotiations on the settlement of outstanding claims between the ITC and its creditors after the 1985 default.)

6 The initial margin paid by a clearinghouse member at the time an account is opened, together with subsequent margin payments associated with losses on positions marked to market on a daily basis or more frequently, limit the clearinghouse's exposure in the

event of default. The exposure of members of clearing houses to their own customers (whose transactions they are responsible for clearing) is limited through separate but similar systems of margin requirements.

7 The following description of what the Armageddon scenario might have involved was provided in evidence presented to the Trade and Industry Committee of the House of Commons of the United Kingdom on 12 February 1986 (quoted in Kestenbaum, *op. cit.*, pp. 57-58): "Should the L.M.E. market resume trading without the I.T.C. having funds to repay its bank borrowings, or to pay the Tin it has purchased from the market, the following sequence of events will unfold:

a) L.M.E. opens with the I.T.C. unable to honour its commitments to the brokers.

b) Broker A takes up Tin from the other L.M.E. Ring-Dealers and then presents to I.T.C. for payment - I.T.C. defaults on the payment.

c) Broker A, now long, forced to sell to mitigate losses - price declines.

d) Banks also sell their Tin held as collateral for loans.

e) Other brokers in similar position, and if price trades at £5000 per ton, total loss approximately £202 million among the 14.

f) Broker A now in a situation where the loss on the closeout of the I.T.C.'s Tin position makes him insolvent.

g) Broker A is forced to cease trading in all commodities (including other metals and softs) and informs all contract parties.

h) Other Brokers/Dealers are defaulted on by Broker A (as well as I.T.C.) and they have to liquidate their unwanted positions with Broker A.

i) Because of g) and h) all markets, not just Tin, will move against firms trying to unload their unwanted positions, therefore losses increase.

j) Another Broker/Dealer becomes insolvent, and cycle repeats itself from g), then the next, then the next, etc.

The entire existence of the London Metal Exchange and all its members will be very seriously at risk. Furthermore, since these companies have heavy commitments in the bullion market, the foreign exchange market, and the soft commodities markets, their demise will cause a domino effect all across the spectrum of financial institutions and trading firms centred in London."

8 Kestenbaum, *op. cit.*, p. 95.

9 *Ibid.*, p. 68. Such unwillingness could lead to conduct in conflict with the regulations of the LME which forbid dealers to refuse to do business with other dealers on the floor (the "Ring") of the exchange.

10 Securities Review Committee, *The Operation and Regulation of the Hong Kong Securities Industry. Report of the Securities Review Committee* (Hong Kong, 1988), p. 410 (this study being the report of the Hay Davison Committee mentioned earlier). If one uses the peak figure of 3,950 attained by the Hang Seng Index on 1 October, the equivalent value in stock of open interest of 35,000 contracts = 3,950 x 35,000 x HK$ 50 (the contract multiplier) = (approximately) HK$ 6.9 billion.

11 *Ibid.*, p. 411.

12 *Ibid.*, p. 155.

13 US Securities and Exchange Commission (Division of Market Regulation), *The October 1987 Market Break*, (Washington, D.C.: US Government Printing Office, 1988), pp. 11-19.

14 R. Fell, *Crisis and Change: The Maturing of Hong Kong's Financial Markets, 1981-1989* (Hong Kong: Longman Group (Far East), 1992), pp. 195-197 and 226. (Robert Fell was successively Hong Kong's Commissioner of Securities and Commissioner of Banking in the 1980s and came out of retirement to serve as Chief Executive of the Hong Kong Stock Exchange after the 1987 crash.)

15 Securities Review Committee, *op. cit.*, chap. VII.

16 Although terminology is fluid in this area, asset reallocation usually refers to the redistribution by investors of funds among broad classes of assets, including stocks, futures and options, on the basis of strategies which often treat such classes as though they were individual assets; arbitrage denotes the shifts of funds between markets, principally those for stocks and stock futures, to profit from divergences between the value of stocks in portfolios underlying indices of stock prices, on the one hand, and the estimated theoretical value of stock futures, as determined by the relevant index, interest and dividend rates, the time to expiry of the futures contract, and relative transactions costs, on the other; and portfolio insurance is a technique designed to assure a minimum rate of return to a portfolio without foreclosing the opportunity to benefit from favourable market movements through trading strategies which vary on a continuous or almost continuous basis the proportions in the portfolio of call options and money-market instruments or of stocks, stock futures and money-market instruments in response to shifts in the assets' prices.

17 A number of reports by official bodies were produced in the aftermath of the 1987 stock market break, of which two of the more comprehensive were that of the Securities and Exchange Commission mentioned above and that of the Brady Commission, *Report of the Presidential Task Force on Market Mechanisms* (Washington, D.C.: US Government Printing Office, January 1988). Extracts from these reports, together with academic commentary, are available in a book published for the Mid America Institute for Public Policy Research, Inc., Chicago, Illinois, entitled *Black Monday and the Future of Financial Markets* (Homewood, Illinois: Dow Jones-Irwin, 1989).

18 Trading in stock futures, stock options or both accompanied that in stocks at the time of the 1987 crash in a number of markets other than those of the United States (and Hong Kong). (There is a

tabulation in R.W. Roll, "The international crash of October 1987" in *Black Monday and the Future of Financial Markets*, p. 54.) But their role varied, the trading strategies described above being less important outside the United States. See, for example, U.S. Securities and Exchange Commission, *op. cit.*, pp. 11-12 to 11-13.

19 M. Mayer, *Markets* (New York, etc.: Simon and Schuster, 1988), p. 78.

20 For the institutional arrangements for the settlement of margin payments at the Chicago Mercantile Exchange see Federal Reserve Bank of New York, *The Chicago Mercantile Exchange* (New York, July 1989), pp. 83-99.

21 Federal Reserve Bank of New York, *An Overview of the Operations of the Options Clearing Corporation* (New York, April 1989), p. 27.

22 U.S. Securities and Exchange Commission, *op. cit.*, pp. 10-44 to 10-48.

23 *Ibid.*, pp. 3-6 to 3-9. For a concise survey also covering more recent literature see D.A. Dubofsky, *Options and Financial Futures. Valuation and Uses*, (New York, etc.: McGraw-Hill, 1992), pp. 171-172 and 435-448.

24 US Securities and Exchange Commission, *op. cit.*, p. xiv.

25 *Ibid.*, pp. 3-9 to 3-16, and *Report of the Presidential Task Force on Market Mechanisms*, chap. 4 (especially pp. 34-36) and *Analytical Study III* (especially pp. III-20 to III-21).

26 The unwinding of the derivatives portfolios of these institutions is described in "Several significant defaults affecting the over-the-counter derivatives market", Working Paper 4 for the report of the Commodity Futures Trading Commission, *OTC Derivative Markets and Their Regulation* (Washington, D.C., October 1993). There is another concise account of the DBL case in *Safety and Soundness Issues Related to Bank Derivative Activities - Part 3*, Hearing before the Committee on Banking, Finance and Urban Affairs, House of Representatives, One Hundred Third Congress, First Session, 28 October 1993 (Washington, D.C.: U.S. Government Printing Office, 1994) ("Leach Report"), pp. 798-800.

27 The notional principal is the amount of principal on which interest payments in a swap are calculated. In interest-rate-swaps in which both series of interest payments are denominated in the same currency there is no exchange of principals. Such exchanges take place more frequently in the case of swaps where the interest payments are in different currencies.

28 Their failure to walk away from their obligations is the more surprising in that more than two-thirds of the swaps of DBL Products are believed to have been in-the-money - in other words, owing to changes in interest rates and thus in the capital value of payments under the swaps since their initial entry into force, DBL was owed money under a negotiated termination before maturity.

29 B. Quinn, "Derivatives - where next for supervisors?", in Group of Thirty Occasional Paper 44, *Global Derivatives: Public Sector Responses* (Washington, D.C.: Group of Thirty, 1993), p. 38. (Brian Quinn, a director at the Bank of England, gave the above address at a seminar on derivatives convened to discuss the Group of Thirty's study of global derivatives, *Derivatives: Practices and Principles* (Washington, D.C.: Group of Thirty, 1993), various speeches at which are reproduced in the publication cited.)

30 At a simple level, for example, a swap dealer may lay off his risks due to payments to be made to, and to be received from, a counterparty by positions in money-market instruments or the corresponding futures contract if another counterparty requiring payments exactly offsetting those under the first swap is not available. The exposure of dealers in the more complex OTC instruments now increasingly common, which may combine features of different types of derivative, will often be disaggregated into constituent risks, each of which will then be laid off through the taking of offsetting positions in derivatives and other financial assets through OTC transactions or ones on exchanges. The process can also work in the other direction, the exposure due to the series of net payments or receipts under a whole set of swaps being offset by opposite cash flows associated with a position in a single instrument such as United States Treasury notes. See, for example, J.F. Marshall and K.R. Kapner, *Understanding Swaps* (New York, etc.: John Wiley and Sons, 1993), pp. 187-191.

31 Wagers on foreign exchange rates at Spanish fairs in sixteenth-century Antwerp, which were settled in a manner with some resemblance to the use of offsetting positions on modern futures exchanges, are described in R. Ehrenburg, *Capital and Finance in the Age of the Renaissance*, translation by H.M. Lucas (London: Cape, 1928), pp. 243-244.

32 The Dojima rice market in Northern Osaka was established in 1688. Trading on this market progressively took on many of the rules characterizing modern exchanges for commodity futures (such as the standardization of contracts, basic commodity grades, a clearing house, and eventually, in the nineteenth century, provision for delivery of the physical commodity). See, for example, A. Alletzhauser, *The House of Nomura* (London: Bloomsbury Publishing, 1990), pp. 26-27, and R.J. Teweles, C.V. Harlow and H.L. Stone, *The Commodity Futures Game. Who Wins? Who Loses? Why?* (New York, etc.: McGraw-Hill, 1974), pp. 8-9.

33 Exporters of commodities such as coal in nineteenth-century Berlin could quote fixed prices in roubles to customers in Russia, laying off their risks through contingent forward sales (in effect options to sell roubles at a specified exchange rate). L.B. Yeager, *International Monetary Relations: Theory, History, and Policy*, 2nd edition (New York, etc.: Harper and Row, 1976), p. 269.

34 Federal Reserve Bank of New York, *Exchanges and Clearing Houses for Financial Futures and Options in the United Kingdom* (New York, March 1989), pp. 15-20.

35 *The Chicago Mercantile Exchange*, p. 96 and Federal Reserve Bank of New York, *Clearing and Settlement through the Board of Trade Clearing Corporation* (New York, February 1990), p. 17.

36 The Basle Committee on Banking Supervision (formerly the Basle Committee on Banking Regulations and Supervisory Practices) was established in 1974 by the central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States with the objective of strengthening collaboration among national authorities regarding the prudential supervision of international banking. For a review of its work see, for example, A.J. Cornford, "The role of the Basle Committee on Banking Supervision in the regulation of international banking", *UNCTAD Discussion Paper* No. 68.

37 Preliminary evaluation suggests that failures to exchange information on the part of regulators in the United Kingdom, Singapore and Japan contributed to the slowness of their reaction to the build up by Barings of positions in futures which eventually caused its insolvency. See, for example, the editorial in *Financial Times*, 6 April 1995, "Looking back at Barings".

38 *Op. cit.*, pp. 7-8.

39 Close-out netting is an arrangement to settle all contracted but not yet due liabilities to and claims on a financial firm by a single payment on the occurrence of one of a list of defined events such as insolvency. Such an arrangement can reduce the exposure to credit risk of the firms concerned.

40 Although the focus of the Group of Thirty's study is OTC rather than exchange-traded derivatives, the importance of this recommendation about lines of authority and the independence of the risk-management from the dealing function was highlighted by the insolvency of Barings, which appears to have resulted from failures in just these areas with respect to its trader, Nick Leeson. The need for independent management of market risk is further fleshed out in recommendation 8 of the study.

41 Basle Committee on Banking Supervision, "Risk management guidelines for derivatives" (Basle, July 1994); and International Organization of Securities Commissions, "Operational and financial risk management control mechanisms for over-the-counter derivatives activities of regulated securities firms" (Montreal, July 1994). (IOSCO is a forum for regulators of securities business from a large number of countries, with a Technical Committee drawn from those with substantial financial centres.)

42 The need for regular stress simulations is the subject of recommendation 6 of the study by the Group of Thirty.

43 Various aspects of the potential for greater use by supervisors of data generated by banks' risk-management systems are discussed in Bank for International Settlements, *Issues of Measurement Related to Market Size and Macroprudential Risks in Derivatives Markets*, Report prepared by a working group established by the central banks of the Group of Ten countries (Basle, February 1995) ("Brockmeijer Report"), pp. 19, 21, 29, and 35, and annex 1 (p. 4).

44 C. Taylor, *A New Approach to Capital Adequacy for Banks* (London: Centre for the Study of Financial Innovation, July 1994).

45 Gaps in the regulatory framework for OTC derivatives in the United States are described in United States General Accounting Office (GAO), *Financial Derivatives. Actions Needed to Protect the Financial System* (Washington, D.C., May 1994), chap. 5.

46 *Op. cit.*, pp. 131-132.

47 The principal directives are Council Directive 89/299/EEC of 17 April 1989 ("Own Funds Directive"), reproduced in *Official Journal of the European Communities*, No. L124, 5 May 1989, and Council Directive 89/647/EEC of 18 December 1989 ("Solvency Ratio Directive"), *ibid.*, No. L386, 30 December 1989.

48 Directive 93/6/EEC, reproduced in *Official Journal of the European Communities*, No. L141/1, 11 June 1993.

49 Basle Committee on Banking Supervision, *The Supervisory Treatment of Market Risks* (Basle, April 1993).

50 Basle Committee on Banking Supervision, *Proposal to Issue a Supplement to the Basle Capital Accord to Cover Market Risks* (Basle, April 1995), p. 2, and *An International Model-Based Approach to Market Risk Capital Requirements* (Basle, April 1995), p. 1.

51 Value at risk is the income shortfall associated with a deviation from expected income having a specified confidence level.

52 Basle Committee on Banking Supervision, *Report on International Developments in Banking Supervision*, Report number 9 (Basle, September 1994), p. 80.

53 Bank for International Settlements, "Public disclosure of market and credit risks", a discussion paper prepared by a Working Group of the Euro-currency Standing Committee of the Central Banks of the Group of Ten Countries (Basle, September 1994).

54 Institute of International Finance, *A Preliminary Framework for Public Disclosure of Derivatives Activities and Related Credit Exposures* (Washington, D.C., August 1994). (The Institute of International Finance is an organization of international banks originally formed after the outbreak of the developing-country debt crisis to improve the flow of information both among banks and between banks, on the one hand, and Governments and multilateral institutions, on the other, and to serve as a forum for debate on key policy issues.)

55 *Framework for Supervisory Information about the Derivatives Activities of Banks and Securities Firms*, Joint report by the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") (May 1995).

56 A proposal of this kind has been put forward by D. Volkerts-Landau and A. Steinherr ("The wild beast of derivatives: to be chained up, fenced in or tamed?"), in R. O'Brien (ed.), *Finance and the International Economy 8*, The Amex Bank Review Prize Essays in Memory of Robert Marjolin (Oxford, etc.: Oxford University Press, 1994).

57 For regulators and dealers' grounds for doubting the net benefits which would result from a clearing house for exchange-traded swaps see the Leach Report referred to in section C.4 above, pp. 720-724.

58 Mimeographed response by Gay Evans to the paper by Volkerts-Landau and Steinherr. (An initiative by the MEFF Renta Fija for exchange trading in standardized peseta-denominated interest-rate swaps is currently under consideration by the Spanish authorities. R. Lapper, "MEFF poised to launch swaps trade initiative", *Financial Times*, 28 April 1995.)

59 C. Goodhart, "Why bonus payments are dangerous", *Financial Times*, 23 March 1995.

60 For a recent discussion by a specialist in the trading of government securities concerning the length of time necessary to evaluate a trader's performance see C.I. Ray, *The Bond Market. Trading and Risk Management* (Homewood, Illinois: Business One Irwin, 1993), pp. 398-402. As Ray puts it, "bonus timing affects risk-taking at every level of the trading desk".

61 A formula of this kind is described in W.F. Sharpe and G.J. Alexander, *Investments*, fourth edition (Englewood Cliffs, New Jersey: Prentice-Hall. 1990), pp. 749-750.

62 The use of derivatives in connection with the management of portfolios of equities from emerging markets is still highly restricted owing to the very limited availability of contracts and regulatory constraints. (See, for example, G.R. Dobson, *The Global Investor. Opportunities, Risks and Realities for Institutional Investors in the World's Markets* (Cambridge, England, and Chicago: Probus Publishing Company, 1994), pp. 105-108.) But there are indications of rapid growth from a low initial level of OTC derivatives linked to the international bonds (including Brady bonds) of Latin American countries. (J. Clark, "The structure, growth and recent performance of the Latin American bond market", *Federal Reserve Bank of New York Research Paper 9416*, October 1994, pp. 22-26.)

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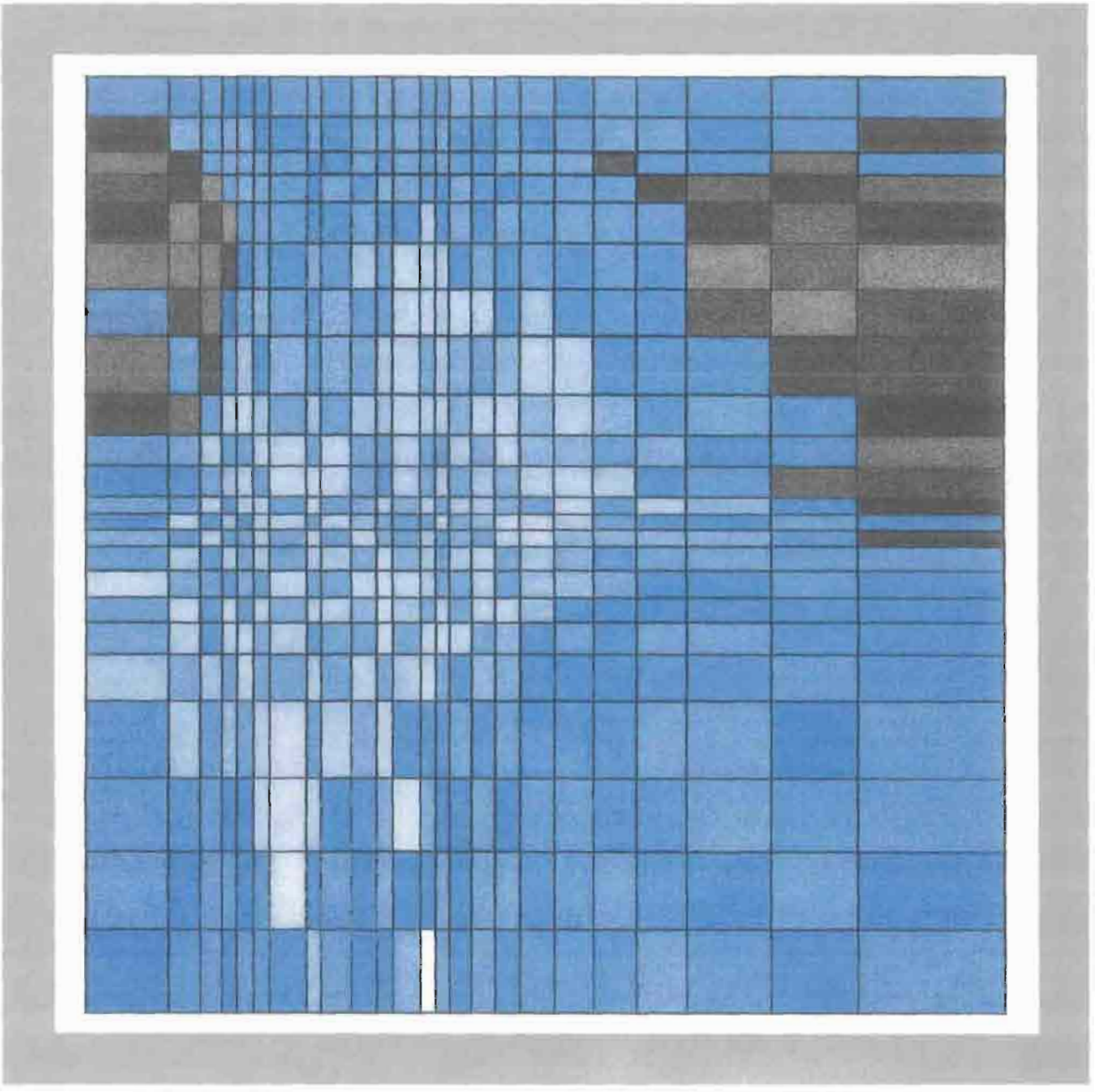
UNEMPLOYMENT AND INTERDEPENDENCE



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Chapter I

THE ISSUES AT STAKE

Mass unemployment and falling pay for unskilled work have become a veritable scourge in the countries of the North. And not only in those countries, for they also cast a long and dark shadow over the world economy as a whole. How those problems are dealt with will influence the future course of all economies, whether developed or developing, given their interdependence.

Despite growing support for globalization, liberalization, and outward-oriented development in the industrialized countries, joblessness is increasingly blamed on imports of manufactured products from the South. The solutions proposed range from raising import barriers ("protectionism"), to imposing higher labour standards on southern producers ("social clause"), to lowering labour standards in the North ("flexible labour markets"). Each of these responses - including the third, favoured by advocates of free markets and minimum government - would slow the industrialization of developing countries.

Trade provides a superficial explanation of unemployment. The same is true of technology, also often identified as the cause. Both factors have, indeed, tended to reduce the demand for unskilled labour. But dislocations of labour as a result of new competition or new technology are nothing new in economic history; besides, demand for skilled labour has also been weak. What, then, has made it so difficult for the labour displaced by structural change to find remunerative work elsewhere in the economy?

Most analysts look for the answer in the labour market, citing either excessive regulation or inadequate training. This issue of the ***Trade and Development Report*** *takes an altogether different view. It traces the root of the problem to the slow pace at which demand, output and investment in the industrialized countries have been expanding over the past two decades. Even if labour is made less costly to employers and more skilled, business will invest on the scale required to provide more and better jobs only if it is confident of buoyant sales. But no country can expand demand on its own for long without suffering an attack on its currency and being forced into "putting its house in order" through a restriction of demand.*

We therefore see the remedy in international cooperation to accelerate world economic growth. Such a strategy would mean "all-boats-afloat"; it would create jobs in the North while benefiting - not hurting - the South. At the same time it would remove the main threat to the liberalization of trade.

By contrast, a strategy of "adjusting" unemployment by pitting worker against worker in the arena of competitive labour markets would exacerbate conflicts among social classes and, no less, among nations. Turning labour back into just another commodity is not a viable recipe for advancing towards an open world economy; on the contrary, it would invigorate the forces that would prefer to go in the opposite direction.

A. The labour market crisis in the North

Over the past two decades there has been a pronounced increase in unemployment in all industrialized countries, although with considerable diversity in the scale and timing of the increase (chart 2).[1] Unemployment in the United States began its rise earlier than elsewhere, and has exhibited the greatest fluctuations, including a strong downward trend in the mid-1980s. The increase was much sharper in the European Union than in the United States or Japan and has been more persistent. But there have also been differences among EU members.

Rising unemployment has occurred alongside continued growth in total employment. Total employment in the European Union actually grew more rapidly in 1973-1990 than in 1960-1973. But this growth was insufficient to absorb the increase in the labour force resulting from rising female participation rates (notwithstanding slower population growth). Moreover, the two-step jump in unemployment rates during the two recessions of the early 1970s and early 1980s was not reversed in the subsequent recoveries. Consequently, in many countries, but particularly in the European Union, there has been a steep rise in the long-term unemployed as a percentage of total unemployment. These changes have coincided with a very uneven distribution of the unemployment burden among different groups in the labour force (see table 25); unskilled and uneducated workers have faced a much higher risk of unemployment than skilled workers.

A failure of the demand for unskilled labour to match supply, does not necessarily imply greater unemployment for unskilled workers. Where hiring and firing regulations are relatively weak, unskilled workers can find employment elsewhere in the economy, albeit at much lower wages. In such circumstances, policy makers have been content to accept less unemployment at the cost of rising income inequality. This coincidence of comparatively low unemployment with growing inequality has been most apparent in the United States, but it is also evident in the United Kingdom and Canada (see table 26). By contrast, France and Germany have experienced little or even diminishing inequality, along with Italy and some of the smaller Western European economies.

B. A one-sided consensus

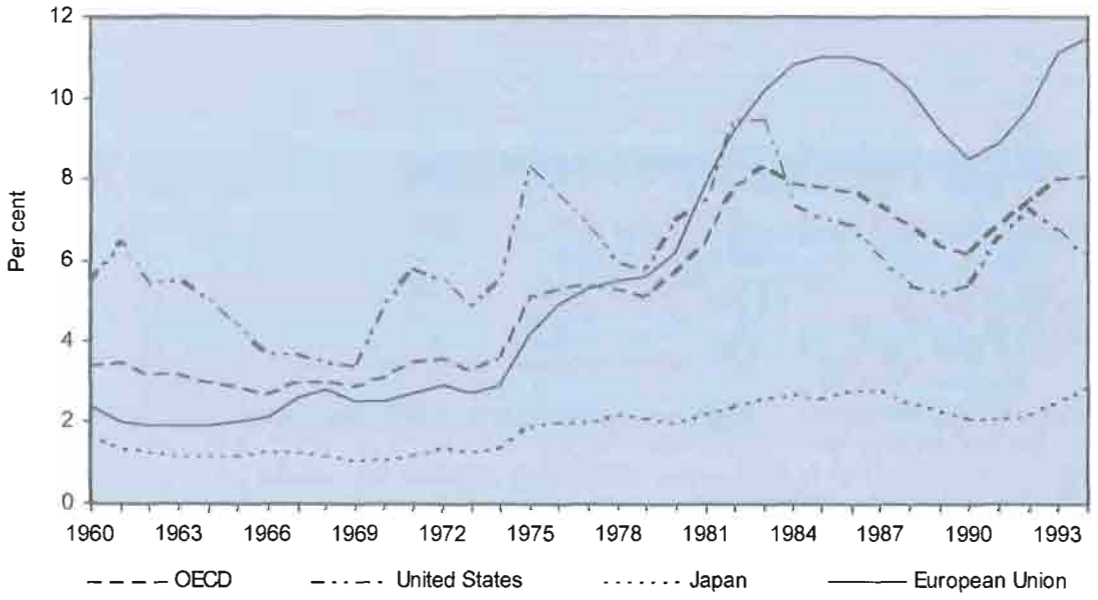
In the face of the rising trend of unemployment, many analysts have emphasized the distinction between structural and cyclical unemployment. The cyclical component moves with fluctuations in overall economic activity, whereas the structural component persists throughout such fluctuations. Because structural unemployment persists over cycles, most observers have assumed it is independent of the level of aggregate demand, and hence not subject to macroeconomic policy influences. They suggest its rise is caused rather by poorly functioning labour markets; this mainstream consensus claims that excessive regulations and the Welfare State prevent labour markets from responding effectively to new pressures and forces in the world economy. These new market pressures and forces are alleged to take the form of increasing imports from the South and/or skill-biased technological progress. On either count, the orthodox view is that the demand for unskilled workers in the North has fallen relative to that for skilled workers, leading to increased wage differentials in favour of the latter in countries with flexible labour markets and greater unemployment of un-

Chart 2

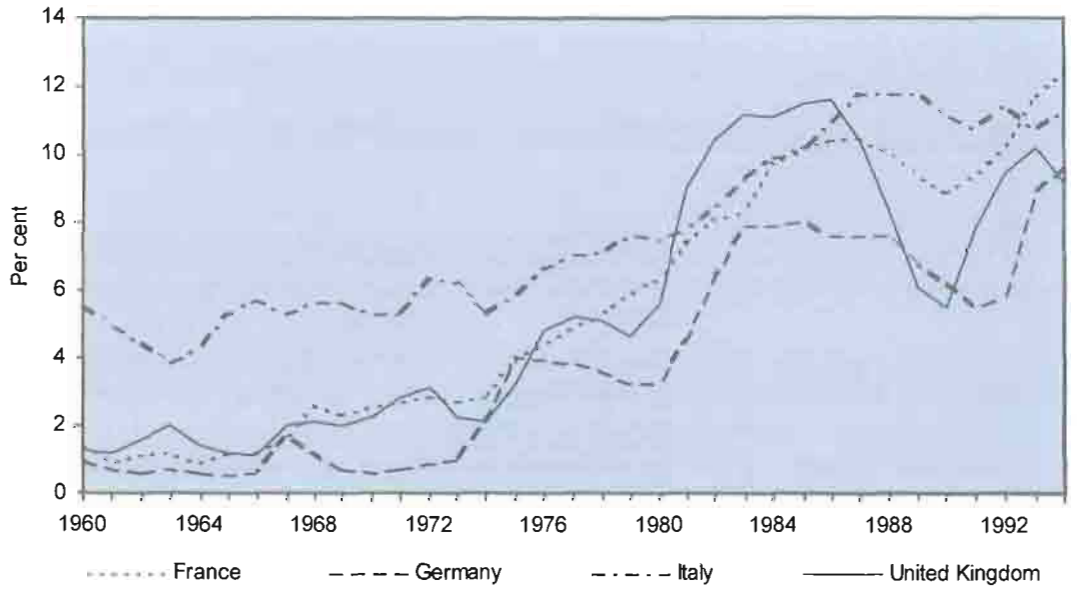
ANNUAL UNEMPLOYMENT RATES IN OECD COUNTRIES, 1960-1994

(Percentage)

A. Major regions



B. Major EU countries



Source: OECD, *Labour Force Statistics, 1964-1984*, Paris, 1986, *ibid., 1972-1992*, Paris, 1994

Table 25

CHARACTERISTICS OF UNEMPLOYMENT IN SELECTED OECD COUNTRIES IN 1994

(Percentage)

Country	Unemployment rate[a]				Long-term unemployment[c]
	Total	Women	Youths	Low-skilled[b]	
United States	6.0	6.0	12.5	13.5	11.7
Japan	2.9	3.0	5.1	..	17.2
European Union	11.1	12.6	18.6	10.0	..
Germany	6.9	6.7	5.2	8.9	40.3
France	12.5	13.6	23.4	12.1	34.2
Italy	12.0	17.8	31.1	7.3	57.7
United Kingdom	9.5	7.4	14.9	12.6	42.5
Other OECD Europe	4.4	4.5	8.2	5.0	.

Source: *The OECD Jobs Study: Implementing the Strategy* (Paris: OECD, 1995), tables 1 and 2.
a Standardized unemployment rates
b 1992.
c 1993. Percentage of total unemployment.

skilled workers where labour markets are inflexible. At first sight this view concords with labour market trends.

Chapter II takes a closer look at these explanations and finds them unconvincing. But not because there are no pressures on the labour market coming from international trade or technological progress. Rather, it is because the size and effect of these pressures is not independent of the wider economic and policy environment in the North, which determines how any resulting dislocations are absorbed.

Dislocations from international trade have not come through the North-South trade balance. The chapter points out that the industrialized countries have consistently run trade surpluses in manufactured goods with the South, creating jobs at home. Although during the 1980s there was a reduction of those surpluses, with subsequent job losses, the swing was much too small and came too late to explain a large part of job loss in the North. Moreover, when the North's trade surplus with the South began to rise again in the 1990s (after 1992 with the East Asian NIEs), this coincided with further job losses and rising unemployment. Nor was the declining trade surplus in the 1980s the result of trade liberalization allowing all developing countries to take advantage of their abundant unskilled labour, but rather of "catching up" in a very small group of highly successful outward-oriented economies in East Asia and, just as importantly, the collapse of imports in other developing countries due to the debt crisis.

But even where there is balanced trade, there may be an adverse effect on employment because Southern exports are generally more labour-intensive than those from the North. The coincidence of falling employment and rising import penetration in sectors such as textiles and clothing lends credence to this possibility. However, in most cases declines in industry in the North predate the export successes of developing countries. Moreover, and contrary to any simple association between labour market problems and North-South trade (or technology), the ratio of skilled to unskilled unemployed workers actually began to rise in a number of countries in the second half of the 1980s, and skilled unemployed became even more prominent during the recession of the early 1990s.

The real question is why the more advanced industrial economies should be affected differently by manufactured exports from the South than they

Table 26

TRENDS IN EARNINGS DISPERSION IN MAJOR OECD COUNTRIES, 1975-1990

(Ratios)

Country	*1975*	*1980*	*1985*	*1990*
Canada	3.22	3.47	4.04	3.98
France	3.44	3.27	3.32	3.44
Germany	..	3.29	2.36	2.31
Italy	..	2.10	2.06	..
Japan	..	2.61[a]	2.75[b]	2.86
United Kingdom	2.38	2.51	2.90	3.24
United States	4.73	4.81	5.58	5.63

Source: As for table 25 (table 3 of the source).

Note: Figures represent the ratio of the lower limit of earnings received by the top 10 per cent (9th decile) of all male workers to the upper limit of earnings received by the bottom 10 per cent (1st decile).

a 1979.

b 1987.

were by the rise in similar exports from Japan and Italy during the 1960s, or why information technology should be any more disruptive than the synthetic materials and transport revolutions of the 1950s and 1960s. What is different today is that displaced workers in the North, both skilled and unskilled, are not being absorbed in expanding industries and services.

The policy recommendations of the consensus invariably focus on the "supply-side": eliminating labour market regulations, reforming welfare institutions, training unskilled labour and implementing measures to boost profits. Although some of these are, potentially, valuable components of a wider employment-creating package, their justification and design is too often motivated by a hasty comparison of labour market institutions. In fact, as is pointed out in chapter III, all labour markets in the North have been undergoing deregulation over the past two decades, resulting in declining trade union membership and a rise in non-standard forms of employment, such as part-time and temporary jobs, and in self-employment. Corporate profitability also rose in the 1980s. But these trends failed to produce the expected expansion of jobs through a faster pace of capital accumulation and did little to ease labour market problems. In those countries where official unemployment figures fell, the absorption by low-productivity sectors of labour made redundant in industry suggests that disguised unemployment, last noticed during the Great Depression, has been expanding and that labour market performance is not so varied among countries as official statistics might suggest. By itself, greater labour market flexibility will determine primarily whether the problems to be faced take the form of increased income inequality or rising unemployment.

These developments cease to be surprising when account is taken of the fact that supply-side policies depend very much on whether they are implemented under conditions of stagnant or growing aggregate demand. Over the past two decades macroeconomic policy has been biased toward restricting demand growth, thereby not only itself limiting the demand for labour, but also blunting the impact of supply-side measures.

C. The "Golden Age" - accident or design?

Despite a tendency in some quarters to disregard the economic experience of the early postwar period, this period still stands out as a standard of economic performance. Up to the 1970s unemployment rates remained low and stable in all the leading industrial economies. Along with the strengthening of the Welfare State, the deep insecurity that had marked the condition of workers in the inter-war years had, by the late 1960s, been relegated to a distant memory. None of this inhibited economic growth. In the period 1950-1973, output expanded by nearly 5 per cent per year and all the major industrial economies grew faster than they had ever done before. Output growth was ac-

companied by a considerable expansion of trade, particularly in manufactures. The period has, accordingly, been dubbed a "Golden Age".[2] Prosperity and stability in the North created, in turn, more favourable circumstances for many developing countries, helping them to embark on an unprecedented period of economic, social and industrial progress.

This Golden Age ended around 1973. A series of events, some dramatic, such as the oil price hikes, some of a more cumulative nature, such as the economic consequences of the war in Viet Nam, intensified distributional conflicts that Governments were unable to resolve. The existing policy consensus unravelled when high employment and low inflation were no longer seen as compatible goals; during the 1980s most Governments accorded priority to combating inflation, arguing that it was necessary for the resumption of economic growth. There has certainly been success on the inflation front; its rate for the G-7 economies since the mid-1980s has been comparable to that achieved during the Golden Age - but this success has not produced a return to the growth rates of that time. More strikingly, it has coincided with rates of unemployment that would have been unthinkable only a few years earlier.

The success of the Golden Age undoubtedly reflected many influences. However, a crucial element was the priority given to growth and full employment, as well as to the pragmatic use of policies to achieve these ends. The reshaping of domestic institutions, such as the systems of wage bargaining and industrial relations, and the creation of new institutions to help manage the international economy, in line with these objectives, went hand-in-hand with high productivity growth, rising consumption and living standards, and high rates of investment in a supportive socio-economic context.[3] The experience of that period shows clearly that full employment, economic growth and very low rates of inflation are compatible, given the right policies; a good part of the responsibility for unemployment must, therefore, lie squarely on the shoulders of policy makers.

Since 1973, however, the industrialized economies have suffered from a fundamental imbalance between investment in fixed capital, productivity growth and the growth of the labour supply. (This theme is elaborated in chapter III.) Much of the rise that occurred in structural unemployment is related to the slowdown in investment, which in turn is closely linked to restrictive macroeconomic policies and deregulation of financial markets. The challenge facing policy makers in the North has already been indicated in Part Two of this Report (see chapter I). There appears to be a real danger of convergence around a growth rate too low to reverse Western Europe's high and persistent levels of unemployment, to prevent Japan's historically high levels from climbing even further, or to address the deep insecurities that have accompanied job growth in the United States. Undoubtedly, avoiding this danger poses many difficult policy challenges, and not all the same for different countries. But what is certain is that the consensus view of structural unemployment as a failure in a particular market is widely off the mark.

D. Policy options

Many supply-side measures (training the workforce, employment subsidies, boosting profits) can help increase employment, provided that there is sufficient demand. But the unemployment problem can only be solved if the fundamental imbalance between investment, growth and job creation is corrected. This does not mean adopting exactly the same policies as were successful in the past. But it does mean finding the right mix of demand and supply-side measures to ensure both internal and external balance in the changed context of the 1990s.

Chapter IV explains that investment could pick up if macroeconomic policy were to favour growth. Monetary policy should be used to bring interest rates down from their unprecedentedly high levels and to keep them stable thereafter; the instability emanating from financial markets should be contained; and public investment (especially in infrastructure) should be stepped up, with a clear separation in public budgets between current and capital expenditure. But the problem of accumulated debt - something that was absent during the Golden Age - has also to be addressed if fiscal, as well as monetary, policy is once again to play a constructive role in managing the economy. Lower interest rates can help alleviate the problem of fiscal deficits over the longer run, but a once-for-all capital levy on financial wealth designed to reduce the debt overhang to a sustainable level offers the best immediate response.

Such a change in policy stance requires international coordination to prevent financial markets from imposing undue constraints on implementation; countries cannot realistically hope to achieve full employment, price stability and open markets on their own. This approach may seem politically out of reach. But, unemployment is itself reaching politically menacing levels, threatening to bring social disintegration and beggar-my-neighbour policies and jeopardizing the stability of the international trading system. ■

Notes

1 Caution is required in the interpretation of unemployment statistics, on account of differences in definitions, in the statutory retirement age, the nature and coverage of labour market programmes, and the extent of labour hoarding.

2 S. Marglin and J. Schor (eds.), *The Golden Age of Capitalism: Reinterpreting the Postwar Experience* (Oxford: Clarendon Press, 1989); A. Maddison, *The World Economy in the 20th Century* (Paris: OECD Development Centre, 1989); A. Cairncross and F. Cairncross, *The Legacy of the Golden Age: The 1960s and their Consequences* (London: Routledge, 1992).

3 It is becoming increasingly common to see the current rising unemployment trend as part - albeit hopefully a temporary one - of a return to a longer historical trend interrupted by two world wars, and to discount the experience of the Golden Age. Indeed, the period from 1850 to 1913 is being described as an earlier Golden Age of greater relevance for policy makers. See IMF, *World Economic Outlook*, May 1995, p. 129.

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Chapter II

TRADE, TECHNOLOGY AND UNEMPLOYMENT

A. Introduction

During the Golden Age, an open and expanding trading regime was considered crucial to economic prosperity and political stability in the North. Indeed, the link between international economic disintegration and mass unemployment was clearly expressed by a leading architect of postwar reform at Bretton Woods in the following terms:

> All of us have seen the great economic tragedy of our time. We saw the worldwide depression of the 1930s. We saw currency disorders develop and spread from land to land, destroying the basis for international trade and international investment and even international faith. In their wake, we saw unemployment and wretchedness - idle tools, wasted wealth. We saw their victims fall prey, in places, to demagogues and dictators. We saw bewilderment and bitterness become the breeders of fascism and finally, of war.[1]

Postwar moves towards greater international economic integration rested, in their turn, on recovery in the world economy. Policies to stimulate domestic investment and growth not only helped prevent a return to the economic chaos of the inter-war years, but also ushered in an era of full employment and freer trade. Managing possible conflicts arising from these domestic and international objectives required positive leadership at the international level, backed by resources and a willingness to make some domestic sacrifice.

Thinking today is radically different. Although the commitment to free trade is stronger, two decades of slower growth and high unemployment have encouraged a new mercantilist outlook, each country seeking to reduce unemployment by improving its external competitiveness. With the onset of recession in 1990, and a further downward twist in manufacturing employment, competition from low-cost manufactured imports from developing countries has increasingly been blamed for the increased unemployment and growing inequality in the North. The rapid increase in the flow of foreign direct investment (FDI) to developing countries has further heightened concerns about a loss of jobs from North to South, and shifted the debate on the links between competitiveness and employment to a global level.

However, there is by no means complete agreement that the main pressures on labour markets in the North are international in origin. Another view sees technological change as a much more disruptive influence on employment and wages in the advanced industrial economies. Despite their differences, both these explanations end up viewing employment problems in the North as a failure to match the supply of and demand for different types of labour. Ultimately, it is this agreement, rather than any disagreement over the source of structural change, that has been the more significant factor shaping policy recommendations in favour of deregulation, better training and welfare reforms.

But such recommendations rest on a very one-sided view of the economy. The crucial point is that international trade is constantly changing un-

der forces of specialization, innovation, market growth and international investment. Through these dynamic forces trade - much like technological change - can strongly influence the composition of domestic labour demand, but any effects on the aggregate demand for labour will depend upon underlying macroeconomic conditions, particularly the pace of demand expansion and capital accumulation. Under conditions of rapid capital accumulation both trade and technology can reinforce a virtuous circle of economic growth, job creation and productivity increase. If global demand is deficient and capital accumulation sluggish, increased trade and technical progress can add to unemployment and/or worsen income inequality. The evidence suggests that dislocations caused by trade with the South have had a not insignificant effect on employment and wages in the North, but not because such dislocations have been any larger than in the past; rather, it is because they are occuring against a background of weak demand and sluggish growth. Failure to adopt appropriate policies to address these fundamental weaknesses in the North will mean that as more and more countries in the South rely on exports as an engine of growth and succeed in catching up, such dislocations will become more pronounced.

B. Trade, capital and the labour market

1. *Trade, wages and employment*

The striking coincidence of abruptly declining manufacturing employment in the North, unemployment levels not seen since the 1930s, growing income inequality and sharp increases in manufactured imports from the South has revived concerns over a destructive link running from trade to the labour market. The link has already provoked considerable controversy in the United States, where manufactured imports from the South have risen more sharply than in either Western Europe or Japan (see chart 3), where the income status of the unskilled has declined drastically, and where the issue has been prominent in the context of NAFTA. But similar concerns have also been expressed in Europe and Japan, and became a divisive issue between the North and South during the troubled birth of the World Trade Organization.

Nor is it only policy makers who have been struck by the coincidence of these various trends. Indeed, turning coincidence into a convincing explanation of contemporary labour market problems has revived some difficult debates that have periodically divided academic economists (see box 5). At the centre of these debates stands the old idea that under free trade countries will specialize in those activities in which they have a comparative advantage as determined by their resource endowments: they will produce and export those goods which use their abundant domestic resources intensively and import others. As trade expands, the relative prices of goods will change, dragging factor prices with them. At the limit, international trade will reduce earning differentials among different trading areas, even if factors are immobile.

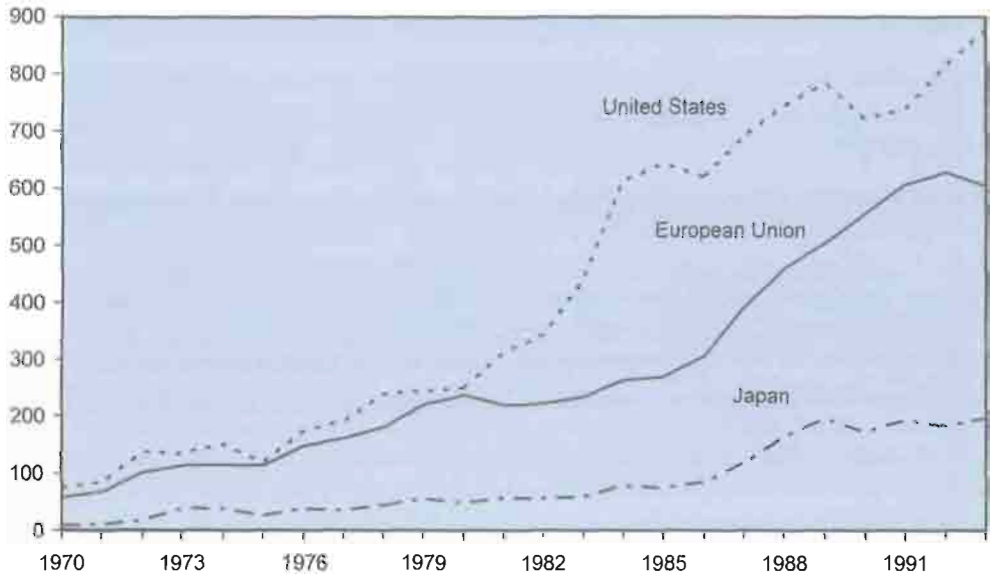
This reasoning was perceived to lose relevance during the Golden Age, when intra-industry trade among the advanced industrial countries came to dominate world trade. However, according to a growing body of opinion, the role of differences in the level of capital stock in determining the nature and impact of international trade has diminished significantly in recent years because of the increased mobility of capital, whilst the growth of trade in goods with a high knowledge and skill content has increased the importance of labour skills in shaping trade patterns. The result is a renewed interest in the importance of North-South manufacturing trade in the international division of labour.

On this view, developing countries, poorly endowed with human capital, should export (unskilled) labour-intensive goods to richer countries and import skill-intensive goods which require large inputs of qualified labour. Assuming that trade liberalization allows countries to participate in the international division of labour on the basis of their

Chart 3

EXPORTS OF MANUFACTURES FROM DEVELOPING COUNTRIES TO THE UNITED STATES, EUROPEAN UNION AND JAPAN, 1970-1993

(Billions of dollars, in 1985 prices)



Source: United Nations, *Commodity Trade Statistics, Series D.*

skill endowments, three additional elements make up the case that North-South trade is the root cause of increasing inequality and unemployment in the North. First, there is a growing degree of geographical specialization in which the skill hierarchy of *goods* matches the skill hierarchy of *countries*; given that the wage of unskilled workers in the South is a fraction of that paid in the North, increased trade between the two regions will result in a dramatic fall in the relative price of labour-intensive goods in the North and the wage of unskilled workers relative to that of skilled workers will consequently fall significantly. Second, wage inflexibility and other market rigidities in the North determine whether workers whose jobs are destroyed by trade are absorbed in other sectors producing skill-intensive and non-tradeable goods or add to the ranks of the unemployed. Third, trade with the South can lead to significant productivity improvements in the North because part of the latter's response to competition from southern exports takes the form of defensive innovation and corporate restructuring, thus compounding the disadvantages of unskilled workers in the North.

As shown in annex I to Part Three, a revised (Heckscher-Ohlin) model of North-South trade that includes these elements predicts a considerable impact on the structure of employment and incomes in the North. The brunt of this impact is felt by unskilled workers, either as increased unemployment or as a large reduction in their relative wage. Given the problem of measuring the individual and institutional determinants of wages, estimates of the effect of trade on income inequality for individual countries are subject to a certain margin of error. Nevertheless, estimates of the decline in the relative wage of unskilled workers due to trade have ranged from under 10 per cent to over 20 per cent.[2] Such changes are consistent with developments observed in recent years in countries with deregulated labour markets, such as the United Kingdom and the United States.

As is also clear from annex I, the effect of trade on manufacturing employment depends on the degree of wage flexibility. If relative wages are rigid, total manufacturing employment falls by around 18 per cent, but even if they are flexible

Box 5

GLOBALIZATION AND THE LABOUR MARKET: SOME CLASSICAL DILEMMAS

The claim expressed by some policy makers and economists that North-South trade and capital flows are behind contemporary labour market problems, whatever its empirical merits, can hardly be judged a recent concern. Certainly, the idea that freer trade enhances the wealth of nations can claim widespread support from economists. However, Governments have been reluctant to dismantle trade barriers, and economists have tended to explain this resistance by a combination of public prejudices and vested private interests. There is, undoubtedly, some truth in this. However, by basing their own policy recommendations on unrealistic assumptions which idealize the response of market institutions to economic change, economists have often hindered their own case for a more open trading environment.

In reality, economic adjustments take place in an environment of market imperfections, can be difficult to carry out and are often long-lasting processes. Moreover, they almost always introduce distributional conflicts because those bearing the costs of adjustment need not be the same as those who ultimately benefit from change. Recognizing these difficulties has often been presented as a first step towards mercantilist-type policies. However, because in their search for measures to enhance the wealth of nations classical economists were also concerned with the economic welfare of the labouring classes[1], adjustments to international pressures were also a key feature of their policy recommendations.

Adam Smith was fully aware of the difficulties that trade liberalization could bring to employment in immature industries: "if those high duties and prohibitions were taken away all at once, cheaper foreign goods of the same kind might be poured so fast into the home market as to deprive all at once many thousands of our people of their ordinary employment and means of subsistence"[2]. As the debate on the Poor Laws in England intensified, David Ricardo tempered his call to leave wages to the "fair and free competition of the market" with the recommendation that abolishing the Poor Laws "should be effected by the most gradual steps" because of the negative distributional effects that would follow. On very similar grounds, Ricardo also opposed the rapid dismantling of the Corn Laws because a rapid increase in agricultural prices following liberalization would depress prices in a manner "ruinous to the interests of farmers".[3]

Even the later contention that international trade would always and rapidly be beneficial even when factors were immobile was, as Heckscher himself was quick to realize, only applicable to countries at very similar levels of industrial and economic development using the same techniques of production: "Just as it is certain that, under free exchange, the same technique leads to the same prices for the factors of production in all countries, so it is equally certain that differences in techniques lead to differences in factor prices."[4] As the staunch advocate of trade liberalization Lionel (later Lord) Robbins pointed out, with significant differences in international efficiency and income levels, free trade can be used as effectively as protection to increase the wealth and power of one group or nation, at the expense of others.[5]

Whilst the adjustment problems associated with rapid trade liberalization were not seen by these writers as undermining the classical case for freer trade, their approach to international capital movements was quite different. Both Smith and Ricardo were strongly opposed to the export of capital, fearing that the loss of productive activity would hasten the advent of a stationary state. According to Ricardo, "A nation is only advancing whilst it accumulates capital. Great Britain is far distant from the point where capital can no longer be advantageously accumulated. I do not mean to deny that individual capitalists will be benefited by emigration in many cases, but England, even if she received the revenues from the capital employed in other countries, would be a real sufferer"[6]

Box 5 (concluded)

These classical concerns receded as faith in the international gold standard to promote improvements in both national and global employment and in incomes grew stronger. However, they resurfaced in the interwar period, when the costs of financial openness once again became intolerable. By the early 1920s, fear of the stationary state had been replaced by mass unemployment and, as Alfred Marshall came to realize, adjusting to international pressures inevitably focused on the labour market, where bargaining, just as much as the forces of supply and demand, help to shape the allocation of resources[7]. But it was left to Keynes to revive classical dilemmas. While remaining committed to free trade, he linked the export of capital to unemployment because "Some foreign investments lead directly to the placing of orders in this country which would not be placed otherwise. Whether or not they are desirable on general grounds, such investments do no harm to employment. As a rule, however, this is not the case. A foreign loan does not ... automatically create a corresponding flow of exports".[8] His abandonment of free trade in 1931 astounded many of his contemporaries, but it was a predictable response to the failure of Britain's interwar politicians and policy makers to address the possible inconsistencies between free trade, free capital flows and full employment.

1 See D. Winch, *Adam Smith's Politics* (Cambridge: Cambridge University Press,1978), p. 87.
2 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937), pp. 435-436.
3 Ricardo's discussion of the Poor Laws can be found in the *Works and Correspondence of David Ricardo*, Vol. I (Cambridge: Cambridge University Press, 1951) and his discussion of the Corn Laws in Vol. IV.
4 E. Heckscher, "The Effects of Foreign Trade on the Distribution of Income", in American Economic Association, *Readings in the Theory of International Trade* (Philadelphia: Blackiston, 1949), p. 291.
5 L. Robbins, *The Theory of Economic Policy* (London: Macmillan, 1952), pp. 10-11.
6 D. Ricardo, *op. cit*, Vol. III, p. 274.
7 A. Marshall, *Trade and Industry* (London: Macmillan, 1923), pp. 335-336.
8 J. M. Keynes, "A drastic remedy for unemployment: Reply to critics", in *The Collected Writings of J.M. Keynes*, Vol. XIX (London: Macmillan, 1981).

the drop is still significant (13 per cent). This is consistent with the lower end of the range of empirical estimates of jobs lost in manufacturing due to trade with the South (12-24 million).[3] The higher figure - which implies considerable trade-induced industrial restructuring in the North - would account for most of the rise in northern unemployment. By contrast, the lower estimates, if spread over the 30 years since southern manufacturing exports began to expand, would imply annual job losses of around 400,000, a not insignificant figure but only a small fraction of total manufacturing employment in the North. However, if the job loss was concentrated in the 1980s, the impact appears to be rather more important, perhaps amounting to between one third and two fifths of total job losses in manufacturing in the North.

2. Foreign direct investment, wages and employment

Trade liberalization and the growing importance of human capital have not been the only developments in the world economy giving rise to the idea of a new international division of labour. Since the early 1970s, there has been a steady increase in the flow of foreign direct investment both in absolute terms and relative to domestic investment.

For most of this period, the flow of FDI has been among developed market economies, but beginning in the late 1980s flows to developing countries began to recover and by the 1990s the share of FDI flows to developing countries had risen significantly.[4]

Concern that FDI could have a negative effect on employment in home countries has been voiced most strongly in North America, where opponents of NAFTA suggested that a more open FDI regime would cause jobs to migrate to Mexico. On some estimates, up to half a million jobs would be lost up to the year 2000 as a result of this process. But similar concerns have been expressed elsewhere in the North. The "delocalization" of French industry has already been estimated to have had a significant impact on unskilled labour in industries such as textiles and clothing, which is expected to be heightened in pace and scope. Most recently, "hollowing out" (or *kudoka*) has entered the discourse of Japanese policy makers. Even more cautious observers of trends in the international division of labour, projecting industrial growth in China and India as well as recovery in Eastern Europe, anticipate a dramatic shift in the balance of world industry over the coming decades driven, in part, by FDI and made at the expense of industries dominated by unskilled labour in the North.[5]

The logical consequences of adding FDI to conventional trade models are straightforward assuming FDI is exclusively of the "market-seeking" type, where overseas production directly substitutes for exports.[6] If capital is already, or is rapidly becoming, fully mobile internationally - and thus no longer a constraint on the scale of low-wage manufacturing production in the South - and the South is amply endowed with unskilled labour, and if locational advantage reflects factor endowments, firms from the capital-intensive countries will invest abroad in the production of goods in the South embodying low skills. In the process, technology is transferred from the North, deepening industrial development in the South. Accordingly, capital outflows will reduce the capital stock in the North, depressing the productivity of labour there and raising it in the South. These trends would reinforce the impact of imports on employment and wages of northern unskilled workers.

But, as recent technological changes have made it easier for firms to organize both a larger number and a more geographically dispersed set of cross-border activities, the link between FDI and trade has been changing in recent years in ways which might reinforce the threat to unskilled workers in the North. The decision of TNCs over where to locate activities is increasingly being driven both by cost considerations and by the desire to gain rents from their control over technology and their various organizational assets. These same changes also appear to loosen the attachment of production activities and their related employment to any particular location. In this context, two new channels making for closer links between labour markets in the North and South accompany the spread of international production. *Subcontracting* unskilled work to firms in low-wage countries has become an integral part of this cross-border division of labour, particularly in those industries (such as clothing and electronics) where the more labour-intensive parts of the production process can be easily separated and technology is standardized and easily transferable. Where such relations occur between the parent and affiliate there is an increase in *intra-firm trade*. Although the importance of these developments is difficult to quantify precisely, subcontracting and intra-firm trade do appear to have shown significant growth over the past two decades.[7]

C. Evolution and effects of North-South trade

There is no disputing that the sharp rise in manufactured exports from developing countries over the past two decades has coincided with a declining share of the leading industrial economies in world trade in manufactures over this period. According to traditional trade theory, for manufactured imports to have been an important influence on labour markets in the North, this rise would have had to be concentrated in low-skill industries, and the price of goods produced in this sector

should have declined significantly relative to other goods. Moreover, any significant impact of increased manufacturing trade with the South should also translate into systematic and persistent employment falls in all low-skill industries in the North and employment expansion in all medium and high-skill industries.

A good deal of effort has been spent on determining whether relative prices have changed in the direction predicted by trade models. The finding of a number of research studies that the international price of skill-intensive goods has fallen over the past decade or so relative to the price of (low-skill) labour-intensive goods has been taken as strong evidence against a trade-based explanation of rising inequality. However, there have been strong methodological and empirical counter-arguments. On the one hand, the analysis appears particularly sensitive to the products chosen as well as the way in which the skill content of goods is measured. On the other hand, the finding for both Europe and the United States that the relative price of both high-skill and low-skill manufactures has fallen relative to the price of those embodying medium skills, and to prices of non-tradeables, cannot rule out the predicted price effect of import competition from the South.[8] In fact, these figures can prove very little about the effect of trade because of uncertainty as to how these prices would have moved in the absence of trade.

Table 27

SHARE OF MANUFACTURED IMPORTS FROM DEVELOPING COUNTRIES IN TOTAL MANUFACTURING OUTPUT IN THE UNITED STATES, EUROPEAN UNION AND JAPAN, 1975-1990

(Percentage)

Country	1975	1980	1985	1990
United States	2.4	5.0	8.1	10.6
European Union	1.9	3.4	4.3	6.1
Japan	1.3	1.8	1.9	3.2

Source: OECD, *National Accounts*, various years, and United Nations, *Commodity Trade Statistics, Series D.*

1. *Manufacturing trade and employment*

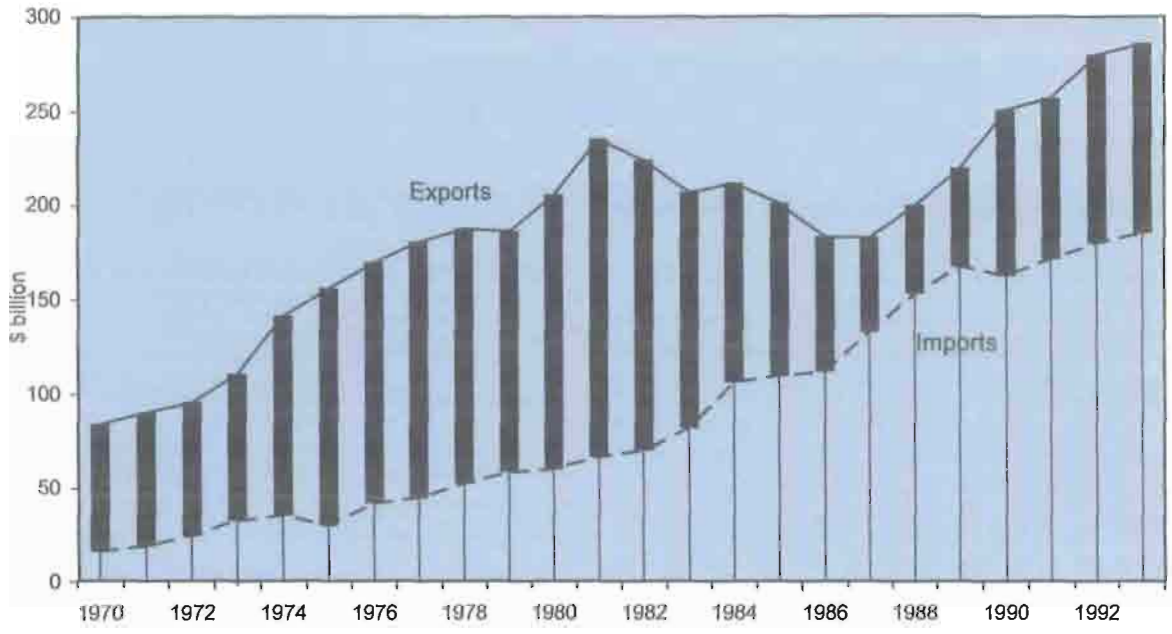
As already noted, an important factor behind rising rates of unemployment in most industrialized countries over the past two decades has been a loss of jobs in manufacturing. The first salient question is whether this general trend could be explained by manufactured imports from the South which, although having risen by around 12 per cent per annum in volume from 1970 to 1990, are still small in relation to the developed countries' combined GDP; at the beginning of the 1990s, OECD imports of manufactures from developing countries (excluding China) accounted for no more than 1.5 per cent of GDP. However, it can be argued that taking GDP as the denominator understates the impact of North-South trade because it includes a large non-tradeable component. Certainly, if only manufacturing output is considered, the significance of imports from the South appears considerably greater (see table 27) and if total manufactured imports are taken as the denominator the impact appears greater still; in 1970 developing countries accounted for less than 5 per cent of total imports of manufactures by developed countries, compared with close to 15 per cent in 1990. But, in terms of any overall employment effect, the size of the national economy (as measured by GDP) is what matters, because labour must be able to shift between the tradeable and non-tradeable sectors as external conditions change.

For southern imports to have had a more general impact on employment, they must have significantly lowered the demand for labour through the trade balance. Assuming the labour contents of exports and imports do not undergo sharp changes, then a deterioration of the trade balance will, over a period of time, almost certainly lead to declining employment. Over the past two decades the North's surplus on manufacturing trade with the South has been falling. In 1991, imports corresponded to 1.5 per cent of GDP, and exports to 2.4 per cent, leaving a trade surplus of 0.9 per cent of GDP, against 1.2 per cent in 1970. While attention has focused in recent years on the potential employment effects of rising imports from developing countries, an important part of this contraction of the OECD trade surplus during much of the 1980s has been due rather to falling exports from the region to the developing countries. Chart 4 suggests that since the early 1970s manufacturing trade between the industrialized and the developing countries has gone through three distinctive

Chart 4

TRADE IN MANUFACTURES[a] OF OECD COUNTRIES WITH DEVELOPING COUNTRIES[b], 1970-1993

(Billions of dollars, in 1985 prices)



Source: UNCTAD secretariat calculations, based on United Nations, *Commodity Trade Statistics, Series D.*

a SITC 5-8 (less 68).

b Excluding China.

phases. Throughout the 1970s, the industrialized countries' surplus with the developing countries increased, peaking in 1981 at 2.3 per cent of total GDP. During that period, their imports from developing countries grew in volume every year (except for the recession of 1975), but exports grew even faster, especially immediately after the oil price rises. Indeed, the North's growing surplus during this period was largely on account of exports to a few oil-exporting developing countries. After 1981, the surplus with the developing countries shrunk. This trend continued until 1988, after which the surplus began to widen again. In real terms, the 1993 surplus was approximately equivalent to its size in 1974, i.e. around one third smaller than in 1981.

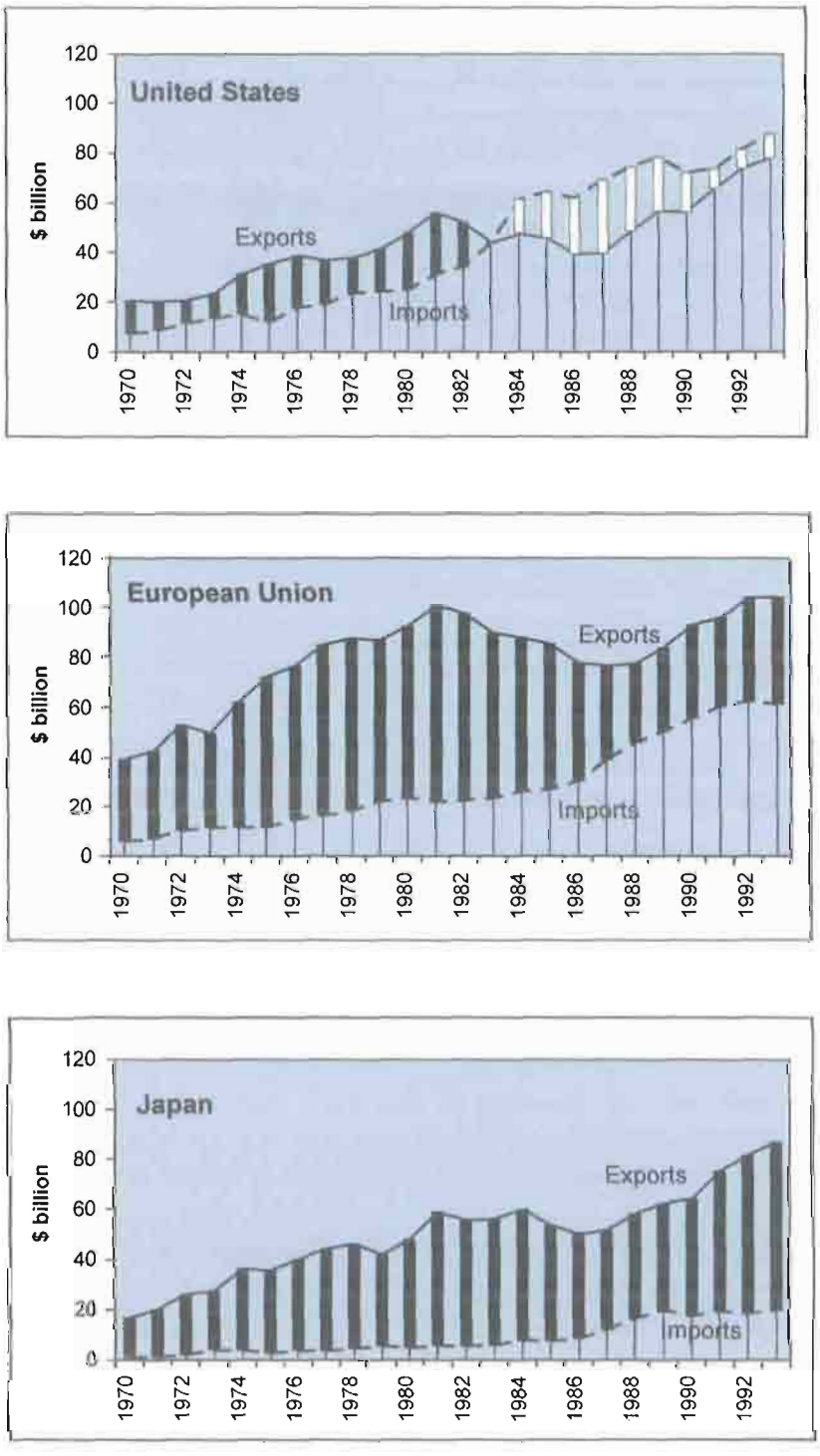
Behind this evolution of the manufacturing trade balance for OECD countries as a whole lies a diverging trade performance among the major countries (see chart 5). While the trade balance of the European Community with the developing countries moved much in line with the OECD average, the United States and Japan diverged widely from the average, but in opposite directions. Exports from Japan in the 1980s fell modestly and there was only a small rise in imports after 1986; the United States, on the other hand, suffered greater export losses while it already had a much sharper rise in imports than Japan, from 1981 onwards. Consequently, there has been a rising surplus in Japan, but a deficit in the United States since 1984 (although it has shrunk since 1987).

Manufacturing employment fell in three phases (see table 28). Of the total fall in employment of around 8.3 million, around one quarter occurred in the first half of the 1970s, more than one half from 1980 to 1985, and a little less than a quarter since 1990. This suggests that the fall was much more closely related to recession in the industrialized countries (1973-1974, 1980-1982,

Chart 5

TRADE IN MANUFACTURES OF THE UNITED STATES, EUROPEAN UNION AND JAPAN WITH DEVELOPING COUNTRIES, 1970-1993

(Billions of dollars, in 1985 prices)



Source: See chart 4.

Table 28

EMPLOYMENT IN MANUFACTURING IN THE G-7 COUNTRIES, BY SECTOR, 1970-1993

Sector	Change						
	1970-1975	1975-1980	1980-1985	1985-1990	1990-1993[a]	1970-1993[a]	
	(Thousands)					(Thousands)	(Per cent)
Chemicals & pharmaceut.	-197	-67	-243	-2	-31	-540	-15.6
Scientific instruments	9	83	-119	303	-168	108	9.1
Printing & publishing	-7	195	115	305	-75	533	21.7
Total high-skill	-195	211	-247	606	-274	101	1.5
Food processing	-103	-20	-274	156	34	-207	-4.2
Fabricated metal products	-252	18	-318	153	-183	-582	-13.7
Wood & paper products	-187	34	-551	126	-183	-761	-17.6
Electrical machinery[b]	-302	394	332	-374	-307	-257	-4.5
Non-electr. machinery[c]	-228	352	-522	195	-402	-605	-9.5
Total medium-skill	-1 072	778	-1 333	256	-1 014	-2 412	-9.4
Transport equipment[d]	217	211	-370	6	-372	-308	-5.8
Textiles & clothing	-961	-663	-1 088	-656	-164	-3 532	-44.0
Rubber & plastic products	112	195	43	367	-53	664	36.3
Non-metal mineral prod.	-99	-76	-333	-1	-130	-639	-27.4
Ferrous metals	-197	-311	-839	-220	-147	-1 714	-55.1
Non-ferrous metals	-85	6	-141	-10	-36	-266	-29.9
Total low-skill	-1 013	-638	-2 728	-514	-902	-5 795	-26.9
Other sectors	-31	-8	-473	299	29	-184	-14.3
All manufactures	-2 311	343	-4 781	647	-2 188	-8 290	-15.0

Source: UNCTAD secretariat calculations, based on UNIDO data base.

a 1990-1992 and 1970-1992 for Germany and the United Kingdom.

b Including office equipment and computers (high-skill) and other electrical machinery (medium- or low-skill).

c Including communication equipment and semiconductors (high-skill) and other non-electrical machinery (low-skill).

d Including aerospace (high-skill), shipbuilding and repair (low-skill) and road vehicles (low-skill).

1990-1991), and a reduction of exports to the developing countries during the 1980s, than to rising manufactured imports from the latter. Indeed, manufacturing employment fell most dramatically during 1980-1985, when the manufacturing trade surplus shrank because of sharp import compression by developing countries (see also subsection 3 and chart 7 below). In other words, any significant impact of North-South trade on total manufacturing employment appears to have originated more from a decline in the purchasing power of the South than from an increase of its volume of exports. UNCTAD secretariat estimates based on a counterfactual scenario in which both OECD imports from and exports to the developing countries grow during 1981-1988 at the same trend rate as in 1976-1981 (i.e. ignoring the drop in exports due to the debt crisis and the jump in imports from the NIEs) suggest that the reduction of the OECD trade surplus in manufactures with developing countries due to lower exports was more than double the reduction due to the rise of imports. If the

Table 29

EMPLOYMENT AND NET TRADE IN MANUFACTURES IN THE G-7 COUNTRIES, 1970-1993

Country	1970	1975	1980	1985	1990	1993[a]	Change 1970 -1993[a]		
	Employment (Thousands)						*Employment*		*Net exports to developing countries*
							(Thousands)	*(Per cent)*	*(Per cent of GDP)*
Canada	1 638	1 743	1 853	1 765	1 867	1 697	59	3.6	-1.4
France	5 196	5 407	5 103	4 543	4 352	3 991	-1 205	-23.2	-0.5
Germany	8 203	7 284	7 229	6 616	7 120	7 056	-1 147	-14.0	-0.9
Italy	3 289	3582	3 333	2 875	2 757	2 697	-592	-18.0	-0.1
Japan	10 880	10 542	10 213	10 646	11 173	10 924	44	0.4	0.7
United Kingdom	7 951	7 394	6 462	4 935	4 798	4 314	-3 637	-45.7	-1.9
Unites States	18 213	17 108	19 210	17 242	17 502	16 402	-1 811	-9.9	-0.7
Total G-7	55 371	53 060	53 403	48 622	49 569	47 081	-8 290	-15.0	-0.3

Source: UNCTAD secretariat calculations, based on UNIDO Data Base and United Nations, *Commodity Trade Statistics, Series D.*
a For Germany and the United Kingdom the last available figures are for 1992.

calculations are extended until 1993, exports to the developing countries are some $100 billion higher (in 1985 prices) and imports some $60 billion lower.

Over the entire period 1970-1993 the swing in net manufactured exports, as a share of GDP, for the G-7 countries taken together, has been in the same direction as the change in employment, but this does not hold for either individual countries (see table 29) or for shorter periods (see table 28). The country that experienced the second-largest swing in net exports as a share of GDP, Canada, had the largest increase in total manufacturing employment (3.6 per cent), whereas Italy, the country with the smallest swing (except Japan, where net exports rose), lost 18 per cent of its manufacturing employment. These differences in the coincidence of swings in net exports of manufactures to developing countries and domestic employment in manufacturing strongly suggest that trade with the South is only one part of a complicated employment equation.

Another way to measure the potential impact on employment is to relate the volume of imports of certain goods to the size of the domestic market for these goods. Much depends on whether such imports are occasioned by a rise in the consumption of the specific goods in the importing country. To the extent that they are a response to increased demand they do not substitute for domestic production, and thus need not be associated with a reduction in domestic employment.

For the OECD countries as a whole, import penetration[9] by developing countries in manufactures rose from around 0.4 per cent in the early 1970s to 3.1 per cent in 1992 (see table 30). There are, however, notable differences among the major industialized countries in the extent of penetration (see table 31). In the United States, the penetration ratio rose from around 0.4 per cent at the beginning of the 1970s to 1.6 per cent a decade later. By 1992 it exceeded 4 per cent. In Western Europe, the trend of increasing penetration was less dramatic; it rose from 0.5 per cent in the early 1970s to 2.8 per cent in 1992. Nevertheless, over the same period the relative loss of manufacturing jobs was far greater than in the United States. In addition, although import penetration in the OECD

Table 30

IMPORT PENETRATION BY DEVELOPING COUNTRIES AND CHINA OF THE OECD MARKET FOR MANUFACTURES, 1970-1992

(Percentage)[a]

	OECD imports from				
	All developing countries[b]	of which:			
Year		First-tier NIEs[c]	Second-tier NIEs[d]	Other countries	China
1970	0.4	0.2	0.0	0.2	0.0
1975	0.7	0.4	0.0	0.3	0.0
1978	1.2	0.6	0.1	0.5	0.0
1980	1.3	0.7	0.1	0.5	0.1
1985	2.0	1.1	0.2	0.7	0.1
1990	2.7	1.4	0.3	1.0	0.4
1992	3.1	1.5	0.5	1.1	0.6

Source: As for table 29.
a Imports of manufactures (SITC 5-8, less 68) as a percentage of apparent consumption (gross output minus net exports).
b Excluding China.
c Hong Kong, Republic of Korea, Singapore, Taiwan province of China.
d Indonesia, Malaysia, Thailand, Philippines.

has risen fairly regularly, by 0.3 to 0.7 percentage points in every five-year period since 1970, employment reductions, as mentioned above, came in three major waves, interrupted by periods of recovery in the second half of both the 1970s and the 1980s.

Table 31

IMPORT PENETRATION BY DEVELOPING COUNTRIES[a] OF THE MARKETS FOR MANUFACTURES OF THE UNITED STATES, EUROPEAN UNION AND JAPAN, 1970-1992

(Percentage)

	Market:		
Year	United States	European Union	Japan
1970	0.4	0.5	0.2
1975	0.8	0.9	0.5
1978	1.4	1.1	0.6
1980	1.6	1.3	0.7
1985	2.7	1.7	0.8
1990	3.8	2.5	1.3
1992	4.3	2.8	1.3

Source and definitions: See table 30.
a Excluding China.

Neither the evolution of manufacturing trade balances nor that of import penetration ratios suggests that there is any significantly close relation between North-South trade in manufacturing and unemployment. The tiny swing in the trade balance from 1970 to 1993 compares to job losses of 15 per cent, and the timing of these losses did not systematically coincide with either declines in the North's overall trade surplus with the South or with the rise in imports from the developing countries. Not only was the growth of manufactured imports from the South actually faster in the 1970s than in the 1980s, but also the most important influence on the trade balance in the 1980s came through a decline in northern exports due to unfavourable economic conditions in the South.

It is true that observing the evolution of import volumes and of import penetration by developing countries in the industrialized countries does not capture all the potential North-South trade dynamics. Even if these indicators were unchanged, rapidly industrializing developing countries could still be substituting for OECD coun-

Table 32

IMPORT PENETRATION BY ITALY AND JAPAN OF THE MARKETS FOR MANUFACTURES OF EEC AND THE UNITED STATES, 1958-1975

(Percentage)

	EEC[a] imports from			United States imports from		
Year	Italy	Japan	Total	Japan	Italy	Total
1958	0.4	0.1	0.5	0.2	0.1	0.3
1960	0.7	0.1	0.8	0.4	0.1	0.5
1965	1.7	0.3	2.0	0.6	0.1	0.7
1970	2.4	0.5	2.9	1.0	0.2	1.2
1975	2.9	0.8	3.7	1.5	0.3	1.8

Source: UNCTAD secretariat estimates based on IMF, *Direction of Trade Statistics*, various issues; OECD, *Historical Statistics on Foreign Trade*, various issues; UNCTAD, *Handbook of International Trade and Development Statistics*, various issues.
Note: See table 30 for the definitions of manufactures and import penetration.
a Belgium-Luxembourg, France, Federal Republic of Germany and the Netherlands.

tries in the markets for manufactures of third countries. This effect would be reflected in smaller exports from OECD countries or a reduction in their import penetration of developing-country markets. Data on the latter is not available, but trade figures do not indicate that this effect has been very strong in recent years. On the whole, OECD manufactured exports to developing countries other than the NIEs have risen substantially since 1989, including a small rise in low-skill goods. The decisive influence on the size of these exports is the purchasing power of the developing countries as a whole (which is largely a function of primary commodity prices, terms of trade, and access to external financing) and not so much the additional supply of such goods coming from the NIEs.

It is also of some significance that the export performance of the newly industrialized economies (which account for two-thirds of the increase of import penetration in manufactures by the developing countries) has not been without precedent in the past 50 years. However, the rise in unemployment is totally unprecedented. Between 1958 and 1975 import penetration by Japan, for example, as well as by Italy, both in the United States market and in the national markets of the other five then members of the European Economic Community (EEC) was on a scale comparable to the rise of today's late industrializers (see table 32). For Italy, the penetration ratio in the other EEC markets rose from 0.4 per cent to 2.9 per cent, and that of Japan in those markets from 0.1 per cent to 0.8 per cent. In the United States market, import penetration by these two former "NIEs" taken together rose from 0.3 per cent to 1.8 per cent. Neither in Europe nor in the United States were these developments associated with labour market problems of the kind experienced today; rather, the opposite was true: the increasing flow of manufactures from Italy to its EEC partners was accompanied by a large migration of labour in the same direction to meet labour shortages.

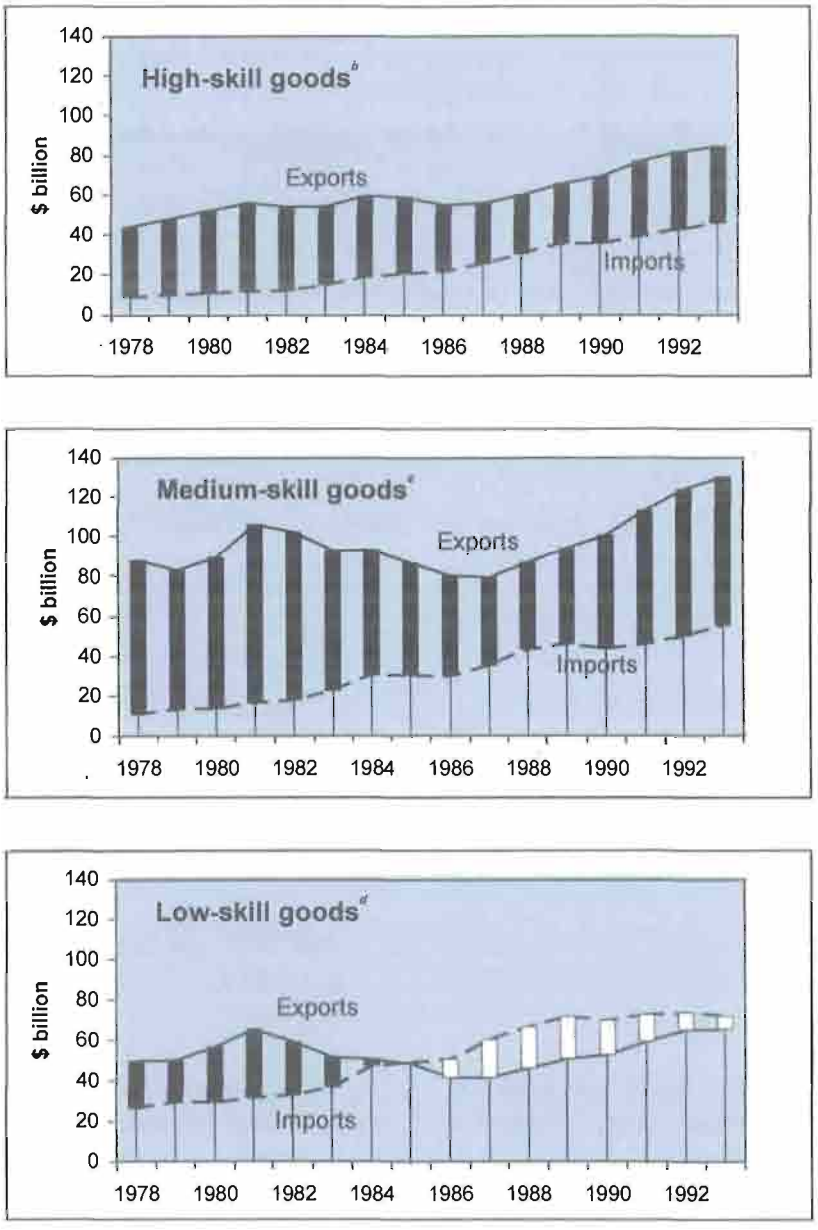
2. The skill content of trade and unemployment

Quite apart from the effect on employment of volume trends in manufacturing trade, there can be consequences in terms of the composition of imports and exports of manufactures, with respect to the factor or skill content they embody. Indeed, it is precisely such differences which have been identified as the source of labour market imbalances in the North arising from trade with the South. Given such differences, jobs can be lost in the industrialized countries even when net exports are rising. The observation that unemployment in the North is higher amongst workers with the lowest educational and professional attainment has given rise to the hypothesis that it is the lower skill (but higher labour) content of imports relative to

Chart 6

TRADE IN MANUFACTURES OF OECD COUNTRIES WITH DEVELOPING COUNTRIES[a], CLASSIFIED ACCORDING TO THE LEVEL OF SKILL EMBODIED IN THEIR PRODUCTION, 1978-1993

(Billions of dollars, in 1985 prices)



Source: UNCTAD secretariat calculations, based on United Nations, *Commodity Trade Statistics, Series D.*

Note: The classification of products by sector of manufacturing differs slightly from that in table 28, due to the limited availability of disaggregated employment data used in that table.

a Excluding China.

b Chemicals and synthetic products, scientific instruments and watches, printing and publishing, aerospace, communication equipment and semiconductors, and computer equipment.

c Office equipment (other than computer equipment), fabricated metal products, wood and paper products, non-electrical machinery, electrical machinery, and transport equipment (other than aerospace and road motor vehicles).

d Textiles and clothing, rubber and plastic products, non-metallic mineral products, and ferrous metals.

exports that has contributed to rising unemployment and/or falling real wages in these occupational groups. While growing exports of skill-intensive goods to the South increase wages for skilled workers, they cannot provide compensating job opportunities for those workers displaced by imports from low-skill manufacturing industries. Thus, to better identify the unemployment problem, the various subsectors of manufacturing industry must be classified according to factor, technology, or skill content.

The skill content of a sector is usually measured as the share of "production" workers in total employment. However, classifying sectors is not without problems since it depends on the definition of sector size and the level of disaggregation.[10] Discrepancies resulting from sector definition are of particular importance for some of the most dynamic subsectors of manufacturing, such as communication equipment and semiconductors, and office and computing equipment, which, if treated separately, would fall within the high-skill industries, whereas if included in the more traditional and broadly defined "non-electrical and electrical machinery" sector would be classified as part of the medium- or low-skill industries.

Despite these methodological problems, the changing employment profile of the leading industrial countries over the past two decades is reasonably clear. In the "high-skill" industries employment in these (G-7) countries as a whole rose, but by only 1.5 per cent, from 1970 to 1993, while in the "medium-skill" industries it fell by 9.4 per cent. The most dramatic change has occurred in the "low-skill" industries, where close to 27 per cent of jobs (some 5.8 million) were lost - more than two thirds of all jobs lost in manufacturing during this period (see table 28).

On the other hand, an analysis of North-South trade according to categories of skill embodied in the products (see chart 6) reveals, not surprisingly, a deficit for the industrialized countries in low-skill goods since the mid-1980s, which is the outcome of both lower exports than at the beginning of the past decade and rising imports, especially from 1983 onwards. However, imports of such products have been levelling off since 1990, while exports have again risen in recent years, thus leading to a narrowing of the deficit.

In the medium-skill category, exports from the industrialized countries have increased more than imports since 1987, causing the surplus to rise, albeit to a level still below that of the early 1980s. The trade balance in high-skill goods has shown the smallest swings over the past 15 years, partly because exports of such goods have been affected much less by reduced import capacity in developing countries. Nevertheless, in this category, too, the surplus of the industrialized countries has been smaller in the early 1990s than at the beginning of the 1980s, since developing countries' exports have steadily expanded (as discussed in greater detail below).

The evolution of employment in the different skill categories thus appears not unrelated to that of trade - both have moved roughly in the same direction over the period as a whole and for the major OECD countries as a whole - but the evidence does not suggest a very close relationship. This conclusion is confirmed by the evolution of employment and trade in the various subsectors within each category as well as by cross-country comparisons of sectoral employment changes.[11]

Compared to the early 1970s, the greatest losses in employment occurred in the textiles and clothing industries (ranging from 59 per cent in the United Kingdom to 29 per cent in Japan) and the ferrous metal industry (ranging from 70 per cent in the United Kingdom to around 30 per cent in Canada). These two subsectors alone accounted for the loss of more than 5.2 million jobs in the G-7 countries over the entire period 1970-1993, i.e. almost two thirds of the total reduction in manufacturing employment (table 28). Other sectors typically loosing employment were non-ferrous metals (particularly in Europe) and non-metallic mineral products (particularly in France and Italy). All these sectors are classified as low-skill. But employment fell considerably also in several "medium-skill" or even "high-skill" industries in some countries: scientific instruments in Italy, France and Canada (by 56 per cent, 28 per cent and 27 per cent respectively); the chemical industry in Italy (over 50 per cent); and fabricated metal products in the United Kingdom (about one half).

While employment losses are clearly concentrated in low-skill sectors, employment gains have not been the preserve of high-skill sectors. In fact, the best employment performance in the major industrialized countries was in the low-skill rubber and plastics industry[12]. In five of the G-7 countries employment also rose in printing and publishing, which counts among the high-skill sectors,

Table 33

IMPORT PENETRATION BY DEVELOPING COUNTRIES OF THE OECD MARKET FOR SELECTED GROUPS OF MANUFACTURES, 1978-1992

	Imports from developing countries into:			*OECD imports from:*		
Main group	*United States*	*European Union*	*Total OECD*	*First-tier NIEs*	*Second-tier NIEs*	*Other countries*
Textiles and clothing[a]						
1978	8 1	6.5	6.6	3.9	0.3	3 8
1980	8 8	7.7	7.7	4.5	0 4	3.9
1985	14.3	9.7	11.2	6.7	0.8	6.9
1990	20.1	14.2	15.0	6.8	1.8	11.5
1992	20.9	17.5	16.3	6.3	2.6	12.0
Office and computer equipment[b]						
1978	1.9	1.8	0.9	0.7	0.0	0.2
1980	2.8	2 3	2.0	1.4	0 1	0 5
1985	5.5	6.7	4.6	3.8	0.1	0 7
1990	17 3	14.9	11.1	9.6	0.7	1.2
1992	21.0	14.6	13.4	10.9	1.7	0.8

Sources and definitions see tables 29 and 30.

a SITC 61, 65, 83, 84, 85

b SITC 751, 752, 759, 895.

but also from a low base. Increases were the largest in Canada, the United States and Japan (ranging from 43 per cent to 35 per cent). Among the four European countries, the rise was around 7 per cent in France and Italy, while in Germany there was no change. Only in the United Kingdom was there a fall, though much smaller than for manufacturing as a whole.

Employment gains in other sectors do not exhibit any clear trend. The non-electrical machinery industry (medium-skill, and including communication equipment) in Canada employed almost 40 per cent more people in 1992 than in 1970; the corresponding increase in Italy was some 25 per cent and in Japan 13 per cent. In the other four countries, however, employment fell (by up to 48 per cent in the United Kingdom). In the high-skill chemical industry employment rose by around one quarter in Canada, remained roughly stable in Germany and France, but fell by between 16 per cent and 50 per cent in the other countries. The figures for transport equipment (medium-skill to low-skill) were an increase of by around 30 per cent in both Canada and Germany and of 8 per cent in Japan, while there was a fall of one quarter in France and Italy and one half in the United Kingdom. In Japan, the second-largest employment gain (after the printing industry) occurred in medium-skill electrical machinery (including computers and office equipment), a sector where employment fell in the other countries. In the United States, on the other hand, it was in the production of scientific instruments that employment gains were the largest (61 per cent), whereas in Italy and France, as mentioned, this high-skill sector was among the main losers.

These differences in sectoral employment behaviour point to the importance of country-specific factors as well as to shifting international competitiveness in particular sectors. Evidence for a relatively close long-term link between employment in the industrialized countries and North-South trade can be found only for textiles and clothing (also including leather products and footwear), where developing countries have their largest share of manufacturing exports. Import penetration more than doubled from the early 1980s to the early 1990s, from around 8 per cent to 16 per cent, at a

time when well over 1.5 million jobs disappeared from the industry (tables 28 and 33). Import penetration was more pronounced in North America than in Europe and Japan. At the beginning of the 1990s, in the United States more than 20 per cent of apparent consumption was constituted by imports from developing countries. But textile employment has been in decline for a considerable time in the North. Moreover, employment losses during the 1980s were far more pronounced during the first half than during the second half of the decade (1.1 million, compared to 350,000), while the rise in import penetration was greater in the second half.

Nor has the strong presence of imports from developing countries in OECD markets been limited to low-skill textiles and clothing. Indeed, the share of such exports in total southern exports of manufactures has been steadily falling, from more than 40 per cent in the late 1970s to less than 30 per cent in the early 1990s, whilst the share of "high-tech" goods has more than doubled, from under 10 per cent to more than 20 per cent. The most striking increases have been in machinery, where the share of developing countries rose steadily in both the European and the North American markets until the late 1980s. For example, imports of computer and office equipment, which were negligible in the late 1970s, accounted for around 12 per cent of all OECD manufactured imports from developing countries at the beginning of the 1990s. The share of other electrical machinery has also increased considerably, now representing almost 13 per cent.

In the OECD countries as a whole, the market share of developing countries in office and computing equipment almost tripled from 1985 to 1992 (table 33), reaching around 13 per cent, and more than 90 per cent of these imports came from East Asia. The share of the OECD market for these products is still relatively small for the second-tier NIEs (1.7 per cent, compared to 10.9 per cent for the first-tier NIEs) though it has been rapidly increasing since 1985. Despite the rapid increase in imports of such goods from developing countries, employment in the subsector has fallen much less than the average for manufacturing - and not more than in transport equipment, a low-skill sector where import competition from developing countries has been relatively weak.

To sum up, export success by developing countries has not been limited to low-skill manufacturing sectors, in some of which employment losses in the North have indeed been substantial; one of the sectors where imports from developing countries have grown fastest (computers) is classified as high-skill but employment losses have been small. Moreover, in some low-skill sectors (mainly transport equipment and plastics) exports from industrial to developing countries have also been rising since 1987, even though their level in 1993 was still below that reached in 1981. Certainly, employment gains in OECD countries have been more in high-skill sectors, where net exports have risen. Low-skill goods imports, on the other hand, rose particularly fast from 1982 to 1984 and from 1986 to 1989, but - except for rubber and plastics - employment in the low-skill sectors as a whole has continued to fall after 1989, despite a narrowing trade deficit in such goods.

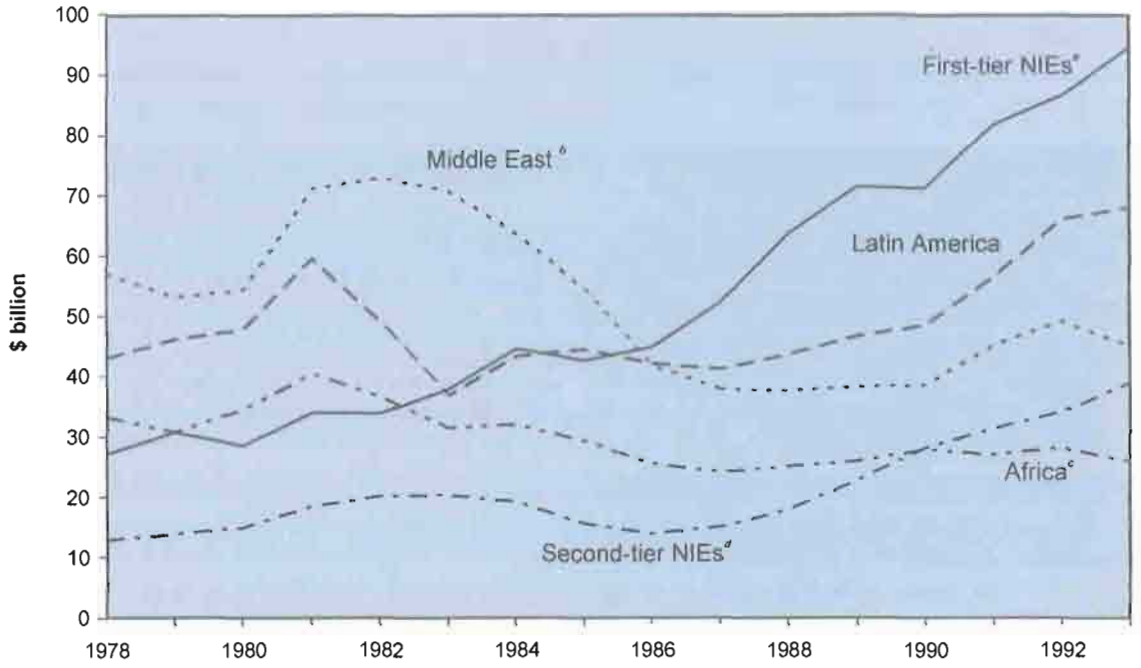
3. *The debt crisis, capital flows and North-South trade*

Efforts to trace problems of rising unemployment and inequality in the North to trade with the South assume, explicitly or implicitly, that it is shifts in comparative advantage that determine trade relations. This ignores the influence of transitory factors, including the possibility of such factors - through hysteresis - having a quite prolonged effect on trade patterns. In fact, during the 1980s various trade and financial shocks had a clearly pronounced influence on the pattern of international trade. During this period, most developing countries experienced major losses of purchasing power due to the collapse of commodity prices and a swing in net financial transfers, the latter arising from growing interest payments on foreign debt and reduced lending by private markets. Since for a long time concessional interest rates and debt cancellation were not instruments of adjustment, debtors had little option but to reduce trade deficits through import cuts; in the most troubled debtor countries, import volumes declined by 28 per cent from 1983 to 1987.[13] Weaker demand for northern goods was inevitable; the average annual value of exports to developing countries from developed market economies fell from 1981-1983 to 1984-1986 by over 10 per cent. This weakening of demand is estimated to have cost directly some 7 million man-years of employment in Europe and close to 1 million in the United States and Canada in 1982-1984[14], on average raising annual unemployment rates in Europe by 1.3 percentage points and in

Chart 7

EXPORTS OF MANUFACTURES FROM OECD COUNTRIES TO SELECTED DEVELOPING REGIONS, 1978-1993

(Billions of dollars, in 1985 prices)



Source: See chart 4.

a Hong Kong, Republic of Korea, Singapore, Taiwan province of China.

b Bahrein, Egypt, Iraq, Islamic Republic of Iran, Israel, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates, Yemen.

c Excluding Egypt and Libyan Arab Jamahiriya.

d Indonesia, Malaysia, Thailand, Philippines.

North America by 0.2 points. Other estimates, taking into account indirect effects, have suggested that these figures might be considerably higher.[15]

The contraction noted above of OECD manufactured exports to developing countries (see chart 7) during most of the 1980s (1981-1988) can thus be explained by two factors . First, the payments adjustments of many developing countries, mainly in Latin America and Africa, following the debt crisis, required a sharp reduction of their imports; the OECD trade balance in manufactures with Latin America was reduced by more than one half from 1981 to 1983, following severe import compression in the highly-indebted countries of the region. Second, the purchasing power of the oil-exporting countries shrunk; initially the industrialized countries moved into recession and the debtor developing countries had to cut down on their oil imports, and subsequently oil prices collapsed. At the same time, restrictive policies in the North, which slowed growth, meant that the export markets of debtor countries - particularly primary commodity exporters - were thin and efforts to increase earnings from manufactured exports to meet debt servicing and overcome balance of payment constraints could easily provoke protectionist responses. In the event, debtor developing countries as a whole increased their export volumes by about 2.5 per cent per annum during 1983-1987, but because of the fall in prices export earnings in many countries failed to increase.

Table 34

EXPORT GROWTH FOR MANUFACTURES IN SELECTED DEVELOPING COUNTRIES, 1982-1990, AND CHANGES IN SOME EXPLANATORY VARIABLES

(Average annual volume increase in per cent)

Country	Exports of manufactures	Gross domestic investment	Real earnings in manufacturing
Mexico	22.4	0.3	-25.6
Venezuela	21.0	-4.7	-42.6
Turkey	14.9	4.5	-1.9
Morocco	13.1	2.6	-15.8
Kenya	10.7	4.6	-10.4
Uruguay	6.9	-3.5	-10.4
Argentina	6.6	-3.0	-6.2
Jamaica	5.6	4.2	-9.4
Peru	3.8	-1.8	-31.4
Thailand	27.0	11.6	54.5
Malaysia	22.0	1.5	15.1
Singapore	13.5	2.4	47.1
Pakistan	13.1	4.9	39.8
India	12.9	7.8	28.1
Republic of Korea	12.7	18.5	83.6
Brazil	7.5	3.2	3.9

Source: UNCTAD secretariat estimates, based on United Nations data and World Bank, *World Tables*, various issues.

This, in combination with reduced financial flows and higher interest payments, limited import capacity still further.

But the tightening of the foreign exchange constraint did prompt many developing countries to seek an increase in manufacturing exports and improve their international competitiveness. Because in most countries the shift in resources to the tradeable goods sector did not take place in the context of output growth or rising investment, it was dependent on a redistribution of domestic resources. A central feature of adjustment was, therefore, falling real wages, particularly in manufacturing.

In this respect, a division emerged in the South between those countries where rising manufactured exports were accompanied by falling or stagnant real wages and low or declining real investment (such as Mexico, Venezuela, Uruguay, Kenya, and Morocco) and those where real wages, investment and exports rose together (such as the Republic of Korea, Thailand, India, Singapore and (less strikingly) Malaysia (see table 34). For the former group of countries, export growth during the 1980s was driven by the distress caused by the debt crisis. Although it is almost certainly the case - given its scale and timing - that the rise of these exports had only a small direct impact on northern labour markets, the fact that it was associated with falling wages in manufacturing gave rise to allegations of "unfair" competition to which vociferous objections are frequently made in the North. However, such competition was in large part self-inflicted: since the international debt strategy was

strongly biased against debtors, it favoured northern finance over northern industry.[16]

The situation changed in the late 1980s. Capital flows to developing countries - including many highly indebted countries - recovered strongly, dominated by private capital. In Latin America, for example, from 1985-1989 to 1989-1994 the average balance on capital account rose from under $9 billion to over $33 billion and in Asia the increase was from $19.7 billion to $42.4 billion.[17]

Combined with a swift and comprehensive liberalization of imports, the result has been a massive inflow of imports (with the notable exception of Brazil, where sluggish economic growth and higher tariffs, until the introduction of the *Real* Plan, dampened imports) and a swing from trade surplus to trade deficit in most of Latin America (see Part Two, chapter II). There has been a move into non-traditional manufacturing exports in some countries, notably Mexico, over the past decade and Brazilian manufactured exports have benefited from a combination of favourable currency movements and a diversified industrial structure established under import substitution measures. But export diversification has not been the path for most countries in the region. Indeed, for them the small increase in the share of manufactured exports during the second half of the 1980s stabilized (at a low level) in the 1990s and actually declined in a number of instances.

A similar process of import liberalization and increased capital inflows has occurred in a number of North African countries, such as Morocco and Tunisia, where there was also a shift towards the export of manufactured goods embodying low skills, helped both by real wage compression and by trade agreements with European Community. However, for sub-Saharan Africa, whilst the impact of the debt crisis on import compression was particularly severe, exports have responded only very sluggishly and export earnings have suffered from falling prices. In addition, there has been little recovery in financial flows to the subregion which could help meet debt servicing requirements and break the foreign exchange constraint on economic growth.[18]

The combined result of these various trends has been a swing in the North-South trade balance, as southern imports from the North expanded more rapidly than exports to the North. However, for those countries which relied on capital flows to revive imports there remains the underlying question of their sustainability. Since the Mexican crisis, the unsustainability of capital flows has become a real concern in Latin America (see Part One, chapter II); but more generally, capital is likely to be more cautious in entering developing-country markets in the near future and developing countries themselves will probably be more reluctant to welcome portfolio investment, preferring FDI. Even if flows revive, developing countries will be more inclined to use them to reconstitute reserves than for boosting imports. Privatization can continue to provide a source of external finance, but it is unlikely to continue at the speed of recent years.

Whilst FDI also plays an important role in financing current account deficits in developing countries, it has been exempt from concerns about the volatility of capital flows.[19] Indeed, because FDI is more closely associated with investment in productive capacity and because it transfers technology and management techniques, it is assumed to be driven by longer-term considerations than portfolio investment. But, in part because of slow growth and increased competition in northern markets, the factors determining longer-term objectives are themselves changing and much FDI in developing countries will be for export activities, which is not without its problems (see section D below).

Still, for many developing countries the only way to finance greater imports of manufactures from the North is to increase exports of primary commodities. In the light of the weak prospects for real commodity prices over the longer term[20], there is thus additional concern over employment in northern export industries.

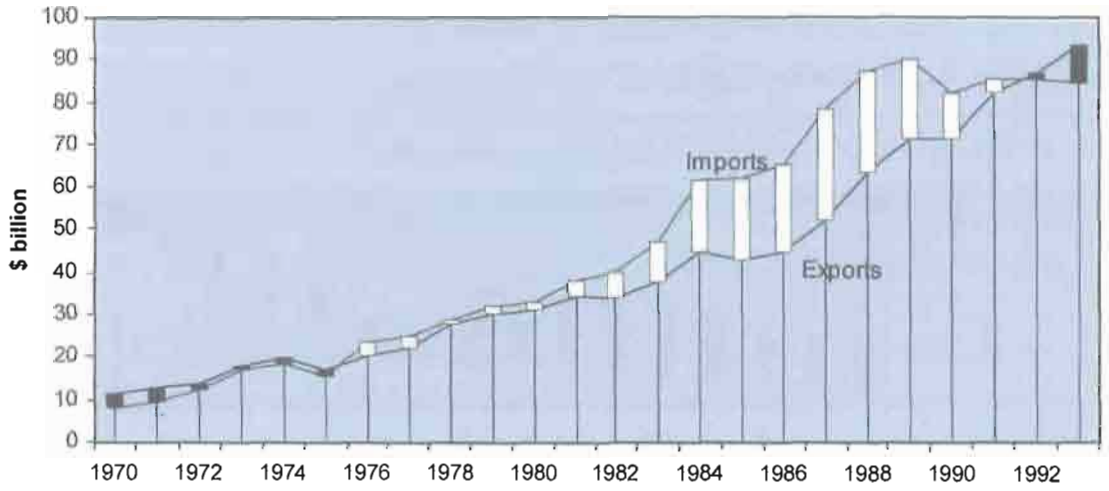
4. *Catching up, productivity growth and the changing trade profile of the South*

In reality, much of the increase in exports of manufactures from developing countries has been accounted for by a small number of newly industrialized economies (NIEs) in East Asia. In 1950, the share of these four economies (Hong Kong, Republic of Korea, Singapore and Taiwan province of China) in total developing country exports was 9.3 per cent; it had risen to 10.9 per cent by 1970 and 42 per cent by 1990. Their share of manufactured exports rose from 40 per cent in 1970

Chart 8

TRADE IN MANUFACTURES OF OECD COUNTRIES WITH THE NEWLY INDUSTRIALIZED ECONOMIES[a], 1970-1993

(Billions of dollars, in 1985 prices)



Source: See chart 4.

a Hong Kong, Republic of Korea, Singapore, Taiwan province of China.

to close to 60 per cent in 1990. Perhaps more revealing, while the share of world manufactured exports rose from 1970 to 1990 from 5.5 per cent to 15.9 per cent for developing countries as a whole, if the four East Asian NIEs are excluded, the corresponding figures are 3.2 per cent and 5.8 per cent, and if the whole of South and South-East Asia is excluded, they are 2.2 per cent and 3.4 per cent.

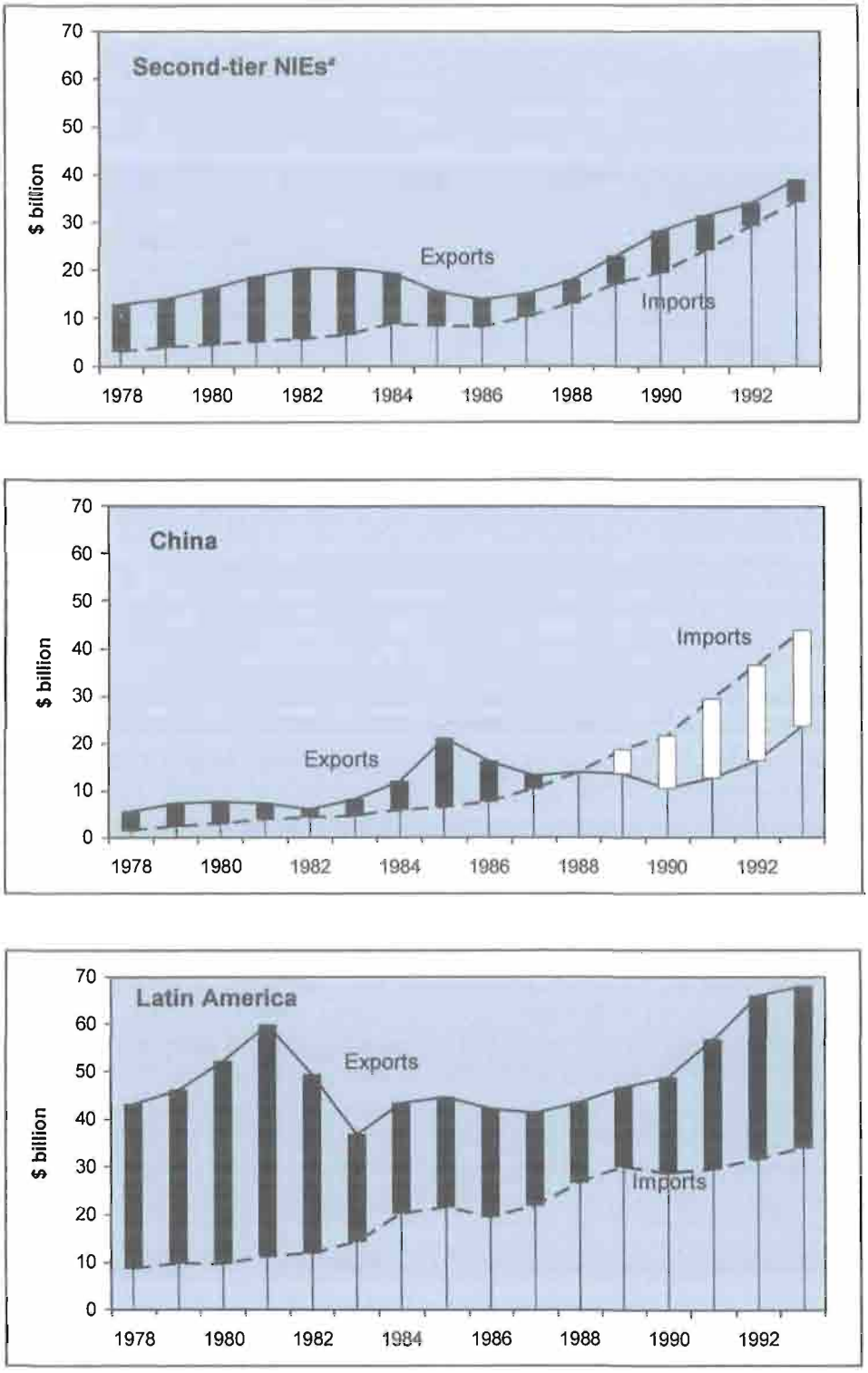
OECD trade in manufactures with the NIEs was until 1980 in rough balance, with a small deficit emerging after 1975 (see chart 8). From 1981 onwards, however, this deficit grew larger every year until 1987, despite sharply rising exports; these four NIEs doubled the volume of their exports to OECD countries, accounting for more than half of the additional OECD imports of manufactures from developing countries. Subsequently, OECD imports from this group of countries levelled off, and in 1992 the trade balance swung back into surplus.

Since the late 1980s, a second tier of NIEs (Indonesia, Malaysia, Philippines and Thailand) and China have taken over the role of the earlier East Asian ones in penetrating the markets for manufactures in the North. Nevertheless, the OECD balance of such trade with the second-tier NIEs remained in surplus despite a more than fourfold volume increase of imports from them from 1986 to 1993 (see chart 9). Manufactured exports to this group of countries have risen almost in parallel with imports. The continuing surplus in manufactures (of some $8-10 billion annually in 1985 prices) was made possible by the fact that these countries (as distinct from the first-tier NIEs) also have significant export earnings from primary commodities. OECD manufactured imports have also risen sharply from China since the mid-1980s, from $6.5 billion in 1985 to almost $44 billion in 1993 (in 1985 prices). However, in this case exports did not keep up and there was a dramatic swing in the trade balance from 1985 to 1992, amounting to $35 billion . In this respect, China's position contrasts sharply with Latin America, where the recovery in financial flows after the beginning of the decade has helped finance a growing manufacturing trade deficit with the North, as exports from the region stagnated but imports shot up by around 50 per cent.

Chart 9

TRADE IN MANUFACTURES OF OECD COUNTRIES WITH SECOND-TIER NIEs, CHINA AND LATIN AMERICA, 1978-1993

(Billions of dollars, in 1985 prices)



Source: See chart 4.

a Indonesia, Malaysia, Thailand, Philippines.

This concentration of southern manufactured exports in a handful of countries indicates that abundant unskilled labour, coupled with international capital mobility, is not sufficient for attaining a competitive advantage in certain lines of manufacturing.[21] The reason is that catching up is not a spontaneous result of specializing with given factor endowments, but a difficult process of forcing the pace of investment, industrial diversification and product upgrading. Convergence, in productivity levels, as well as in the structure and organization of economic activity, is the result of this process. In this respect, although there are certainly signs of catching up in other developing regions, the trade performance of Latin America, where the share of world manufactured exports rose merely from 1.0 per cent to 1.7 per cent from 1970 to 1990, and Africa, where over this period it has remained unchanged at 0.4 per cent, suggests that rather different development pressures were operating in those regions than in East Asia.

Export growth in East Asia emerged after a successful period of industrialization during which these countries built up internationally competitive industries through a process of rapid capital accumulation, learning and productivity growth. As discussed in last year's *TDR*, although each country has had to manage this process of rapid industrialization in the light of its own particular circumstances - reflecting such factors as resource base, size, and past history - common to all has been the strategic interventions of the Government in support of entrepreneurial, technological and managerial capabilities in particular industries, as well as the use of a variety of general policy measures to raise profits as a means to encourage rapid capital accumulation. A significant feature common to all these countries is that this industrial dynamic went hand-in-hand with rising real wages. In the Republic of Korea, for example, real wages rose on average by 9.8 per cent each year in 1965-1973 and by 6.7 per cent in 1974-1984.[22] In other words, it was not abundant cheap labour that made the catching up process possible, nor was that the basis of export success; rather, it was an unprecedented pace of productivity growth which made possible an unprecedented growth of exports and wages.

By the 1960s, the East Asian NIEs had built up a very strong base of industries using unskilled labour - primarily textiles and clothing but also other industries, such as wood products and basic chemicals. These industries, often supported by selective export promotion policies, provided the initial push into foreign markets. However, it was already apparent by the early 1970s that these industries could no longer be relied upon as engines of growth or to secure a sounder footing in the international division of labour. An orderly exit from them was essential to the continuing process of catching up. The need for structural change was reinforced during the 1980s as rising wages eroded cost advantages and a second tier of newly industrializing countries, together with China, began to exhibit particularly high rates of output growth and exports in such industries.

The response to these regional dynamics by firms and by Governments in the first-tier NIEs has taken two forms. On the one hand, large domestic producers in industries using unskilled labour began to run down their domestic production and to invest abroad in labour-intensive activities. Much of this investment has been located in other countries in the region, such as Malaysia, Thailand and (most recently) China. On the other hand, there has been a continued upgrading towards more capital and technology-intensive industries such as electronics, machinery and transport equipment.[23] This upgrading process has been associated with an acceleration of private investment - from already high levels - and with complementary public sector investments. The influence of catching up on country trade profiles can be seen from the figures for revealed comparative advantage shown in table 35.

Traditional industries such as textiles and clothing and toy making now appear to form a locus more for South-South than North-South competition, with producers such as those in the Republic of Korea and Taiwan province of China finding themselves in a similar position to producers in the United States and the more industrialized Western European economies in the 1950s and 1960s. There are already signs of a similar process in industries such as electronics, where the second-tier NIEs have made an almost simultaneous entry alongside more traditional exports. It would not seem unreasonable to conclude that it is precisely the rapid pace of capital accumulation that has allowed the first-tier NIEs (unlike OECD countries) to manage a process of structural change without the emergence of high rates of unemployment.

Already by the early 1980s, newer industries had overtaken traditional industries as the leading

Table 35

REVEALED COMPARATIVE ADVANTAGE OF SELECTED ASIAN COUNTRIES, 1976-1993

	Unskilled labour-intensive				Human capital-intensive				Technology-intensive				Physical capital-intensive			
Country	*1976*	*1980*	*1990*	*1993*	*1976*	*1980*	*1990*	*1993*	*1976*	*1980*	*1990*	*1993*	*1976*	*1980*	*1990*	*1993*
Japan	0.867	0.815	0.465	0.394	1.796	1.966	1.485	1.441	1.714	1.693	1.820	1.604	1.592	1.460	1.233	1.291
Hong Kong	. .	6.354	3.992	3.504	. .	1.016	0.792	0.627	. .	1.148	1.264	1.205	. .	0.104	0.203	0.286
Republic of Korea	4.885	4.272	2.901	1.946	0.617	0.952	0.832	0.970	1.133	1.154	1.428	1.380	0.359	0.628	0.584	0.723
Singapore	. .	0.696	0.654	0.534	. .	0.432	0.321	0.308	. .	1.437	2.343	2.354	. .	0.458	0.576	0.630
Taiwan province of China	4.858	4.846	2.803	2.146	0.439	0.654	0.663	0.683	1.458	1.400	1.569	1.527	0.294	0.356	0.537	0.639
Indonesia	. .	0.790	1.286	1.882	. .	0.110	0.129	0.243	. .	0.510	0.115	0.206	. .	0.102	0.167	0.154
Malaysia	. .	0.372	0.716	0.703	.	0.115	0.310	0.342	. .	0.790	1.696	1.841	. .	0.483	0.265	0.355
Thailand	0.950	1.203	2.158	2.017	0.720	0.147	0.381	0.434	0.170	0.439	0.982	1.060	0.300	0.567	0.211	0.350
China	. .	. .	3.065	3.578	. .	. .	0.635	0.469	. .	. .	0.457	0.557	. .	. .	0.503	0.433

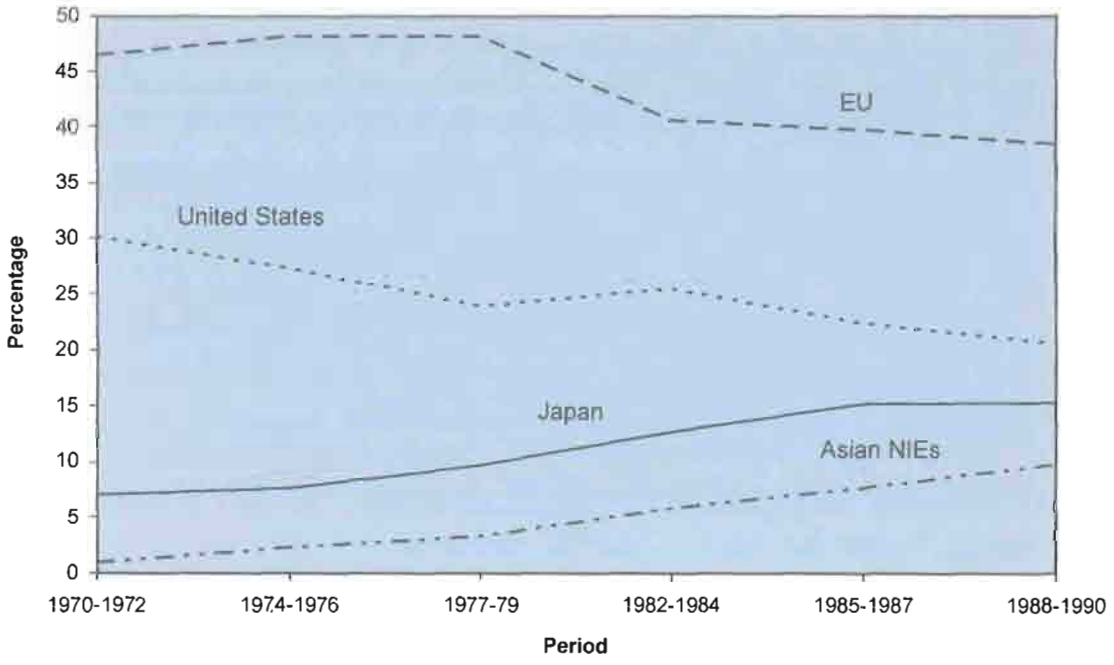
Source: UNCTAD secretariat calculations, based on data from United Nations, *Commodity Statistics, Series D*, as well as national and international sources.

Note: A country's RCA index in a given commodity group is defined as the ratio of the share of that commodity group in the country's total exports to the share of the same commodity group in world exports. A value greater or less than unity thus respectively denotes a revealed comparative advantage or disadvantage. For the classification of the commodity groups by factor intensity, in terms of SITC, see *TDR 1993*, text relating to table 49.

Chart 10

SHARE OF ASIAN NIEs AND OTHER REGIONS OR COUNTRIES IN WORLD TRADE IN PRODUCTS OF HIGH-TECHNOLOGY INDUSTRIES, 1970-1990

(Percentage)



Source: P. Guerrieri and C. Milana, "Changes and trends in the world trade in high-technology products", *Cambridge Journal of Economics*, 1995, Vol. 19, pp. 225-242

exporters in the first-tier NIEs, and by the early 1990s they accounted for between 40 per cent and 52 per cent of their total manufactured exports. But what is also significant is that these countries have begun to move into the higher technology end of these industries; from only 1 per cent of world trade in high technology goods in the early 1970s they had captured close to 10 per cent of the market by the late 1980s (see chart 10).[24] Their success in catching up with developed countries was particularly remarkable for high-technology electronics goods, but the trend of rising shares is also apparent with respect to chemicals, mechanical products and instruments.[25]

An important consequence of the catching up view is that increased trade is driven by productivity growth, not the dismantling of trade barriers. Indeed, it was in precisely those industries which appear to have been most strongly challenged by imports from the South that trade barriers remained high during the 1980s; textiles and clothing is still one of the most heavily protected sectors in developed countries. Calculations by the UNCTAD secretariat of the use of non-tariff measures in selected developed market economies in 1981-1991 showed no decline in the importance of such measures, and their incidence appears to impede imports from developing countries of the very products, such as textiles and clothing and footwear, for which import penetration has been greatest.[26]

Arguably, the OECD countries have already undergone structural changes in labour-intensive manufacturing industries in response to this import penetration. As industrialization spreads, future competition in these low-skill areas will be among developing countries themselves, but some of them have already acquired advanced technol-

ogy and skills and are able to challenge leaders in the North. This is certainly true for the first-tier NIEs. Even among some poorer countries there are already areas of industrial excellence which can produce sophisticated goods at low prices because labour costs are relatively low even for skilled labour.

However, a defining characteristic of developed-country growth is that it is strongly conditioned by product and process innovation and development, whereas newly industrializing countries are primarily product and process imitators. Their success lies in catching up with the product innovators, and adapting available technologies to the needs and capabilities of local industry. The resulting competitive challenge facing countries in the North is not new and assessing its wider impact does not depend only on the catching-up process in the South but also on the pace of capital accumulation and structural change in the North. Maintaining a leadership position in existing industries, as much as creating new industries, involves an ongoing commitment to product and process innovation as part of a general growth dynamic, which in turn requires high rates of capital accumulation. But, this was as true when the catch-up economies were in Southern Europe and Japan in the period after the Second World War as it is for the East Asian NIEs of the past two decades.

D. Foreign direct investment, trade and employment

Because FDI is composed of various elements which are likely to have very different direct and indirect employment effects, a comprehensive empirical analysis of the recent upsurge of FDI is difficult to make and needs still to be undertaken.[27] So far, much of the evidence linking the relocation of production abroad and domestic employment has been anecdotal and focused on the enterprise level. At this level, the picture is, in fact, reasonably clear. Today's transnational corporations (TNCs) use capital-intensive techniques and are modest employers of labour; world-wide, TNCs directly employ less than 2 per cent of the economically active population and perhaps 10 per cent of the manufacturing labour force. Indirect employment effects might double these figures. The bulk of this employment is located in the North, and FDI in manufacturing has, until very recently, been overwhelmingly among developed market economies.

Although the flow of FDI to developing countries has recovered strongly since the second half of the 1980s, its direct employment effects have been small. In total, during 1985-1992 affiliate employment in developing countries rose each year on average by under a million, and much of that was in China alone.[28] Much of the additional employment has been in export processing zones. These zones expanded particularly rapidly during the second half of the 1980s and early 1990s (again with China dominant) and were strongly concentrated in two industries - textiles and clothing, and electronics. Even assuming all this was directly substituting for manufacturing employment in the North, it still constitutes only a tiny fraction of total northern manufacturing employment. Moreover, for FDI in developing countries to have had a significant impact on the relative demand for different types of labour in the North, one would expect to see a rise in the ratio of skilled to unskilled workers in the parent companies and a fall in this ratio in developing-country affiliates. There is, in fact, little evidence of this having happened. Indeed, if anything, the ratio has shifted in favour of skilled labour in developing-country affiliates, too.[29]

But firm-level evidence and case studies, however interesting, cannot provide the basis for an aggregate analysis of the effects of outbound FDI on the domestic economies of the North. The most obvious route into such an analysis is through the link between trade and FDI. Accelerating FDI

flows during the 1980s coincided with a decelerating growth of international trade. Although much of the increased flow has been in non-tradeable services, the possibility that production abroad might substitute for exports from the domestic economy has, as noted earlier, given rise to concerns that FDI outflows from developed countries could adversely affect employment.

Two reasons are traditionally offered for why firms might replace exports with production abroad. The first is the need to circumvent tariffs or other protectionist measures and to overcome limits on exporting if an appreciating national currency continuously cuts into the profitability of exporting firms. These pressures appear particularly important for FDI flows among developed economies. The second is that, because of increased international competition firms are constantly searching for new production locations where costs are lower. This would appear to be a more significant influence on FDI flows from North to South, associated with increased intra-firm trade. There is some evidence that whilst intra-firm trade in manufactures within the North showed little or no increase in the 1980s, it expanded considerably between northern parents and foreign affiliates in developing countries, particularly in South and South-East Asia but also in some Latin American countries such as Mexico.[30] Also during the 1980s, subcontracting arrangements between northern TNCs and southern firms have become increasingly common.

In recent years, the market-seeking and cost-reducing pressures on FDI appear to have become more closely related. A combination of large trade imbalances among the OECD countries, increased protectionist sentiments and currency realignments has meant that, by a shift in production activities through FDI, what appears to be North-South trade in manufactures is in fact displaced competition among the OECD countries themselves. This is consistent with the strong, but uneven, recovery of FDI flows to developing countries beginning in the late 1980s,[31] where searching for developing-country markets for manufactured goods has become secondary to producing for export to third markets. Japanese FDI, particularly to East Asia can, in part, be seen as the result of increased competition within the North. Similarly, Japanese (and more recently some East Asian) electronics firms have relocated production in the Mexican *maquiladora* and in the export processing zones of the Caribbean basin with a view to exporting to the United States market.[32] But the more visible consequence of intra-North competition in Latin America has come in the form of United States FDI, particularly in Mexico. The impact has been most perceptible in the integration of the Mexican automotive industry into the wider North American industry, which during the late 1980s and early 1990s has been a major factor behind the growth of Mexican exports.[33] Although the role of FDI in the transition economies of Eastern Europe has been weak, there are also signs that Western European TNCs, under increasing pressure in their domestic markets, are following a similar strategy in such industries as furniture, consumer electronics and automotive components.[34]

In light of these changes in FDI flows a series of additional linkages between outward FDI and trade, which have implications for employment in the home country, must be considered. On the one hand, there is an export-inducing effect when the plants established abroad through FDI import inputs from the home country. On the other hand, there is a reverse-import effect when the final goods produced abroad are exported to the home country. The export-inducing effect of FDI is likely to occur in the initial stage of the investment process as a newly established affiliate imports equipment and intermediate goods from the home country - much of which might take the form of rising intra-firm trade. However, this positive effect is likely to decline over time as local procurement begins to play a more significant role. Moreover, as affiliates begin to replace goods previously imported from abroad, the export-substituting effect of FDI will begin to impact negatively on the trade balance of the home country. This trend will be reinforced when the home country begins to import from overseas affiliates what it used to produce at home. Thus, a more general discussion of the links between FDI and employment hinges on whether the substitution effects of FDI on domestic investment and exports outweigh its complementary effects.

On the strength of these various effects on the trade balance, FDI could either reduce or increase domestic demand and employment. The former outcome would appear most likely in small high-wage economies with a large number of TNCs. Some recent studies of outward investment by Swedish TNCs, for example, have concluded that FDI has substituted for exports, with a negative impact on domestic production and employment. Other studies, focusing on larger economies, have

concluded that any reduction in exports is more than offset by demand for capital goods and intermediate goods from the home country.[35] However, many of these studies were concluded before the recent upsurge of FDI in the 1980s and were focused on the traditional home countries of Western Europe and North America. The most important change in FDI patterns in the second half of the 1980s was the rise of Japan as an outward investor.

Possibly because Japan's export-oriented policies have traditionally kept the share of manufacturing in total FDI outflows lower than for many of its competitors, there has been a growing concern that new competitive pressures might result in a dramatic relocation of production abroad with an accompanying "hollowing out" of the traditional export industries and a negative impact on domestic employment. The Plaza agreement is often seen as a watershed for the Japanese economy in this respect. The challenge to exports from the rising yen was met, in part, by increased domestic investment in an effort to raise productivity and lower costs. But there was also a relocation of production through FDI directed to lower-cost locations. From 1985 to 1990, outward Japanese FDI rose from around $12 billion to $47 billion. Three quarters of this increase was absorbed in Europe and North America, much of it in service activities. However, there were important changes in manufacturing FDI, especially in respect of flows to developing countries. In particular, there was a steep rise in flows to East and South-East Asia in the electrical and electronic machinery and transport equipment industries.[36]

Taking the period 1985-1990, it appears that Japanese FDI in North America did have a large export-inducing effect, but the export-substituting effect was even greater. Furthermore, increasing pressure for greater local procurement made an important contribution to a reduction in the export-inducing effect towards the end of this period. However, the vast bulk (over 90 per cent) of the final goods produced are for local consumption and any reverse-import effect appears to have been small. Overall, the combined result of these effects has been estimated to have been a reduction of the annual Japanese trade balance of between $1 billion and $10 billion (see table 36).

Japanese FDI in Asia has impacted differently on the trade balance. In particular, the export-inducing effect of assembly operations has been generally greater than the export-reducing effect. But since there has also been a reverse import effect - around one quarter of the output in electronics and electrical machinery is exported back to Japan - the total effect on trade was slightly deficit-inducing during this period (see table 36). However, in both the first and the second-tier NIEs, Japanese FDI is clearly being driven not only by the yen appreciation but also by the successful process of catching up in those economies. As a result, Japanese manufacturers are shifting both low-end and medium-end products to the region not only for export to third markets but also - and increasingly - for reimporting into Japan. Despite the adverse combination of domestic and external factors in the early 1990s, leading to a slower increase in total Japanese FDI, the intensive search for more cost-effective production and sourcing locations has meant that the share of Asia in the total has increased steadily during this period.[37] As already noted, FDI from Japan picked up strongly in 1994, in advance of domestic investment, a situation likely to continue in the light of domestic economic conditions (see Part Two, chapter I).[38]

Overall, the trade effects of FDI on the Japanese economy appear to have been employment-reducing. Indeed, if it is assumed that the effects of FDI in Europe were similar - and in proportion - to the effects in the United States, and that likewise the effects of FDI flows to Latin America were similar - and in proportion - to those going to Asia, then the overall impact on outward Japanese FDI in 1985-1990 was a reduction in the country's trade surplus of some $70 billion. This is not an insignificant figure, but it makes only a small dent in the surplus.

More importantly, however, the trade and investment effects stemming from a relocation of production should not be explained simply in terms of a rising yen. The yen's rise is itself a reflection of the tendency towards underconsumption in Japan and the deficiency of aggregate demand.[39] Until this problem is addressed directly, the pressure on firms to relocate abroad will continue unabated and job destruction due to deficient home demand will continue to be disguised as job destruction due to the outflows of FDI to developing countries.

A second important macroeconomic link is that between FDI and domestic capital formation. When resiting is an alternative to investing at home, the associated FDI comes, in the first place, at the

Table 36

TRADE EFFECTS OF FDI FLOWS FROM JAPAN TO NORTH AMERICA AND ASIA, 1985-1990

(Billions of dollars)

	Net impact on:				
	Exports to		*Imports from*		*Trade balance*
Year	*North America (1)*	*Asia (2)*	*North America (3)*	*Asia (4)*	*[(1)+(2)]-[(3)+(4)]= (5)*
1985	0.5	1.9	1.4	2.4	-1.5
1986	-7.0	1.4	1.1	3.5	-10.3
1987	-4.7	1.9	2.2	5.1	-10.1
1988	-3.6	0.0	2.3	4.6	-10.4
1989	-5.9	-1.0	3.5	4.5	-14.9
1990	-1.5	6.4	2.8	6.0	-3.8

Source: The Economic Planning Agency of Japan, *Economic White Paper,* 1993 (in Japanese), Tokyo, table 3-3-15.

expense of employment or wages which any future repatriation of profits from abroad will not fully offset. Surprisingly little empirical work has been done on this question. One of the few studies of the effects of outward FDI on capital formation in the United States suggests that each dollar invested in foreign affiliates reduces the domestic capital stock by as much as 40 cents.[40] Unfortunately, a comparable assessment of inward investment - including crowding-in or crowding-out effects through the demand and supply sides - on the domestic capital stock does not exist. In any event, the size of these flows remains small in relation to domestic investment and any noticeable increase in share has been as much, if not more, a reflection of declining domestic investment.

None of these trends suggests that FDI directed to the South has been a significant factor in job loss or rising inequality in the North. Moreover, most OECD economies remain dominated by firms which produce their output within their national boundaries or at most within a small sub-set of similar economies. Still, there is every reason to expect a continuing rise in the South's share of world industrial production over the coming years. This leaves open the future scope for relocation, as export promotion and trade and financial liberalization become more pervasive features of the world economy. But because much manufacturing FDI directed to developing countries is the result, rather than the cause, of catching up, the policy issues this introduces are part of the larger response by northern Governments to successful industrial development in the South. With appropriate policies, FDI flows to the South are no more a threat to jobs and wages in the North than were similar flows from the United States to Europe a threat to American jobs and wages in the 1950s and 1960s.

E. Technology, wages and unemployment

Those not persuaded by the claim that trends in North-South trade have been a significant influence on northern labour markets have sought to explain rising unemployment and wage inequality in terms of the development and diffusion of new technologies. This explanation appeals on a number of levels, not least in shifting any suspicion away from trade. More specifically, the idea that new technologies have accelerated the pace of sectoral change in employment from manufacturing to services, and as well as a shift from unskilled to skilled labour within sectors, appears to offer a very direct link to the structural problems of contemporary labour markets.

Where technological change introduces resource-saving techniques which permit greater output from a given set of inputs, labour markets will be disrupted by technological progress, and in the face of market rigidities it is not possible, *a priori*, to exclude significant transitional effects from such change. These effects could be pronounced where technological change is accompanied by product innovation and where the new technologies can involve using more of some resources than the earlier ones. From this perspective, it is precisely a bias in contemporary technologies towards a more intensive use of knowledge inputs that has favoured skilled workers, simultaneously raising their productivity (and wages) relative to the unskilled as well as the demand for such workers.

1. *New technologies and the skill mismatch*

Skill-biased technological change has, in recent years, been associated with the increasing economic importance of collecting, storing, processing and distributing information. Evidence of technological progress in this direction - collectively referred to as information and communication technologies (ICTs) - is apparent. Not only has the industrial landscape already been transformed by the rise of the semiconductor and computer industries, as well as related services, such as software design, but also the tremendous productivity improvements in these industries have brought about rapid falls in the price of information-based technologies. Coupled with improvements in the speed, capacity and accuracy of generating and managing information, this has led to the widespread use of computers, integrated circuits and robotics in both industry and households. Similar trends in satellite technology and fibre optics have advanced carrying capacity, increased the locational coverage of these technologies and enlarged the application of related services. Not surprisingly, ICT goods have become one of the most rapidly growing components of world trade.

The impact of these new technologies on labour market trends in the 1980s has been most extensively analysed for the United States, where differential productivity growth between skill-intensive manufacturing and the rest of the economy was particularly pronounced and where the fall in the price of skill-intensive goods relative to other goods was significant. These trends have coincided with a relatively fast rate of high-technology investment in such industries as electronics, machinery and chemicals, where, correspondingly, the demand for highly educated workers with problem-solving skills appears to be greatest. There is also evidence that the use of computers and the R&D intensity of jobs are both positively linked to higher wages, and it seems likely that the relative wage of skilled labour was further increased by the slower expansion of the number of college graduates in the 1980s.[41]

Together, these various pieces of evidence have been taken as confirmation of the skill-biased technology explanation of rising wage inequality in the North in the 1980s. However, shifting from partial evidence to a more general explanation of labour market problems is not so simple. In the United States, productivity growth in skill-intensive industries did not accelerate relative to other industries until the latter half of the 1980s, well after inequality and unemployment had began to increase. There is also some evidence to suggest that the rising relative wage of skilled workers was

Table 37

RATIO OF UNSKILLED TO SKILLED UNEMPLOYED WORKERS IN SELECTED OECD COUNTRIES, 1975-1993

Country	1975-1978	1979-1982	1983-1986	1987-1990	1991-1993
Australia	.	2.4	2.8	2.6	2.4
Canada	3.5	2.9	3.3	3.4	3.0
France	..	3.1	3.6	4.1	3.0
Germany	1.9	2.8	2.9	2.6	2.6
Italy	..	3.1	3.6	4.1	3.0
Netherlands	2.0	2.4	2.9	1.9	2.0
Spain	1.7	1.7	1.9	2.0	2.2
Sweden	4.0	3.4	3.7	2.4	2.5
United Kingdom	3.1	3.4	4 3	3.9	3.0
United States	3.9	4.5	4.7	4.7	3.9

Source: S. Nickell and B. Bell, "The collapse in demand for the unskilled and unemployment across the OECD", *Oxford Review of Economic Policy*, Vol 11, No. 1, 1995, table 2a

strongly biased towards professional business services and legal services and that the wages of more obviously technology-using professions, such as computer specialists and engineers, actually fell relative to those of high-school graduates during the 1980s. Moreover, an important source of measured inequality in the 1980s appears to have come from diverging wages among business and legal professionals.[42]

In addition, if skill-biased technological change is the operative force on labour markets, then in countries where the Welfare State remains strong, such as in Western Europe, there should be a clear and steady rise in the ratio of unskilled to skilled unemployed. In fact, this does not appear to be the case. In a number of countries, notably Australia, Germany, Netherlands, Sweden and the United Kingdom, this ratio has been falling since the mid-1980s, as also in the United States since the early 1990s (see table 37). None of this is compatible with a simple skill-biased technology story.

Moreover, the pace of technological change has not accelerated dramatically compared to the 1950s or 1960s, when the labour force profile was also steadily shifting towards higher skills but unemployment fell to historically low levels and the relative wage of skilled and unskilled workers showed no clear trend. These decades were marked by a backlog of new technologies from the inter-war period, the introduction of which had a profound impact in such basic activities as transportation, as well as giving rise to new industries in such areas as consumer durables. It seems unlikely that the process of skill upgrading has accelerated over the past two decades at the kind of pace that would be required to explain the dramatic shifts in labour market performance.[43] Indeed, the rather prolonged and steady introduction of new information technologies since the 1960s contrasts sharply with the punctuated rise in unemployment in 1973-1974 and again in the late 1970s, and is not obviously consistent with widening wage inequalities, which did not really begin until the 1980s.

2. *New technologies, productivity growth and job creation*

Technological progress is a process of creative destruction. On the one hand, innovations that lead to new products create new industries; along with expanding markets in these products they can increase employment. On the other hand, techno-

logical obsolescence goes along with declining industries and job loss. Complementary improvements in process technologies can raise productivity in both types of industries; however, the overall effects on employment are more uncertain, depending on price and income elasticities.

Not surprisingly, the employment effects of the recent wave of technological progress have been difficult to assess, in part because of the problem of singling out the effects of product and of process innovations. Firm and industry-level studies do point to a labour-saving bias in new production techniques, but do not find a large impact of new technologies on either job creation or job destruction, suggesting that productivity improvements, along with price reductions, as well as product improvements, have generated compensating demand growth and employment.[44] The growth of employment in software and information services, as well as in high-skill industries such as computers, office equipment and aerospace, in the 1980s is seen as a reflection of this process, as are the forecasts of future trends, which predict continued growth in these and related areas.[45] At a more macroeconomic level, it has been pointed out that in the United States and Japan high investment rates in new technologies have been combined with low or falling unemployment, whilst in Western Europe, where such investment has been weaker, unemployment has been rising.[46] Strong historical evidence of an association between new products and high growth of output employment and productivity also points to favourable prospects of job creation stemming from these new technologies.

However, rapid output growth in high-technology industries has not been accompanied by a proportional expansion of employment, and their rising share of manufacturing employment is largely due to shrinkage elsewhere.[47] Nor are simple country comparisons always convincing. During the 1980s employment in high-technology industries actually contracted in the United States, and over the entire period 1970-1991 it grew no more than in Western Europe, with the exceptions of the United Kingdom and the Netherlands, where employment actually fell. Moreover, high rates of high-technology investment in a number of Western European countries, notably Germany and Sweden, have coincided with a rising unemployment trend.

But there is a more fundamental problem with any argument that relies too heavily on the introduction of new technologies to explain the stagnation or decline in manufacturing employment. The introduction of skill-biased technological change has actually coincided with a pronounced slowdown in productivity growth in all the advanced industrial economies. Attempts to explain this paradox by broadening the concept of technological change to include institutional changes, particularly those linked to human capital formation, that help set new technologies in their wider economic and social setting, although helpful in correcting a narrow conception of flexibility defined exclusively in terms of wage costs (see next chapter), do not explain why output growth has slowed down even more than productivity growth.

A better understanding of the impact of technological change is through its link to investment - whether in human or in physical capital. In fact, the evidence offered in support of technologically generated inequalities appears to hinge on greater investment in high-technology industries which then feeds through to higher productivity and wages. Thus, evidence for the United States in the 1980s shows that relative wage increases in such industries as machinery, electronics, chemicals and instruments are strongly correlated with a larger change in net high-tech capital stock per worker in these industries.[48]

However, once investment is made the starting point, income effects become of central importance. A lack of aggregate demand on top of shifts in the pattern of demand would tend to limit employment growth even as investment accelerates in the high-technology industries. It would also exaggerate job loss in traditional industries as efforts to remain competitive in the face of excessive shrinking of markets, by labour shedding, compound the effects of lower investment.

F. Conclusions

Increasingly it is being recognized that trade and technology are not separate, but complementary, aspects of an ongoing process of structural change which has become much more international in scope. The best descriptions of a more competitive international environment combine catching up in the South (through a fast pace of capital accumulation and productivity growth and an increase in and diversification of manufactured exports) with increased trade among countries at a similar level of development because of economies of scale. The pressures from such competition add to those that always confront technological leaders in keeping ahead of rivals by automating their production of more traditional activities and creating new employment opportunities in expanding markets for knowledge-intensive manufactures and services. But history shows that both trade with newly industrializing countries as well as the advent of new technologies have always caused displacements in the labour markets of the more mature industrial economies, without always leading to unemployment and greater wage inequalities. Arguably, these forces have been no more pervasive in the world economy over the past two decades than they were in earlier times; indeed, if anything, their importance during the 1980s diminished as both trade and productivity growth slowed down compared to the Golden Age. However, their adverse impact on employment has been felt more strongly because of the slowdown in accumulation and growth in the major industrial economies. The issue, then, for the North is not how to save, let alone create, jobs in traditional manufacturing industries but how to generate new domestic employment opportunities in all non-tradeable sectors and to create capacity to compete internationally in expanding markets for knowledge-intensive manufactures. Providing there is adequate growth, dislocations can be absorbed and full employment maintained.

But there is a fundamental flaw in both trade and technology-based explanations of rising unemployment in the North, if in linking structural change to labour market performance these explanations assume that there is always an adequate level of aggregate demand. Given the restrictive demand policies pursued in the North over the past two decades, the question to be asked is what are the effects of increased trade and technological progress under conditions of slow and inadequate economic growth? Indeed, because all technological change - albeit to differing degrees - is embodied in physical and human capital and, because leading economies must, in the face of catching-up pressures, invest in new capacity of one kind or another, any discussion of the impact of technological change or trade independently of the macroeconomic determinants of capital accumulation is likely to be unhelpful. As it has been put in the OECD Jobs Study, "a low level of aggregate demand may hamper the efficient development and absorption of new technology. Overly deflationary economic policies may have a long-term negative impact on economic growth and employment".[49] Despite this emphasis on a more interdependent analysis, neither the OECD study nor other studies of the causes of high unemployment give enough credit to demand factors and the policies shaping them. This issue is examined in the next chapter. ■

Notes

1 United States Secretary of the Treasury, Henry Morgenthau, quoted in Armand Van Dormeal, *Bretton Woods: Birth of a Monetary System* (New York: Holmes and Meier, 1978), p. 1.

2 See G.J. Borjas and V.A.Ramey, "Time-series evidence on the sources of trends in wage inequality", *The American Economic Review*, May 1993; G.J. Borjas, "The internationalization of the US labour market and the wage structure", *Federal Reserve Bank of New York Economic Policy Review*, January 1995; L.F. Katz and K.V. Murphy, "Changes in relative wages, 1963-1987: Supply and demand fac-

tors", *Quarterly Journal of Economics,* February 1993; Adrian Wood, *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World* (Oxford: Clarendon Press, 1994), chap. 7. See also annex I.

3 On some estimates this figure would double if non-manufacturing trade is included. See A. Wood, *op. cit.*, chap. 5. See also A. Ravenga, "Exporting jobs? The impact of import competition on employment and wages in US manufacturing", *Quarterly Journal of Economics*, February 1992; E. Leamer, "Trade, wages and revolving door ideas", *NBER Working Paper* 4716, New York, April 1994; and J. Sachs and H. Shatz, "Trade and jobs in US manufacturing", *Brookings Papers on Economic Activity*, 1, 1994.

4 UNCTAD, *World Investment Report 1994* (United Nations publication, Sales No. E.94.II.A.14), chap. I.

5 For a review of the literature assessing the impact of NAFTA on jobs, see G.C. Hufbauer and Jeffrey Schott, *NAFTA - An Assessment* (Washington, D.C.: Institute for International Economics, 1993); on the French debate see B. Madeuf, "Foreign direct investment, trade and employment delocalization" in *Foreign Direct Investment, Trade and Employment* (Paris: OECD, 1995); on Japan see Hideo Kato, *Japanese Industry in Transition: Overseas Production and Industrial Hollowing-out* (Tokyo: Shimpyoron, 1994, in Japanese). M. Slaughter, "The impact of internationalization on US income distribution", *Finance and the International Economy*, 8, 1994, discusses the future impact of FDI on unskilled jobs in the North.

6 See, for example, P. Minford *et al.*, "The elixir of growth: trade, non-traded goods and development", *CEPR Discussion Paper*, No. 1165, London, May 1995.

7 UNCTAD, *op. cit.*, chap. III.

8 On the issue of relative price movements see R. Lawrence and M. Slaughter, "International trade and American wages in the 1980s: Giant sucking sound or small hiccup?", *Brookings Papers: Microeconomics*, 2, 1993; M. Slaughter, *op cit.*; J. Sachs and H. Shatz, *op. cit.*; P. Minford *et al.*, *op. cit.*; D. Neven and C. Wyplosz, "Does Europe have a competitiveness problem", in Emil Ems (ed.), *35 Years of Free Trade in Europe - Messages for the Future Proceedings of EFTA's 35th Anniversary Workshop* (Geneva: EFTA, 1995).

9 Import penetration of a particular good is defined as the share of imports in total apparent consumption (gross output minus net exports) of that good.

10 See, for a fuller discussion, OECD, *Industrial Policy in OECD Countries. Annual Review 1994* (Paris: OECD, 1994); Sachs and Shatz, *op. cit.*; and D. Brauer and S. Hickok, "Explaining the growing inequality in wages across skill levels", *Federal Reserve Bank of New York Economic Policy Review,* January 1995. While the chemical industry, the production of scientific instruments, petroleum refining, and printing and publishing are unanimously classified as high-skilled, and iron and steel as well as textiles and clothing as low-skilled, different classifications can be found for other sectors. For example, both the food and the fabricated metals industries are classified as high-skill ones by OECD but as low-skill by Brauer and Hickok, and are not taken into account by Sachs and Shatz. Electrical machinery, on the other hand, falls in the low-skill category in the OECD classification, but in the relatively high-skill sectors in the two American studies.

11 Employment data in the following paragraphs are from the UNIDO Data Base, computer tapes.

12 In this sector a four-fold increase of employment was registered in Canada and a doubling in the United States. Smaller increases also occurred in the other countries, with the exception of the United Kingdom. But even there proportionally fewer jobs were lost than elsewhere in manufacturing - only 5 per cent from the early 1970s to the early 1990s. However, in absolute terms the rise in employment was comparatively modest (around 620,000 in the G-7 countries taken together) and not even sufficient to compensate for the reduction of employment in non-metallic minerals, much of which is likely to have been the result of substitution by plastics.

13 See *TDR 1988*, Part One, chap. IV, sect. A.5.

14 See *TDR 1985*, para. 301.

15 M. Marcel and J.G. Palma, "Third world debt and its effects on the British economy: a Southern view of economic mismanagement in the North", *Cambridge Journal of Economics*, 1988, 12, p. 390, suggest that the figure for the United Kingdom would be some 25 per cent higher if indirect effects were taken into account.

16 A study prepared for the United States Congress in 1986 noted: "It was clear from the outset that the third world debt problem posed a serious, potentially even catastrophic, threat to the stability of the international financial system. Thus far, a financial catastrophe has been averted, which was the initial goal of policy makers. The evidence suggests, in fact, that the policies that were implemented have permitted US banks to maintain and even increase their profitability. But, at the same time, those policies have seriously - and unnecessarily - injured the economic well-being of other sectors of the US economy, agriculture and manufacturing in particular..." Cited in Marcel and Palma (*op. cit.*, p. 381).

17 G. Calvo, "The management of capital flows: Domestic policy and international cooperation", *International Monetary and Financial Issues for the 1990s*, Vol. IV - *The International Monetary and Financial System: Developing Country Perspectives* (UNCTAD/GID/G24/4), New York, 1994, tables 1 and 2.

18 For a fuller discussion see *TDR 1993*, Part Two, chap. II.

19 However, this is not true for all types of FDI, some

of which can be made with a relatively short time horizon. Indeed, in a world of volatile exchange rates, TNCs are particularly well placed to hedge, in various ways, their cash flows and their balance sheets. Not only does this heighten the importance of the financial aspects of FDI but also the resulting strategies of financial engineering in the face of uncertainty, whilst rational from the firm's viewpoint, could prove socially wasteful. See G. Holtham, "Managing the exchange rate system " in J. Mitchie and J. Grieve Smith (eds), *Managing the Global Economy* (Oxford: Oxford University Press, 1995); and United States Congress, *Multinationals and the National Interest: Playing by Different Rules*, Office of Technology Assessment, Washington D.C., 1993. There is some evidence that the difference in the relative stability of different types of foreign investment is actually quite small. See S. Claessens *et al.*, "Portfolio Capital Flows: Hot or Cold?", *The World Bank Economic Review*, 1, 1995.

20 For World Bank projections of commodity prices up to 2004 see Part Two, chap. I, sect. A2, above.

21 It is sometimes suggested that successful catching up reflects a simple combination of strong property rights and openness to FDI (see P. Minford *et al., op. cit.).* However, FDI played only a small role in the catching up process of Japan, Republic of Korea and Taiwan province of China, and the concept of "strong" property rights is far too vague to capture the close and complex links between business and the State in the development process of these countries. (See *TDR 1994*, Part Two, chap. I.)

22 See *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press for the World Bank, 1993), p.262; A. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford: Oxford University Press, 1989), table 4.10.

23 All the East Asian NIEs have responded by getting out of traditional industries and specializing in more sophisticated exports. Interestingly, of the four, the Republic of Korea and Taiwan province of China most closely resemble Japan, whilst the city State economies of Hong Kong and Singapore are subject to different pressures.

24 The classification of "high technology goods" is not identical to "high technology industries". However, there is widespread agreement that the former involve technological leadership and a high degree of product innovation, and are usually associated with high productivity and high-wage industries. See P. Guerrieri and C. Milana, "Changes and trends in the world trade in high technology products", *Cambridge Journal of Economics*, 1995, 19.

25 Guerrieri and Milana, *op. cit*, pp. 234-236.

26 For details, see *TDR 1993*, Part One, chap. II., sect. D1.

27 But see UNCTAD, *World Investment Report 1994* (United Nations publication, Sales No. E.94.II.A.14), Part Two; and ILO, *World Employment 1995* (Geneva: International Labour Office, 1995).

28 *World Investment Report 1994*, table IV.3.

29 See Slaughter, *op. cit.*

30 Sachs and Shatz, *op. cit.*, p. 46.

31 There was a steady increase in flows to developing countries in the second half of the 1980s. However, as a proportion of global flows, their share actually fell. The strong recovery of flows occurred in the 1990s. Moreover, the share of total flows going to developing countries rose from 15 per cent in 1990 to 40 per cent in 1993. Much of the increase has been concentrated in Asia; South, East and South-East Asia accounted for one third of flows to developing countries in the first half of the 1980s, one half in the second half and over 60 per cent in the early 1990s.

32 Whilst Japanese manufacturing FDI in Latin America was stagnant in the second half of the 1980s, the share going to electronics and transport equipment rose from 30 per cent in the first half of the 1980s to close to 50 per cent in the second half.

33 For a more complete assessment see M. Mortimer, "Transforming sitting ducks into flying geese: the Mexican automobile industry", ECLAC/UNCTAD Joint Unit, Santiago, Chile, 1994 (mimeo).

34 See H. Radice, "The role of foreign direct investment in the transformation of Eastern Europe", in H-J Chang and P. Nolan (eds), *The Transformation of the Communist Countries - Against the Mainstream* (London: St. Martin's Press, 1995).

35 On the links between FDI and employment in Sweden, see R. Svensson, *Production in Foreign Affiliates: Effects on Home Country Exports and Modes of Entry* (Stockholm: Industrial Institute for Economics and Social research, 1993); and T. Andersson, "Foreign direct investment and employment in Sweden", in *Foreign Direct Investment, Trade and Employment* (Paris: OECD, 1995). For a summary of other studies see G. Hufbauer, *et al.*, "Determinants of direct foreign investment and its connection to trade", *UNCTAD Review*, 1994 (United Nations publication, Sales No. E.94.II.D.19).

36 During 1971-1985 these two sectors accounted for only 20 per cent of FDI flows to Asia, but in 1985-1990 they accounted for close to 40 per cent. An additional feature of this regional FDI was the larger variety of locations, now including the second-tier NIEs (particularly Malaysia and Thailand).

37 This regional emphasis appears to reflect, in part, increased FDI in intermediate goods industries, as many Japanese affiliates in the region have significantly increased their sourcing of domestic parts from Japanese affiliated parts-makers. But there has also been a growing interest in locating production activities in China and elsewhere in the region.

38 One result of these developments was a redistribution of the Japanese trade surplus in the 1980s; an emerging trade surplus of South-East Asia with the United States has coincided with a rising trade deficit of South-East Asia with Japan. Indeed, the Japa-

nese trade surplus with its regional partners now surpasses that with the United States. This pattern is, as one would expect, particularly pronounced in machinery and transport equipment.

39 See *TDR 1994*, Part Two, chap. II, sect. C.

40 M. Feldstein, "The effects of outbound foreign direct investment on domestic capital stock", *NBER Working Paper No. 4668*, New York, March 1994.

41 See Brauer and Hickok, *op. cit.*; E. Berman, J. Bound and Z. Griliches, " Changes in the demand for skilled labour within US manufacturing: Evidence from the annual survey of manufacturing", *Quarterly Journal of Economics*, February 1992; A. Kruger, "How computers have changed the wage structure: Evidence from micro data 1984-89", *Quarterly Journal of Economics,* February 1993; A. Bartel and F. Lichtenberg, "The comparative advantage of educated workers in implementing new technology", *Review of Economics and Statistics*, February 1987; Lawrence and Slaughter, *op. cit.*

42 See B. Pierce and F. Welch, "Changes in the structure of wages", Texas A&M University, 1994 (mimeo); P. Krugman, "Past and prospective causes of high unemployment", paper for the economic symposium of the Federal Reserve Bank of Kansas City at Jackson Hole, 25-27 August 1994.

43 See C. Juhn and K. Murphy, "Inequality in labour market outcomes: Contrasting the 1980s and earlier decades", *Federal Reserve Bank of New York Economic Policy Review*, January 1995.

44 For a review of this evidence see *The OECD Jobs Study*, chap. 4, sect. IV.

45 C. Freeman and L. Soete, *Work for All or Mass Unemployment? Computerized Technical Change into the Twenty-first Century* (London: Pinter, 1995).

46 See *The Economist* (London), "Technology and Unemployment", 11 February 1995, p. 22.

47 *The OECD Jobs Study*, chap. 4, sect. V.

48 See Brauer and Hickock, *op. cit.*

49 *The OECD Jobs Study*, Part I, p. 127.

Chapter III

THE LABOUR MARKET, CAPITAL FORMATION AND JOB CREATION

A. The labour market and unemployment

As already noted, according to the trade and technology explanations of unemployment, import penetration and technological change have led to persistently rising structural unemployment through the workings of the labour market. The trade and technology explanations thus link up with earlier "stagflation" theories of the 1970s, based on the concept of a "natural" rate of unemployment, which hold that inflexible labour markets themselves are the source of unemployment.

The natural rate of unemployment is defined as the rate that is consistent with a stable rate of inflation, for which reason it is also called the non-accelerating inflation rate of unemployment (NAIRU).[1] Expansionary policies that reduce unemployment below its natural level ultimately accelerate inflation. One explanation for this is based on the assumption of perfect competition: since the productivity of labour diminishes as employment is increased, the demand for labour can rise only if real wages fall. Hence if real wages rise at a rate equal to that of productivity, macroeconomic policy can only increase labour demand and employment through a faster rise of prices than of wages. But as workers eventually adjust their wage claims to the new rate of inflation, labour demand will fall. Therefore unemployment can only be kept below its natural level by continuously accelerating inflation.

An alternative explanation focuses on the restraining effect of unemployment on wages and the inflationary effects of wage-setting behaviour in relation to productivity growth. When aggregate demand is strong enough to bring unemployment below a certain level, real wages start to rise faster than productivity and push costs up, eventually leading to accelerated inflation.

The rigidities that are alleged to cause structural unemployment include: minimum wages that preclude employment for the unskilled and young workers in jobs where their productivity would be lower than the statutory wage floor; dismissal protection, social security contributions, and rigid working hours, all of which increase labour costs and make producers more hesitant to take on new employees when markets expand; unemployment insurance and benefits, which prolong job searches and encourage workers to hold out for a better job; the actions of trade unions, which tend to protect the interests of their members (i.e. employed workers or "insiders") exclusively, preventing wages from flexing downwards in the face of unemployment.[2]

With respect to the current unemployment problem in the industrialized countries, the natural rate theory propounds that the establishment and strengthening of welfare state institutions and

the regulation of labour relations in the postwar period have created rigidities, or inflexibilities, which impede the labour market from making the wage adjustments necessary to attain full employment. The rigidities, by raising real labour costs, reduce the rate of return on investment, hinder the accumulation of capital that could absorb the growing labour force, and encourage the substitution of capital for labour, thereby reducing the level of employment associated with a given level of output. Moreover, by the same token, they discourage entrepreneurs from employing more labour with the existing capital equipment, thus preventing the more intensive use of the capital stock in the short term.

The most important rigidity underlined by the natural rate theory is that of relative wages. The higher rates of unemployment among unskilled workers compared to the skilled are attributed to inflexibilities in the labour market that obstruct the adjustment of relative wages to an ongoing change in the composition of labour demand in favour of skilled workers (for reasons noted in the preceding chapter). Collective bargaining tends to reduce wage differentials, making it difficult for relative wages to adjust. The argument draws support from empirical evidence that, across countries, increases in earnings dispersion are associated with greater private sector job expansion, and from evidence that sectoral employment performance also depends on intra-industry wage dispersion.[3]

The call for more flexibility disregards the fact that the demand for products determines the impact of increased labour market flexibility on employment. First, lowering real wages can reduce employment if it redistributes income from income groups with higher propensities to consume to those with lower ones, thus lowering aggregate demand. Therefore, reducing the labour costs of operating the existing stock of capital will not ensure that more labour is employed to use it, unless an increase in demand to absorb the increase in output is expected. Secondly, reducing the costs of employing labour will increase the expected rates of return of investment projects, but this itself will only induce new projects to be undertaken if there is an expectation that demand for the products will be greater. The prospect of strong demand growth provides a powerful incentive to entrepreneurs to shoulder the risks involved in expanding productive capacity; prospective weak demand is a deterrent. Indeed, when the latter is expected, increasing some forms of flexibility can even reduce employment. Removing the restrictions on assigning jobs to workers in the workplace ("functional flexibility"), or on working hours ("internal numerical flexibility"), and increasing the pace of work all enhance labour productivity in the enterprise, which will lead to *less* employment if output is not also increased.

B. Recent experience of labour market flexibility and unemployment

1. General tendencies

The 1980s witnessed a general trend towards deregulation in practically all industrialized countries. The pressure on employers stemming from increased competition in stagnant markets, together with rising unemployment and the growing pressure on Governments to deal effectively with the problem, have led to a weakening of the organized bargaining power of labour. A number of Governments have accordingly sought to deregulate contractual labour relations and to circumscribe trade union activities. Nevertheless, there was little creation of new employment and no reversal of the rising trend of unemployment.

In most OECD countries, trade union membership (as a percentage of all wage and salary earners) declined in the 1980s, quite sharply in some cases.[4] In Sweden the discipline of centralized bargaining weakened as unions increasingly started to conclude their own agreements with employers.[5] In Germany unions have been tempering wage claims in sectoral collective bargaining. In Japan enterprise-based unions have likewise been

accommodating wage demands to recessionary conditions, and the employment of seasonal, temporary and part-time workers has been increasing. In the 1980s the proportion of involuntary part-time employment or temporary employment has increased (notably in the United States, Canada, Australia, Denmark, Belgium, Finland, the Netherlands); and in some countries the amount of subcontracting has risen.[6]

In the major industrial countries there has been no clearly rising trend of real unit labour costs in the 1980s.[7] Wage differentiation according to age or educational attainment has been increasing in the United States, United Kingdom, Canada and Australia.[8] Wage inequality among "observationally similar" workers (i.e. those having similar qualifications and doing similar jobs) has been increasing in the first three of those countries, indicating a weakening of coordination in bargaining across sectors and companies and more individual bargaining.[9]

New legislation in the 1980s introduced new flexibilities, such as fixed-term contracts (Germany, France and Spain), less stringent prohibition of night-work by women (France and Finland), abolition of minimum wages for young workers (United Kingdom), weaker protection against dismissal (United Kingdom and France) and easier conditions for mass redundancies (France).[10] In the United Kingdom and New Zealand collective bargaining and trade union structures were reformed to increase competition in the labour market.[11]

In the 1980s various attempts were also made to reform systems of unemployment benefits, such as shortening the maximum duration of benefits in the United States and reducing replacement rates (the ratio of benefit to recent wage) in most EU countries. However, the variety of conditions attached to benefits that influence job search and acceptance behaviour (duration of benefits, replacement ratios, relationship of benefits to the employment status of the spouse, provisions relating to job search and job acceptance, the effectiveness with which the rules are enforced) makes it difficult to draw firm conclusions about the effects of the changes in benefit systems on unemployment. Evidence indicates that unemployment benefits increase unemployment rates not only by facilitating the prolongation of job search, but also by encouraging inactive groups (students, women) to register as unemployed.[12] OECD has concluded that "... only fairly large changes in the summary measure of benefit entitlements, corresponding to major reforms as seen from the perspective of changes in the long-term social security history of individual countries, could by themselves achieve a significant reduction of unemployment in high-benefit countries and thus partly reverse the rises in unemployment that most European countries have experienced".[13]

Table 38

AVERAGE ANNUAL GROWTH OF EMPLOYMENT IN OECD COUNTRIES

(Percentage)

Country	*1960-1973*	*1973-1979*	*1980-1994*
United States	1.9	2.5	1.5
Japan	1.3	0.7	1.1
European Union	0.3	0.2	0.1
Germany	0.3	-0.3	0.7[a]
France	0.7	0.3	0.0
United Kingdom	0.3	0.2	0.0
Total OECD[b]	1.1	1.1	0.9

Source: 1960-1973 and 1973-1979: calculated from *OECD Historical Statistics 1960-1990* (Paris: OECD, 1992); 1980-1992: calculated from *OECD Economic Outlook*, No. 56, December 1994.

a 1980-1990.

b Excluding Mexico prior to 1988.

In spite of the increasing flexibility in labour relations, the growth of employment in OECD countries during 1980-1992 was on average not much faster than in 1960-1979, when labour inflexibility was increasing (see table 38). It failed to absorb the increase in the labour force and there was consequently a rising unemployment trend (see table 39). Manufacturing industries, where job losses were concentrated, made use of flexibility to increase productivity through labour shedding, thus contributing to unemployment and giving rise to the perception of a "recovery without jobs". The net increase in employment from 1980 to 1992 was mainly due to the service sectors.

Table 39

AVERAGE ANNUAL UNEMPLOYMENT IN OECD COUNTRIES

(Percentage of total labour force)

Country	1960-1973	1974-1979	1980-1994
United States	4.8	6.7	7.0
Japan	1.3	1.9	2.5
European Union	2.4	4.7	9.8
Germany	0.8	3.4	7.1
France	1.5[a]	4.5	9.6
United Kingdom	1.9	4.2	8.9
Total OECD	3.2	5.1	7.3

Source: As for table 38.
a 1960-1967.

greater ease with which wages are adjusted. The larger wage differentials in that country are also considered to be a function of greater relative wage flexibility.

The flexible labour relations in the United States that are considered to account for the faster increase of employment include the short duration of unemployment benefits, relatively weak trade union organization and collective bargaining, low federal minimum wages relative to the average wage, and limited regulation of other elements of labour relations. European countries wishing to emulate the United States model thus face the option of dismantling the welfare State and assimilating their labour markets to the more competitive environment of the United States, or allowing unemployment to remain high and bearing the burden of social transfers.[14]

2. Divergent national experience

The natural rate explanation of unemployment finds its strongest support in intercountry comparisons, especially in a comparison of the United States and European OECD countries since the 1980s. However, a close examination of labour market structures, unemployment experience and wage and productivity performance reveals that the important differences among countries are not in the unemployment rates, but in the manner in which part of the labour force is maintained in employment without being productive.

In the United States the rate of inflow into the pool of unemployed is higher than in Europe, but the average duration of unemployment is shorter (see table 40), with the result that unemployment is low compared to the European Union (table 39). The relatively higher incidence of long-term unemployment in countries such as Germany and France (see table 41) is often attributed to the more generous unemployment benefit systems in those countries, which tend to prolong the period of job seeking during which the unemployed worker gradually loses his skills and working habits. The higher rate of employment expansion in the United States compared to Europe is often ascribed to the

Table 40

TURNOVER OF THE POOL OF UNEMPLOYED IN 1991 IN MAJOR OECD COUNTRIES

Country	Average monthly outflow[a]	Average monthly inflow[a]	Average duration of unemployment[b] (months)
United States	37.3	2.1	2.5
Japan	23.6	0.3	5.0
Germany[c]	8.0	0.2	14.2
France	5.5	0.3	22.5
Italy[c]	3.6	0.2	38.9
United Kingdom[c]	13.4	0.6	8.7
Canada	23.8	2.3	3.7

Source: *OECD Economic Outlook*, No. 56, December 1994 (table 13)
a The monthly outflow rate is expressed as the percentage of unemployed finding work or leaving the labour force in a given month. The monthly inflow rate is expressed as the percentage of employed and non-participants who become unemployed in a given month.
b Generally estimated by the ratio of the stock of unemployed to the number of individuals unemployed for less than one month (job losers and unsuccessful new entrants).
c 1990.

Table 41

LONG-TERM UNEMPLOYMENT AND ITS INCIDENCE IN MAJOR OECD COUNTRIES

	1979		*1990*	
Country	*Unemployment rate (Per cent)*	*Incidence of long-term unemployed[a]*	*Unemployment rate (Per cent)*	*Incidence of long-term unemployed[a]*
United States	5.8	4.2	5.5	5.6
Japan	2.1	16.8	2.1	19.1
Germany	2.9	28.7	4.9	46.3
France	6.0	30.3	8.9	38.3
United Kingdom	4.5	29.5	5.9	36.1
Italy	7.8	51.2	11.1	71.1
Canada	7.4	3.4	8.1	5.7

Source: *OECD Employment Outlook,* July 1993 (table 3.1).

a The number of long-term unemployed (12 months and over) as a percentage of the total unemployed.

Emulating the United States model assumes that unionization and wage flexibility are inversely related: the greater is the power of unions and the extent of collective agreements, the less is the responsiveness of wages to changes in economic conditions. Empirical research finds that wage flexibility depends on the extent to which wage bargaining is centralized. In those European countries where bargaining is more centralized, wages tend to be more sensitive to unemployment and adjust faster to shocks. One study that classified countries according to the level of "corporatism" (measured by the level at which bargaining takes place, the power of national labour organizations vis-à-vis their members, the extent of organization of employers and the autonomy of local shop stewards) found that wage setting is most sensitive to the economic environment in the most corporatist European countries and in the United States (the least corporatist), whilst in countries in the middle range (especially the EU countries) wage behaviour showed least sensitivity. The explanation is that when unions represent a large part of the labour force they are obliged to consider the possible losses of jobs and price inflation that might result from high wage claims in collective bargaining; and when wage bargaining is done at the firm level, the union has to consider the effects on the competitiveness of the firm. By contrast, wage bargaining at the level of an industry can typically aspire to much stronger wage increases, because entrepreneurs in the same sector can (depending on the degree of foreign competition) pass on the additional wage costs to consumers; jobs will not be lost, and the other sectors of the economy will pay for the increase in relative sectoral prices (and wages). However, Japan, which also has an intermediate position on the corporatism scale, has traditionally had a low rate of unemployment. In that country it seems that firm-based unions and firms co-ordinate their negotiating stance among themselves in a way that takes the economy-wide impacts of claims into account.[15]

There are too many dimensions to corporatism and too many influences on wage setting to establish a simple relationship between corporatism - however measured - and wage flexibility. OECD has estimated elasticities of the long-term response of real product wages (the cost of labour for producers in terms of their output) with respect to unemployment. The English-speaking countries, generally seen as examples of decentralized labour relations, show elasticities between -1.0 and -4.0, while the more unionized countries have elasticities ranging from -3.0 to -10.0. When the full impact

Table 42

UNEMPLOYMENT RATES BY EDUCATIONAL ATTAINMENT IN FOUR MAJOR OECD COUNTRIES

(Percentage of the labour force)

			Educational attainment		*Labour force ranked from lowest to highest qualification*	
Country		*Year*	*Lower secondary or less*	*Upper secondary or higher*	*First quartile*	*Last quartile*
United States	Men	1970	4.0	2.1	4.0	1.7
		1979	6.6	3.2	6.4	1.8
		1989	9.7	3.9	8.1	2.3
	Women	1970	5.7	3.2	5.7	2.6
		1979	8.3	4.1	7.6	3.1
		1989	8.4	3.5	6.2	2.0
Japan	Men	1979	2.7	1.5	2.7	1.3
		1992	3.0	1.6	2.9	1.1
	Women	1979	11.6	15.4	11.6	15.4
		1992	7.2	8.8	7.3	8.7
Germany	Men	1978	4.1	1.8	3.6	1.7
		1987	14.6	5.0	11.0	4.2
	Women	1978	4.4	3.7	4.4	3.5
		1987	12.5	8.2	12.5	8.1
France	Men	1979	3.7	2.6	3.9	2.6
		1990	8.3	4.1	8.9	3.1
	Women	1979	5.9	4.6	6.3	3.8
		1990	13.6	7.6	14.6	5.1

Source: *The OECD Jobs Study. Evidence and Explanations.* Part I - *Labour Market Trends and Underlying Forces of Change* (Paris: OECD, 1994), table 1.16

Note: The data relate to unemployed persons in the age group 25-64.

of a change in unemployment on real product wages is realized, it appears that a 1 per cent increase in unemployment in the United States evokes a 1 per cent decline in real product wages, whereas in countries with regulated labour markets, such as Germany, France and Sweden, it appears to generate reductions of real product wages of some 3 per cent, 3.5 per cent and 10 per cent, respectively.[16]

The higher unemployment rates for unskilled labour in the industrialized countries than for skilled labour are commonly interpreted as evidence of a shift in demand in favour of the latter. Increasing wage differentials in the United States are considered to reflect a more flexible labour market, adjusting more easily to this demand shift. In contrast to the United States, it is alleged that the more

rigid European labour markets have prevented relative wages from adjusting sufficiently, thereby increasing unemployment for unskilled labour. If unemployment resulted from relative wage inflexibility in the face of changes in the pattern of demand for labour, it could be expected that, while unemployment would increase for unskilled labour, there would be excess demand for the skilled. The higher premiums for educational attainment that now prevail do indeed indicate a shift in demand towards more skilled labour, but the rising trend of unemployment for skilled labour (see table 42) points to a more general weakness of labour demand stemming from the weakness of aggregate demand for goods and services.

Since most of the low-wage jobs taken up by displaced United States workers are in the service sector, expanding employment in that sector is often seen as providing a solution to the unemployment problem. Those industrialized countries with relatively unregulated labour markets (such as the United States, United Kingdom, Canada and Italy) also tend to be those where employment in services has increased the most. The increase has generally been attributed to a faster demand growth for services than for manufactures, and labour market flexibility is believed to have facilitated this increase: differences in the growth of service sector employment are attributed to differences in labour market flexibility.

The increased demand for services may, however, have less to do with changing consumer preferences than with income redistribution in favour of unearned income (as discussed more fully in annex II to Part Three). Various studies reveal that the share of services in consumer expenditure rises with income. The deterioration in income distribution in the countries with more flexible labour markets (such as the United States and the United Kingdom) may be one reason why the demand for services has risen faster in those countries than elsewhere. If so, falling wage shares themselves contribute to the decline in manufacturing employment.

However, the increasing productivity and wage differentials between manufacturing and services suggest that the expansion of service employment did not entirely correspond to an autonomous increase in demand for services. If manufacturing employment is stagnating or contracting while the redundant workers find jobs in services where productivity and wages are much lower, it could well be concluded that the increased service employment reduces labour productivity in that sector, with consequent effects on the levels of wages in the sector. A rise in employment in services greater than can be justified by the increase in demand for services is tantamount to *disguised unemployment* (see annex III to Part Three). The pattern of change in sectoral productivity differentials also suggests that some non-service sectors, such as construction, may also have been harbouring disguised unemployment. Indeed, the unemployment records of the industrialized countries are not so different from each other when due account is taken of differences in the incidence of disguised unemployment.

Growing disguised unemployment in services is caused by stagnant demand for the products of high-productivity sectors, and by the absence of unemployment benefits or other forms of social assistance, which force redundant workers to accept alternative jobs, whatever the wage, or to take up self-employment, however modest the income. Consequently, if aggregate demand does not expand, more flexible labour relations in services merely make for more disguised unemployment. This point is worth emphasizing, because calls for flexibility in labour markets are rarely, if ever, accompanied by calls for aggregate demand expansion.

In sum, in the United States, where the labour market is relatively unregulated, unemployment has been lower than in Western Europe since the 1980s, but increased employment in certain services has been at the cost of falling average real wages and widening wage differentials, as well as of growing disguised unemployment. Of the 7.76 million new jobs created in various service sectors from 1979 to 1987, 55 per cent constituted disguised unemployment (see annex III). Japan, where flexibility is exercised in wage determination and intra-firm assigning of jobs to workers, and hiring and firing practices are inflexible, has had by far the lowest unemployment rates among the major industrialized countries since the early 1970s. However, agricultural subsidies and protection served to retain labour in agriculture, where labour productivity is much lower than in manufacturing. In Germany, with its relatively regulated labour market, unemployment has not been much higher than in the United States, especially if the effects of unification are taken into account. France has suffered from high levels of open unemployment, which may be associated with labour market inflexibility, but has relatively little disguised unemployment in agriculture or services. On the

Table 43

ACTUAL AND NATURAL UNEMPLOYMENT RATES IN OECD COUNTRIES

(Annual average rate in per cent)

Country		1957-1966	1967-1974	1975-1978	1979-1982	1976-1980	1981-1983
United States	Actual	5.18	4.35	7.05	7.31	..	..
	Natural	5.18	4.71	7.80	6.20	..	..
Japan	Actual	1.56	1.25	2.04	2.18	..	..
	Natural	1.56	1.89	2.47	2.37	..	..
European Union	Actual	..	..	..	..	5.40	8.80
	Natural	..	..	..	..	5.30	7.30
Germany	Actual	1.38	1.12	3.89	4.51	3.70	6.70
	Natural	2.03	1.06	3.82	3.34	3.70	5.30
France	Actual	..	..	..	..	5.30	7.30
	Natural	..	..	..	..	5.30	6.90
United Kingdom	Actual	2.03	3.78	6.80	11.28	5.50	10.80
	Natural	2.03	4.25	7.53	10.47	4.60	9.50

Source: ECE, *Economic Survey of Europe in 1990-1991* (United Nations publication, Sales No. E.92.II.E.1), table 5.7.

other hand, the United Kingdom, where deregulation of the labour market began in the early 1980s, has both a high rate of unemployment in general, comparable to that of countries with much more regulation, such as Germany, and a high incidence of long-term unemployment in particular.[17] Low-wage employment in services has also expanded in that country; while employment increased by 879,000 in various service sectors from 1979 to 1987, some four fifths of this increase represented disguised unemployment. Among these five countries, those where disguised unemployment has been increasing most (the United States and the United Kingdom) have witnessed a significant increase in wage inequality whereas in those where disguised unemployment diminished (Germany and France) there was no rising trend of wage inequality. In the particular case of Japan, where disguised unemployment increased in agriculture, income levels in the sector have been maintained through subsidies and protection.

Varying national experience, therefore, does not tend to support the proposition that the key to solving unemployment in the industrialized countries lies in increasing labour market flexibility. On its own that would merely redistribute income and increase the demand for low-wage jobs. The principal difference between the United States, Japan and European OECD countries has been the degree of success not in creating productive employment, but in disguising unemployment. The underlying problem is the same in all: how to provide the entire labour force with productive employment.

C. Hysteresis in unemployment and growth

As already noted, the theory underlying the concept of the natural unemployment rate holds that macroeconomic policies can influence only cyclical unemployment. The experience of the industrialized countries clearly refutes the idea that structural unemployment is something entirely distinct. The natural rate of unemployment tends to move with actual rates (see table 43), implying that unemployment has no inherent tendency to return to a previous level when the factors responsible for the change of level no longer prevail (i.e. that it is subject to hysteresis). But actual unemployment at any given time is influenced by macroeconomic policies. Therefore the evolution of the natural rate over time cannot be impervious to the stance of such policies.

Since labour relations have become more flexible since the early 1980s, a rise in the NAIRU cannot be attributed to labour market imperfections or hardened wage bargaining. If anything, market structures, social policies and wage-setting behaviour have all been changing in a direction that should reduce the NAIRU. However, that result has not been achieved in many countries. Whereas differences in labour market flexibility explain differences in the extent of such factors as open unemployment, disguised unemployment, involuntary part-time unemployment and participation rates, the unemployment hysteresis common to the industrialized countries is due to the lower trend rate of GDP growth. It is partly related to the rising rates of long-term unemployment observed in nearly all OECD countries during the 1980s (see table 41). Even when employment has expanded, the pace of expansion has not been vigorous enough for firms to take on new employees beyond those recently dismissed. In addition, because the growth of employment lags behind that of the labour force, firms prefer to hire experienced unemployed workers. New entrants into the labour force remain inexperienced because they cannot find jobs, and they remain unemployed because of lack of experience.

"Deskilled" or inexperienced long-term unemployed consequently find it increasingly difficult to compete for jobs against workers already employed, and workers in employment negotiating with employers can afford to ignore the long-term unemployed, and to bargain harder when demand for labour picks up. As the numbers of long-term unemployed increase, so does the unemployment rate at which wages rises start to exceed productivity growth. In this way long-term unemployment pushes up the natural rate of unemployment.

Since the natural rate of unemployment is subject to hysteresis, its reduction requires an understanding of the causes of structural unemployment and policies responsible for it. The experience of recent decades in the industrialized countries suggests that an important part of structural unemployment stems from a capital shortage in the sense that the capital stock using state-of-the-art techniques is expanding more slowly than the labour force. Unemployment consequently cannot be eliminated simply by expanding demand and thereby raising the utilization rate of the existing stock of capital. The tendency for unemployment at given capacity utilization rates in OECD countries to rise over the past 20 years[18] clearly points to a fundamental imbalance between the growth of the labour force and the accumulation of capital.

The productive capacity of the existing capital stock in an economy determines the level of output that can be produced without accelerating inflation (defined as potential output). If high unemployment persists at high capacity utilization rates, potential output is not consistent with full employment. Full employment in the longer run depends on securing a greater growth of potential output (i.e. more investment) than in the past. If investment remains low during periods of recovery, the growth rate of productive capacity will be sluggish. Thus, the manner in which cyclical unemployment is generated and reduced has a major influence on the behaviour of structural unemployment over time.

The major influence of policy on capital accumulation is through the level of economic activity. Since profits depend critically on sales, the higher the average level of capacity utilization, the

Box 6

POTENTIAL OUTPUT, NAIRU AND HYSTERESIS

There are two commonly used methods for estimating potential output. One is based on past trends of actual output and the other on the observed link between inputs and output that is, on the relationship between the factors of production and output itself. Once the relationship (the production function) is determined from past observations, the estimated full employment values of the factors are inserted into the function and the output derived is an estimate of the potential output.

Potential output estimates obtained on the basis of past trends, and macroeconomic policy based on these estimates, are liable to generate a low-growth hysteresis in potential output: a period of low growth would pull down the trend, and policies giving priority to preventing GDP growth from exceeding potential output so determined would eventually serve to lower the trend still further. However, calculating potential output from production functions also suffers from a similar inherent bias.

The OECD secretariat has in the past used both methods of estimate in its assessments. Recently, however, it decided to stop making estimates based on past trends, on the grounds that this method is mechanical and does not do justice to the constraints to trend growth due to inflationary pressures,[1] and to use only estimates obtained by the production function method. In the latter, the business-sector potential output for each country is computed from an aggregate Cobb-Douglas production function, with labour, capital and total factor productivity as inputs. The production function is first calculated with only labour and capital inputs. The residuals obtained from this function are then smoothed, to give a measure of the total factor productivity trend. In the second step, estimates for the actual capital stock, the total factor productivity growth trend, and "potential employment" are substituted in the production function to obtain estimated potential output.

The part of the estimation that is crucial with regard to hysteresis generation is the way "potential employment" in the business sector is determined, which is by subtracting government employment and non-accelerating-wage unemployment from the labour force. Thus, "potential employment" is inversely related to the non-accelerating-wage rate of unemployment (NAWRU) estimate. NAWRU has been rising in the industrialized countries, as may be seen from the table below. As the NAWRU estimate rises along with actual unemployment, the difference between the labour force and "potential employment" increases. Macroeconomic management based on such potential output estimates consequently ends up disregarding a growing proportion of unemployment in the economy.

Furthermore, potential employment estimates based on NAWRU do not take into consideration that total factor productivity is constantly rising and hence provides room for wage increases that need not raise production costs. Thus the use of NAWRU (instead of, say, NAIRU) imparts a downward bias to the estimates, one that is unnecessary even from the standpoint of preventing inflation.

In any case all measures of "natural" unemployment are necessarily approximations, and the Directorate-General for Economic and Financial Affairs of the European Commission has consequently concluded that NAIRU is "unusable operationally" because "empirical studies on both sides of the Atlantic have shown that large variation in NAIRU may be caused by apparently small differences in sample, retained explanatory variables and analytical formulation. Furthermore, the confidence interval around these estimates is so large that it generally contains the whole historical range of unemployment rates observed in the last 15 to 20 years".[2] Yet natural rate estimates are still used to assess and guide macroeconomic policy, thereby contributing to rising unemployment.

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1 Claude Giorno, Pete Richardson, Deborah Roseveare, and Paul van den Noord, "Estimating Potential Output, Output Gaps and Structural Budget Balances", *OECD Economics Department Working Paper*, No.152, Paris, 1995.

2 *European Economy, Supplement A*, No.1, January 1995, p.2.

Box 6 (concluded)

UNEMPLOYMENT AND NAWRU IN OECD COUNTRIES

(Annual average rate, in per cent)

Country group	1970-1979	1980-1989	1990-1993	1994
Four major European countries				
Unemployment	4.3	8.7	8.8	10.2
NAWRU	4.3	8.4	9.0	9.4
Small EU countries[a]				
Unemployment	4.7	13.4	12.9	16.7
NAWRU	4.6	12.5	14.1	15.0
Other European countries[b]				
Unemployment	1.3	2.1	3.8	5.8
NAWRU	1.3	2.1	3.5	5.1
Non-European countries[c]				
Unemployment	4.6	5.9	5.6	5.7
NAWRU	4.8	5.8	5.4	5.5

Source: *OECD Economic Outlook*, No. 56, December 1994, table 12.
a Excluding Belgium, Greece and Ireland.
b Excluding Finland, Iceland and Turkey.
c Excluding Mexico.

greater will be the willingness of firms to invest to enlarge potential output. When capacity is regularly underutilized investment is adversely affected, which in turn reduces the growth of potential output. The interaction between actual output and investment can thus give rise to a *low-growth hysteresis* whereby the tendency for actual output to fall short of potential output is corrected by reducing the growth of the latter, resulting in higher structural unemployment. Restrictive macroeconomic policies can therefore be self-validating: if demand growth is checked too much on the grounds that potential output is not sufficient to satisfy it, the growth of potential output will be held back (see box 6).

Besides raising structural unemployment, a low rate of capital formation can also make it necessary to maintain some degree of unemployment in order to restrain wage demands. A slowdown of investment will reduce productivity growth, and higher unemployment may be necessary to keep real wages in line. In addition, a smaller capacity to produce makes for a lower capacity to export, and balance of payments considerations may also argue for the restraint of real wage increases, in order to improve competitiveness.

All industrialized countries have experienced these effects of slower investment on employment over the last two decades. Potential output growth has slowed down (see table 44), due to the slower growth of fixed capital formation after 1973 (table 45). The cumulative effects of lower rates of capital accumulation since the early 1970s explain much of the rising structural unemployment. Ac-

Table 44

POTENTIAL OUTPUT GROWTH IN FIVE MAJOR OECD COUNTRIES

(Average annual growth in per cent)

Country	*1960-1970*	*1970-1980*	*1980-1990*	*1990-1994*
United States	3.8	2.6	2.5	2.3
Japan	8.8	5.1	3.7	3.3
Germany[a]	4.1	2.7	2.2	2.7
France	5.2	3.3	2.1	1.9
United Kingdom	2.8	2.0	2.2	1.9

Source: Economic Commission for Europe, *Economic Survey of Europe in 1994-1995* (United Nations publication, Sales No. E.95.II.E.1), table 2.2.3.

a Excluding the eastern *Länder* throughout.

cording to one study, in which manufacturing and services employment growth are regressed on the gross capital stock growth in these sectors in 10 OECD countries over the period 1960-1992, a 1 percentage point increase in the rate of capital stock growth in the two sectors combined increases the rate of employment growth in those sectors by nearly half a point. In manufacturing alone, the effect on employment is a growth of 0.48-0.61 percentage points, and in services, 0.12-0.35 points.[19] On this basis, it can be concluded that if the capital stock in manufacturing in European OECD countries had grown by a modest 1 percentage point faster since 1973 than it actually did (which would still be below the rate prevailing in 1960-1973), the capital stock by 1992 would have been 23.4 per cent greater than it actually was, making room for an extra 3.9 million jobs in manufacturing and 4.1 million in services.

D. Capital accumulation

The slowdown in the rate of capital accumulation in the industrialized countries following the Golden Age is closely related to the macroeconomic and financial policies introduced after the oil price shocks in the 1970s. During the Golden Age labour productivity rose rapidly, while demand grew sufficiently to offset the employment-reducing effects of productivity growth, so that unemployment remained low. Indeed, in countries such as the United Kingdom sectors with the highest productivity growth expanded so fast that they became leaders in job creation. On the other hand, rising productivity made it possible for real wages to rise while keeping inflation at tolerable levels.

Opinions differ on the extent to which active aggregate demand management contributed to the steadiness of aggregate demand in this period. But there was a policy stance, shared by parties across the political spectrum, that was clearly in favour of growth and employment. Policymakers had a balanced attitude towards the two objectives of price stability and full employment, with recognition of the trade-off; accordingly, full employment was not defined in relation to price stability, but was treated as a separate objective.[20] The commitment by Governments to full employment, and the general conviction that they would act to sustain aggregate demand, fostered expectations of strong demand growth, and thereby encouraged investment.

The first oil price shock caused dislocations in the OECD economies, involving a reduction of investment. The declines in output in the mid-1970s were attributed to the failure of wages to absorb the effects of the oil price increases. It was also held that the labour market itself, as well as excessive taxation for social spending since the 1960s, had cut into profits, caused wage-price spirals, and reduced the incentives for investment. These perceptions led to a change of government priorities

Table 45

REAL GROSS FIXED CAPITAL FORMATION IN OECD COUNTRIES

(Average annual percentage increase)

		Total fixed capital formation		
Country	*1960-1968*	*1968-1973*	*1973-1979*	*1979-1990*
United States	5.0	3.7	1.9	2.5
Japan	15.2	12.2	1.6	5.0
European Union	6.0	5.0	0.1	2.5
Germany	3.1	5.4	0.4	1.9
France	8.0	6.8	0.1	2.3
United Kingdom	6.3	2.0	0.2	3.2
Total OECD	6.5	5.8	1.1	3.1
		Non-residential construction		
United States	5.1	-0.7	-	..
Japan	..	11.8	2.0	2.7
European Union	5.9	3.8	-0.7	2.3
Germany	3.0	4.9	-0.4	0.7
France	8.8	3.0	0.6	2.7
United Kingdom	..	1.6	-2.3	5.1
Total OECD	6.5	3.8	0.4	1.8
		Machinery and equipment		
United States	7.3	5.9	4.4	..
Japan	..	11.8	1.8	9.3
European Union	5.9	7.8	1.9	4.1
Germany	3.7	7.3	3.1	3.8
France	7.7	10.3	0.7	3.8
United Kingdom	..	3.5	2.4	3.5
Total OECD	7.2	7.7	2.7	5.3

Source: *OECD Historical Statistics 1960-1990* (Paris: OECD, 1992), tables 4.3, 4.5 and 4.6.

after the first oil price shock. After the recovery in the later 1970s, investment ratios again declined in 1980-1982, this time under the influence of disinflationary policies.

Controlling inflation, fiscal retrenchment and financial deregulation became the new guiding principles of economic policy. It was believed that low inflation would reduce inflationary expectations

Table 46

NET PROFIT RATIOS AND FINANCIAL PROFITABILITY IN MANUFACTURING IN FIVE MAJOR OECD COUNTRIES

(Percentage)

Country	1982	1984	1986	1988	1990	1992
			Net profit ratio			
United States	-	4.5	3.7	5.7	3.8	1.0
Japan	1.4	1.7	1.2	2.2	2.2	1.0
Germany	1.5	2.0	2.5	2.6	2.5	1.4
France	-1.3	-1.3	1.2	3.6	2.7	1.2
United Kingdom	3.6	4.9	6.1	7.4	6.4	5.1
			Financial profitability			
United States	-	12.8	10.3	15.9	10.3	2.8
Japan	7.7	8.7	5.3	8.9	8.0	3.5
Germany	10.7	14.7	16.0	16.3	16.2	9.1
France	-8.6	-10.0	6.7	15.4	10.6	4.1
United Kingdom	8.7	12.1	14.3	15.8	15.2	10.6

Source: *European Economy, Supplement A*, No.2, February 1995, tables 2 and 3.

and thereby ease long-term interest rates. Reductions in public sector deficits would likewise eliminate the upward pressure on interest rates. Tax measures would boost business profitability. Tax breaks on capital gains would boost private saving and encourage the channelling of savings into financial markets. A strong stance against trade unionism and deregulation of labour relations would reduce labour costs. In brief, supply-side measures were to help correct relative prices, boost profits and thereby create the incentives for investment, output, employment and productivity growth.

Tax policies, labour market policies and the decline in commodity prices in the first half of the 1980s did indeed help restore profit margins, and by the middle of the decade the share of profits in manufacturing value added in the major industrialized countries exceeded the 1972 level.[21] In the second half of the 1980s, net profit ratios (ratio of profit, net of depreciation, taxes and interest payments, to turnover) and financial profitability (net profit in relation to equity capital) in manufacturing increased (see table 46), and profits as a share of GNP also showed the normal cyclical upturn in this period.[22] Nevertheless, the expected rise in private investment failed to materialize. This was because of the slowdown in demand growth, the rising costs of finance, increased financial instability, and the deterioration of public infrastructure.

Increasing profitability of the existing capital stock does not motivate new investment unless there are prospects of growing sales.[23] Without steady demand growth, tax measures aimed at increasing profitability (such as investment tax credits and accelerated depreciation allowances) have no greater effect on private investment than do measures to reduce labour or raw material costs.

Monetary policy played a major role in slowing down the expansion of effective demand. In the recovery following the 1980-1982 recession, inflation in most OECD countries was brought down by 1985 to levels comparable to those of 1960-1973. However, central banks, convinced that inflation remained the greatest obstacle to investment

Table 47

LONG-TERM REAL INTEREST RATES IN MAJOR INDUSTRIALIZED COUNTRIES: A HISTORICAL COMPARISON

(Percentage)

Country	1890-1899	1900-1913	1924-1929	1930-1932	1933-1939	1956-1973	1974-1980	1981-1993
United States	5.4	2.3	3.6	11.5	1.1	1.1	-0.3	5.6
Canada	..	1.6	4.9	10.0	1.8	2.2	0.3	6.7
Japan	..	..	..	..	..	0.3	0.5	4.4
Germany	2.9	3.5	5.3	17.1	4.9	3.0	3.0	4.5
France	3.8	1.8	0.2	7.1	-1.2	1.0	0.4	5.7
United Kingdom	1.9	2.7	5.5	6.4	2.1	1.8	-3.3	4.5
Italy	..	..	5.7	12.7	0.4	1.1	-5.0	4.2
Average of four countries[a]	3.5	2.6	3.7	10.5	1.7	1.7	0.0	5.1

Source: Robert Rowthorn, "Capital Formation and Unemployment", *Oxford Review of Economic Policy*, Vol.11, No.1, 1995 (table 3).

a United States, United Kingdom, Germany and France.

and growth, have continued to steer monetary policy according to the perceived risks of inflation, thus maintaining a generally tight policy that tends to restrict demand growth.

Some monetary authorities, such as the Federal Reserve Board of the United States, have conducted monetary policy by monitoring the evolution of unemployment in relation to NAIRU and actual GDP growth in relation to its estimated potential growth.[24] Others (like the Bundesbank) have adhered to targets for the growth of selected monetary aggregates, while yet others also monitor movements in the inflation rate. The merits of these strategies are evaluated on the criterion of how far the inflation rate can be reduced, not only to discourage inflationary expectations, but also to leave a safety margin for exogenous shocks on prices. With such a policy stance, the deflationary bias of discretionary monetary policy has turned out to be stronger than even the bias which a monetarist fixed rule for monetary expansion would entail. As explained in Part Two, Chapter I, the growth targets set by policymakers according to indicators that they take as given (such as a 2-3 per cent growth rate, obtained from potential growth estimates) have determined, and continue to determine, the pace of capital accumulation and the trends of employment and unemployment. The fact that policy aimed at preventing growth from exceeding such rates (except temporarily, at times of recovery from recession) has effectively imposed limits on capacity and job creation in the private sector.

As a result of tight monetary policies, real short-term and long-term interest rates in OECD countries have risen to exorbitantly high levels. Long-term rates in recent years have been higher than in almost any similar period since the last century.[25] They were exceeded only in the Great Depression years 1930-1932 (see table 47), and they are three times as high as those during the subsequent recovery of 1933-1939 and in the Golden Age.

Increased financial instability has also contributed to the rise in interest rates. The instability has been due largely to the deregulation of financial activities and the conduct of monetary policy. Financial deregulation, by easing access to credit,

Table 48

VOLATILITY OF PRIVATE CONSUMPTION, EXPORTS AND IMPORTS SINCE 1961 IN FIVE MAJOR OECD COUNTRIES

(Coefficient of variation of annual real growth rates)

Country	Private consumption		Exports[a]		Imports[a]	
	1961-1973	1982-1994	1961-1973	1982-1994	1961-1973	1982-1994
United States	0.28	0.50	0.70	1.10	0.59	0.86
Japan	0.19	0.34	0.48	1.00	0.55	1.44
Germany	0.39	0.74	0.32	1.16	0.58	1.04
France	0.18	0.48	0.43	0.91	0.43	0.97
United Kingdom	0.51	0.91	0.68	0.67	0.72	0.81

Source: UNCTAD secretariat calculations, based on data in OECD, *National Accounts 1960-1984* - Vol. I: *Main Aggregates* (Paris: OECD, 1986) for 1961-1973, and *OECD Economic Outlook*, No. 56, December 1994, for 1982-1994.

a Goods and services

lifting restrictions on the transactions of financial intermediaries and encouraging increased competition among them, led to excessive risk taking and speculation. Intermediaries have thus become more vulnerable to shocks, transmitting financial instability among money, exchange and stock markets. Systemic risk of the financial system has consequently increased, creating greater uncertainty in the economy.

The shift in monetary policy to targeting monetary aggregates implied allowing interest rates, exchange rates and other asset prices to fluctuate more widely. However, central banks have also resorted excessively to using interest rates to fine-tune the economy. As explained in greater detail in Part Two, Chapter I, the lowering of United States short-term rates in seven discrete steps from November 1990 to August 1992, and the subsequent seven rises in rates since February 1994, have created confusion and instability in financial markets. Thus, the policies of managing monetary aggregates and fine-tuning the economy were both implemented at the cost of interest rate stability.

At times readjustments in monetary policy have been forced upon central banks by turmoil in currency markets. Growing and volatile international capital flows have heightened exchange rate fluctuations and necessitated counter-action through interest rate adjustments. The result has generally been a tendency for interest rates to rise, particularly since the burden of corrective action, essentially through monetary policy, has fallen primarily on deficit countries (or countries with weak currencies).

The growing instability of key financial prices has placed a higher premium on liquidity. This increase in liquidity preference is clearly evident from the term structure of interest rates and changes in the sensitivity of long-term rates to short-term ones. For example, in the United States long-term rates have risen much more than short-term rates, compared to the 1960s. The average yield gap was 2.3 percentage points in 1983-1993, compared to 0.6 in the 1960s; and the sensitivity of long-term rates to changes in short-term rates has diminished considerably during the last decade.

Increasingly volatile interest rates, together with the shortening of maturities, have made the long-term costs of borrowing for the corporate sector less predictable, as the rates on short-term loans being rolled over became liable to change more frequently. Greater uncertainty over the costs of borrowing has raised the rate of return required to undertake investment projects. The requisite rate of return has also been raised by increased borrower's risk arising from two other sources of instability: greater fluctuations in exchange rates and in aggregate demand.

With the slowdown in domestic demand growth, firms have tended to look for markets abroad. This, together with the rising share of foreign trade in the economy, has increased the influence of the exchange rate on investment decisions. Indeed, for investors in the traded goods sectors, particularly manufacturing, the exchange rate has become the single most important price, but firms in other sectors are also affected, since they use traded goods as inputs. Exchange rate movements have thus produced considerable uncertainty regarding prospective yields on investment, and, like volatile interest rates, have raised the average return required for investment projects.

Financial deregulation has also made aggregate demand more unstable by increasing the volatility of consumption expenditures, exports and imports. Easier access to credit has enabled consumers to spend more freely, but their accumulated debt has made their current expenditure more vulnerable to changes in interest rates. Furthermore, financial deregulation has made it easier for household savings to be used for investment in high-risk assets. This, together with the increased frequency and intensity of booms and busts in real estate markets, has made the value of household wealth more unstable. The consequent fluctuations in household net wealth and debt-servicing obligations have reduced the stability of consumption expenditure.[26] The increase in the coefficient of variation in the volume growth of private consumption in five major OECD countries from 1961-1973 to 1982-1994 ranged from 78 per cent to 167 per cent (see table 48). Export and import volatilities have also increased, due to sharp changes in competitiveness brought about by exchange rate fluctuations and to swings in economic activity. With the exception of the United Kingdom, where exports fluctuated sharply even in 1961-1973, the volatility of export growth of the major industrialized countries increased greatly in the subsequent period (1982-1994), and the coefficient of variation of import growth also rose. The net result of all these movements has been to increase investors' risks.

Cuts in public investment do not seem to have made way for greater private investment, contrary to expectations. In the United States, the United Kingdom and the former Federal Republic of Germany general government gross fixed capital formation rose less than GDP in the 1980s (see chart 11).

The expectation that the private sector would make up for the shortfall in public investment, using the resources set free by public expenditure cuts, was in any event misconceived, for it considered only the relationship between the two sectors in financing their respective expenditures and disregarded the complementarity between public and private investment. The profitability of private investment tends to be influenced positively by public investment, especially in infrastructure (which is why the availability of infrastructure plays a role in foreign direct investment decisions). According to one study of the United States economy, each percentage point increase in public investment is associated with a 0.4-0.6 percentage point increase in private investment in equipment. On this basis it has been estimated that if the rate of growth of the stock of public capital had continued unchanged in 1966-1987 from its average in 1947-1965 (instead of declining by 10 percentage points), the annual growth of investment in equipment in the private sector would have been 4-6 points above the actual rate.[27] Taking into account the strong linkage that has been observed between GDP growth and equipment investment,[28] it has thus been concluded that annual GDP growth in the United States could have been 1.3-1.9 percentage points higher had public infrastructure investment been sustained.[29]

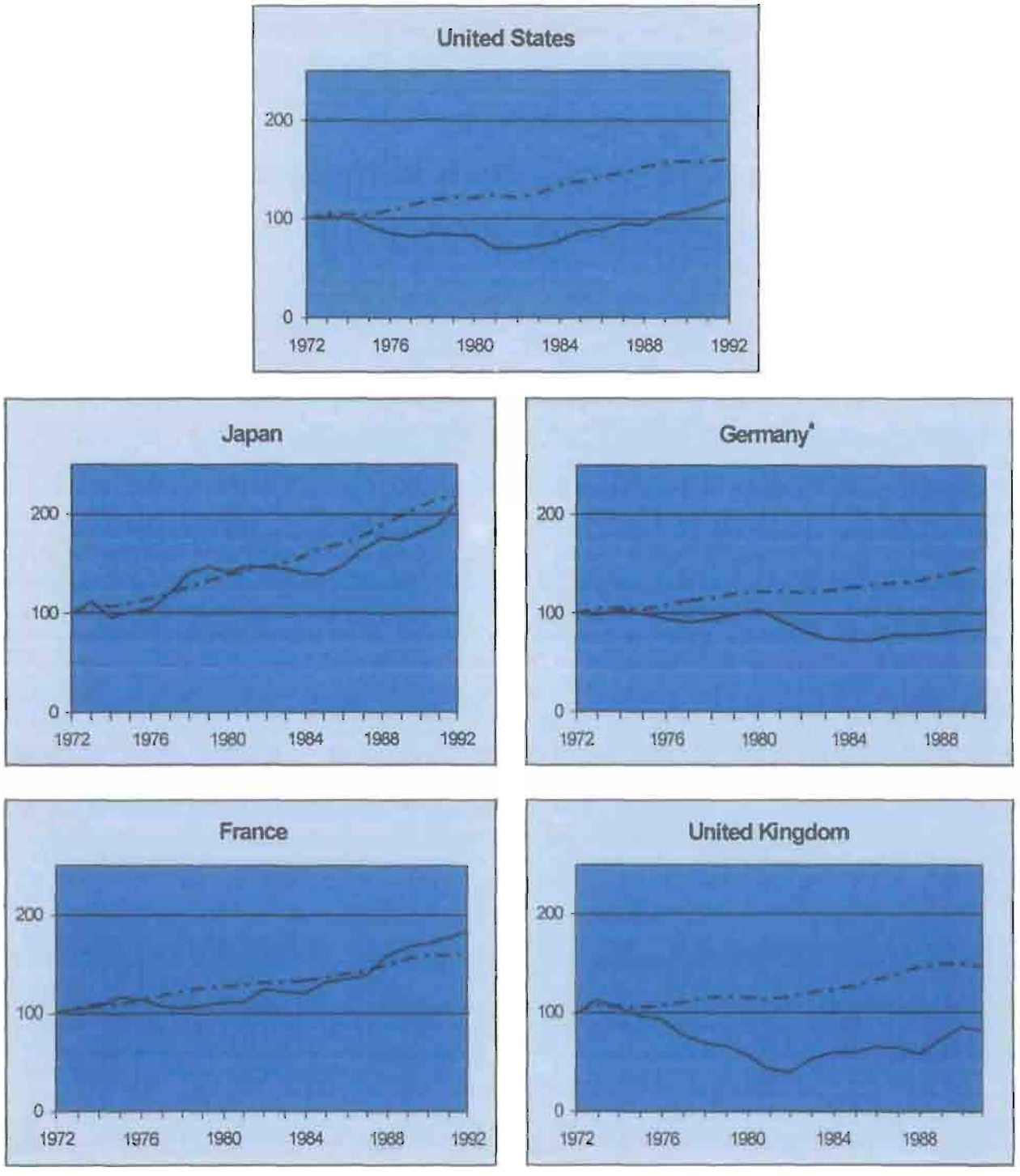
In sum, private investment has been adversely influenced by a combination of factors closely linked to the policies pursued by the major industrial countries during the past two decades. Slow demand growth and deteriorating public infrastructure have lowered the expected rates of return to investment projects, while high interest rates have raised the feasibility threshold rate of return and increased the opportunity cost of devoting funds to investment. Greater demand instability and exchange rate volatility have increased borrowers' risk for investment projects, again raising the required rate of return on projects.

This new environment, while inimical to new investment to expand capacity, has forced the business sector in industrialized countries to cut costs through restructuring. Firms in Japan and most EU countries reduced their overall indebtedness ratios in the 1980s in order to diminish their exposure to high interest rates.[30] In most countries firms have downsized and restructured their operations so as to reduce costs and boost profitability, competitiveness and market shares; stagnation in markets has made enlarging market share or obtaining quick capital gains through mergers and acquisitions more attractive than new investment. As increased uncertainty has shortened firms' time horizons, they have tended to prefer short-term activities with

Chart 11

REAL GDP AND GENERAL GOVERNMENT GROSS FIXED CAPITAL FORMATION IN FIVE OECD COUNTRIES, 1972-1992

(Index numbers, 1972 = 100)



Source: UNCTAD secretariat calculations, based on data in constant prices in OECD, *National Accounts, 1972-1984* (Paris: OECD, 1986) and *ibid., 1980-1992* (Paris: OECD, 1994).

a Excluding the eastern *Länder* throughout.

large financial components to long-term investment in physical assets. Such activities have been facilitated by financial deregulation, which has made it easier to borrow in order to acquire existing assets.

The process of restructuring has caused a large-scale shedding of labour. Together with physical investment, human investment in in-house training of labour has been curtailed and skill requirements are being met less by such training and more by formal educational credentials obtained and financed by the workers themselves. Employment has stagnated or declined in sectors with higher-than-average productivity growth, indicating that productivity growth is no longer being driven by output growth as in the Golden Age.[31] In short, the higher productivity has resulted from attempts to cut costs in order to increase competitiveness, rather than from the creation of new capacity and the application of new technology embodied in new capital goods. There has consequently been a destruction rather than a creation of jobs.■

Notes

1 In its original conception natural unemployment was described as the "frictional" unemployment generated by labour and commodity market imperfections such as the costs of gathering information about job vacancies and labour offers, the costs of mobility, and slow adjustment to fluctuations in demand. Conceived in an economic model with perfectly competitive markets, natural unemployment was understood as the unemployment level that would be consistent with general equilibrium, or full employment. (Milton Friedman, "The Role of Monetary Policy", The *American Economic Review,* Vol.LVIII, No.1, March 1968, p.8).

2 Charles R. Bean, "European Unemployment: A Survey", *Journal of Economic Literature,* Vol.XXXII, June 1994; Assar Lindbeck, *Unemployment and Labour Market Imperfections* (Stockholm: Institute for International Economic Studies, University of Stockholm, 1989), Seminar Paper No.446.

3 *The OECD Jobs Study: Evidence and Explanations.* Part II - *The Adjustment Potential of the Labour Market* (Paris: OECD, 1994), chap.5, sect. II(a).

4 *Ibid.,* table 5.8.

5 Ramana Ramaswamy, "The Structural Crisis in the Swedish Economy", *IMF Staff Papers,* Vol.41, No.2, June 1994.

6 Bernard Brunhes, "Labour Flexibility in Enterprises: A Comparison of Firms in Four European Countries", in *Labour Market Flexibility: Trends in Enterprises* (Paris: OECD, 1989), p. 13; Jacques Rojot, "National Experiences in Labour Market Flexibility", *ibid.*, pp.39-55; *The OECD Jobs Study: Evidence and Explanations.* Part I - *Labour Market Trends and Underlying Forces of Change* (Paris: OECD, 1994), chap.1, sect.IV(c). It is reported that of the 2.4 million increase in part-time workers in the United States between 1979 and 1986, only 600,000 voluntarily sought part-time employment (Eileen Appelbaum, "The Growth in the US Contingent Labour Force", Wissenschaftszentrum Berlin für Sozialforschung Discussion Paper, June 1988, p.23).

7 *European Economy, Supplement A*, No. 11/12, Nov./Dec. 1994. table 15.

8 Andrew Glyn, "The Assessment: Unemployment and Inequality" *Oxford Review of Economic Policy,* vol.11, No.1, 1995.

9 Steven J. Davis, "Cross-Country Patterns of Change in Relative Wages", in O.J. Blanchard and S. Fisher (eds.), *NBER Macroeconomics Annual 1992* (Cambridge, MA. and London, MIT Press), pp. 273-277; *OECD Employment Outlook,* July 1993, p.176.

10 Bernard Brunhes, *op. cit.;* Jacques Rojot, *op. cit.;* Peter Auer, "Labour Market and Labour Market Policy Trends in Selected Industrialized Counties 1980 to 1985 - An Overview", Wissenschaftszentrum Berlin für Sozialforschung, *Discussion Paper*, March 1988, pp.19-20.

11 *World Employment 1995* (Geneva: International Labour Office, 1995), p. 147.

12 *The OECD Jobs Study: Evidence and Explanations,* Part II, chap.8, sect.III(c).

13 *Ibid.,* p.181.

14 Paul Krugman, "Past and Prospective Causes of High Unemployment", paper prepared for the economic symposium of the Federal Reserve Bank of Kansas City at Jackson Hole, August 1994.

15 Charles R. Bean, *op. cit.;* Andrew Glyn, *op. cit.*

16 *The OECD Jobs Study,* Part II, table 5.2.

17 Whence the conclusion that the "experience of countries that have started to implement reforms in the early-to-mid-1980s suggests that comprehensive labour market reforms may take a long time to show positive results" *(OECD Economic Outlook,* No. 56,

December 1994, p.23).

18 J. Elmeskov, "High and persistent unemployment: Assessment of the problem and its causes" (*OECD Economics Department Working Paper* No.132, Paris, 1993).

19 Robert Rowthorn, "Capital Formation and Unemployment", *Oxford Review of Economic Policy,* vol.11, No.1, Spring 1995, p.33.

20 Angus Maddison, *Phases of Capitalist Development* (Oxford: Oxford University Press, 1982), chap.6; J.R. Sargent, "Roads to full employment", *National Institute Economic Review* (London), No.151, February 1995, p.78; Andrea Boltho and Andrew Glyn, "Macroeconomic Policies, Public Spending and Employment", *International Labour Review* (forthcoming issue).

21 See *TDR 1987,* Part One, chap.II.

22 Merih Uctum, "The Evolution and Determinants of Corporate Profits: An International Comparison", *Federal Reserve Bank of New York Research Paper,* No. 9502, March 1995 (chart 3).

23 For empirical research in this regard see, for example, Steven Fazzari, "Investment and US Fiscal Policy in the 1990s", Washington University in St.Louis, The Jerome Levy Economics Institute of Baird College, New York, *Working Paper* No. 98, October 1993.

24 Mr. R. Heller, a member of the Board of Governors of the Federal Reserve System, has indicated that the strength of GDP expansion and inflation appear as separate "policy variables conditioning reserve pressure" in Federal Open Market Committee Directives (see his address on 27 April 1988, as reported in *BIS Review,* 27 May 1988).

25 Rowthorn, *op.cit.*

26 For a discussion of this subject, see *TDR 1991,* Part Two, chap.II.

27 Sharon J. Erenburg, "The Relation Between Public and Private Investment", Washington University in St.Louis, The Jerome Levy Economics Institute of Baird College, New York, *Working Paper* No.85, February 1993, pp. 15-16.

28 See J. Bradford De Long and Lawrence H. Summers, "Equipment Investment and Economic Growth", *The Quarterly Journal of Economics,* Vol. CVI, May 1991.

29 Erenburg, *op. cit.*

30 *European Economy, Supplement A*, No.2, February 1995.

31 See Ajit Singh, "Institutional Requirements of Full Employment in Advanced Economies" *(International Labour Review,* forthcoming issue).

Chapter IV

POLICIES FOR FULL EMPLOYMENT

The discussion in the previous chapters pointed to the need to attack unemployment on two fronts: the supply side and macroeconomic management. Supply-side policies are needed to shift labour demand towards the unskilled by reducing the cost of employing such labour and/or to enhance skill levels, and hence productivity, through training and education. However, such policies will only be effective if the existing stock of physical capital is sufficient to provide additional employment and if there is sufficient demand to absorb the extra output that would be produced. Adequate expansion of effective demand is essential both to increase employment by utilizing the existing capital stock more fully and to generate a higher rate of investment and thus the total amount of jobs potentially available at any moment of time. Labour market policies cannot ensure adequate demand growth; this is the responsibility of macroeconomic policies. If macroeconomic impulses are not sufficiently strong, supply-side policies may simply aggravate the labour market problems instead of alleviating them.

However, unless supply-side measures are also taken, demand expansion can come up against serious bottlenecks due to mismatch between the composition of the aggregate demand for and the aggregate supply of labour. As noted in the preceding chapters, the potential for such supply-side problems has increased considerably over the past two decades because an important part of the labour force has become long-term unemployed and has indeed become unemployable due to hysteresis. Such bottlenecks could result in faster inflation and eventually lead to overly restrictive policies.

Domestic policies, both macroeconomic and on the supply side, have implications for other countries. Each may be used in a beggar-my-neighbour fashion to reduce unemployment. Examples are: seeking higher employment at home by increasing competitiveness in international markets through increased productivity not accompanied by increased demand; reducing wages; competitive devaluations; and imposing higher labour standards on trading partners. Equally, attempts to achieve full employment at home may be stymied by external influences and constraints, in particular balance of payments and exchange rate pressures. Individual attempts to secure full employment by the major industrial countries are likely to lead to tensions and conflicts unless they are coordinated, taking into account that the nature and the appropriate mix of supply- and demand-side policies vary from country to country.

A. Supply-side policy options

There is no disputing that the position of unskilled workers in the North has deteriorated in relative (and sometimes in absolute) terms over the past 20 years. From an intellectual standpoint, it may be of interest to choose between competing causes, but in practice this may not be so impor-

tant, since the policy measures suggested for tackling the problem are often similar, no matter whether the original cause is believed to be North-South trade or the advent and application of new technologies. Indeed, the fact that a policy consensus has been emerging does suggest that a deeper analytical thread has been running through much of the discussion. This is indeed the case: there is consensus that new competitive pressures have dramatically shifted the relative demand for labour in the North away from the unskilled, and that this has been resisted by policy makers and impeded by labour market regulations, resulting in higher unemployment (particularly in Europe) and greater income inequality (particularly in the United States). Consequently, the broad thrust of policy recommendations in the industrialized countries aims at creating a labour force compatible with production in high-technology, high-skill industries and in sectors producing non-tradeable services.

1. Technology policies for employment

If competition is seen as ensuring the best basis for economic growth and job creation, a healthy economy will be one where labour markets are in continuous flux, with some markets shrinking whilst others are growing. Innovation and productivity growth will be combined in older sectors and industries with a declining employment (and output) share, and in new sectors and industries with a rising employment (and output) share. Over the past two decades, new sources of economic growth have centred around the production and distribution of information technologies and the evolution of complementary service activities. These are the major sources of job creation in the North. They are also areas which are essential for maintaining growth momentum in the more mature industrial countries in the face of increased competition from the "catch-up" countries, and for generating the "first-mover" advantages associated with creating new product markets and the pricing power resulting from the inelasticity of demand for new products.

In the current technological environment, product innovation is largely concentrated in industries where the "product cycle" has become increasingly short and imitation much more rapid than even two decades ago. Prices of new products have to be reduced rapidly to achieve the volume of sales required for cost-efficient production, and there is little price inelasticity attached to the introduction of new, technologically advanced, goods. It is by exploiting related scale economies that firms are able to compete in and dominate the development of these new product markets.

A high level of investment is needed to ensure that new production technologies are fully developed and widely diffused, to help the development of new products and new markets and to create new jobs. There is nothing automatic about the emergence of conditions that are conducive to faster accumulation in these areas, and public policy will have an important role to play. One area of intervention is public investment in support of private activity in new production technologies (discussed in the next section). Another set of policies includes measures to support the innovation activities of firms both by encouraging higher national R&D expenditures and by targeting such expenditures on the most dynamic sectors. The creation of an information superhighway linking businesses, government agencies and the wider public is also seen by many as essential to an effective information infrastructure, and product market deregulation is offered as a means of opening up new investment opportunities. More ambitiously, these specific measures are often harnessed to more wide-ranging efforts at social engineering aimed at encouraging different types of enterprise and social organization in a "new learning economy" in which continuous education is the driving force of economic prosperity.[1]

2. Active labour market policies in the North

The term "active labour market policies" covers various measures aimed at correcting mismatches and imbalances in the composition of the labour force either by reducing the cost of unskilled labour to employers or enhancing skills or by making labour markets more responsive to innovation and structural change. Unlike other measures to reform labour markets discussed in the previous chapter, these policies imply that the problem of unemployment should not be solved at the expense of the living standards of those most vulnerable to economic change and that certain types of labour market failures still require positive intervention by Governments.

Employment subsidies

The first type of active labour market policies involves employment subsidies, with a view to lowering the cost of unskilled labour to employers in the private sector. If subsidy schemes are not self-financing (through savings on unemployment benefits or the generation of additional income tax) budgetary considerations will necessitate higher taxes on capital or skilled workers. To be effective these schemes must also ensure that subsidies are used for the purposes intended. These problems are well known and make for an uncertain impact of subsidies. However, their appeal, in whatever form, lies in their being preferable to unemployment benefits.[2]

Subsidy schemes can take the form of subsidizing existing unskilled manufacturing jobs through grants or other fiscal transfers to employers. Such measures, however, can only be considered a temporary expedient. Differences in unit labour costs between traditional unskilled industries in the North and South do not suggest that subsidies could preserve the competitiveness of these industries on world markets. However, subsidies could make for a more manageable process of restructuring and the avoidance of the heavy social and economic costs of a permanently large low-wage, low-skilled underclass which could emerge from too rapid a process of adjustment.

Rather, subsidies must primarily be used to encourage redeployment of unskilled workers displaced from declining industries into expanding industries or into other sectors, particularly services, including public services. In essence, such subsidies become necessary when wages are not sufficiently flexible or when wages are too flexible and employment can therefore only be generated at poverty wages. Correspondingly, employment subsidies can be delivered in two forms: either, where wages are fully flexible, through support to workers' income via some form of negative income tax for the low-paid or, where wages are less flexible, through subsidies to employers in the form of grants or changes to payroll taxes which make it profitable to hire unskilled labour.

The results of simulations of the effects of such subsidy schemes are set out in annex I to Part Three. They suggest that correcting today's labour market problems in the North would require a significant rise in the average tax rate; indeed, employment subsidies require higher marginal tax rates than unemployment benefits.[3] The burden will naturally fall on high income earners, including skilled labour. However, the simulations also suggest that because subsidies raise national income and hence the pre-tax wage of skilled workers, skilled workers are better off with employment subsidies than with the funding of unemployment benefits.

There are also other reasons to support subsidies as an alternative to unemployment benefits. First, there are dynamic effects from subsidies as workers also acquire skills on the job and avoid the stigma and loss of morale that come with prolonged spells of unemployment. Second, they have an additional appeal in an interdependent world economy because they might actually help the South. As is shown in annex I, if the subsidies are not industry-specific, designed to protect labour-intensive production, their immediate effect is to encourage greater employment and production in sectors which do not compete with southern exports. These subsidies raise national income in the North and increase the global demand for labour-intensive goods, thereby increasing national income in the South. That in turn should raise demand for imports from the North. Thus, employment subsidies for unskilled labour in the North would appear to offer a "raising all boats" strategy of benefit to everyone.

However, if there is no expansion of effective demand, subsidies will simply serve to substitute unskilled labour for skilled labour and/or capital, and will raise aggregate employment only if more unskilled labour is employed for each skilled, more productive, worker discharged. Over the longer term, subsidies could lead to the substitution of unskilled labour for capital rather than skilled labour, provided that new investment is made in order to adapt to the underlying techniques of production. The impact on unemployment will therefore depend on the pace of expansion of the economy.

Training

The second broad category of active labour market policies aims to improve the skills of unskilled and unemployed workers through training programmes. The expectation is that these workers, endowed with better skills, will price them-

selves back into employment in expanding industries. But training, no more than subsidies, is not a costless option. Formal training aimed at easing workers out of unskilled jobs (or unemployment) into higher-skilled jobs requires both important additional public expenditures on education as well as a fundamental restructuring of national training programmes to ensure that the unskilled are the ones to benefit. There is certainly plenty of evidence that effective training programmes can improve productivity, and a comparison and assessment of national training systems can certainly help in the design of better training programmes.[4] However, productivity gains from improved training will only materialize over the longer term, whilst its costs (in terms of higher taxes) will have to be borne immediately. It would, consequently, be misleading to suggest that the training option does not face fiscal constraints as do subsidies. Again, meeting this challenge will be the responsibility of politicians in the North over the coming years.

However, designing better training schemes begs an important question. Because there is considerable evidence to suggest that trained labour is more productive, why are firms not themselves taking on the training responsibility? Alternatively, if the returns to education are clearly so great and the income of the unskilled has dropped so visibly, why are the unskilled not funding their own investment in human capital? Possible answers are, first, that employers fear that their trained labour might be poached by other firms and, second, that there are well established difficulties for capital markets to fund investment in human capital.

Such market failures are why government action is required. Nevertheless, when unemployment is high and employment prospects are low, the motivation to join and fully participate in training schemes is likely to be low. Much training is received on the job and there is already a pool of unemployed skilled labour, which during the last recession grew more rapidly than the pool of unskilled unemployed (see table 37). For reasons already explained, if demand is sluggish, employment may actually fall as the labour force becomes better trained and more productive.

3. *Higher labour standards in the South*

Those who blame imports from low-wage developing countries for the rising unemployment and income inequality in the North naturally advocate protectionist measures such as the imposition of higher labour standards in the South. It is to be noted that when developing countries' exports consisted largely of primary commodities, little concern for the adoption of "internationally recognized labour standards" was expressed by industrial countries. Moreover, the growing differences in labour market standards among developed countries during the 1980s due to divergent policies in these countries, have not figured in the debate on labour standards so far.

However, as discussed in annex 1 to Part Three, it is unlikely, in view of the still very large wage differentials between the South and the North, compared to those for productivity, that any increase in wage costs imposed on manufacturing industry in the South by higher labour standards would help save northern labour-intensive industries. Still, higher labour standards would reduce output and employment in the South because higher wage costs and prices depress both exports of and the overall demand for labour-intensive goods, a result that may be only partially offset by improved terms of trade. Moreover, they would result in growing inequalities in the South, as part of the labour force becomes unemployed and unable to benefit from the type of social safety nets available in the North. Wages of the unskilled would also go down in the North because of increased import costs. Furthermore, there is likely to be an even larger fall in national income in the North; thus, global income would certainly decline.

Any concrete policy proposals put forward on the question of international labour standards must necessarily be tentative. However, the above discussion does provide real grounds for scepticism on the desirability of international labour standards linked to trade. In some cases, as suggested by the simulations, such trade-restrictive measures are unlikely to achieve their labour objectives in the North. Moreover, because the countries that have successfully penetrated northern markets have been catch-up economies which have experienced rapid real wage increases alongside productivity growth, it seems unlikely that the kind of higher labour standards that are being called for would be applied to them and hence have much impact on their ability to compete. Rather, they would hurt those countries in the South that already face difficulties in exporting. Furthermore, in most developing countries (as in the North) wages in the export sector tend already to be higher than in other sectors, a situation which would be further exac-

erbated by the introduction of higher labour standards.

Nevertheless, there are good reasons for improving working conditions and reducing inequality in the South; but the most appropriate response should be to design and implement redistributive policies which do not impede the growth of southern manufactured exports. One possibility, as described in annex I to Part Three, would be to introduce fiscal reforms and active labour market policies of benefit to the unskilled in the South. However, these involve programmes to provide subsidies for retraining, as well as effective welfare support, which developing countries will have major difficulties in financing. Whilst fiscal reform could undoubtedly help fund these programmes in some countries, financial assistance from the North would appear essential. Such policies would be less costly than the potential damage to the world economy from enforced higher labour standards linked to trade. They would also help to strengthen the multilateral trading system.

B. Macroeconomic policy

1. *Demand expansion and inflation*

The discussion in the previous chapters has shown that a faster pace of capital investment holds the key to reducing unemployment in the major industrial countries. This is unlikely to occur without a substantial improvement in business expectations regarding future sales and the level and volatility of key determinants of the costs of and return on investment such as interest rates and exchange rates. Macroeconomic policies can help improve both sets of expectations. For one thing, the level of effective demand determines total sales. For another, monetary policy can affect directly the degree of volatility and instability and thus influence the risks and uncertainties associated with investment decisions. Without policies designed to bring about a faster expansion of demand and greater financial stability, there is little hope of finding a solution to the unemployment problem.

It is often held that, rather than lift growth and reduce unemployment, expansionary policies would only fuel inflation. On this view, monetary policy designed to lower short-term interest rates would instead lead to faster inflation, and hence to higher long-term interest rates, thereby restraining rather than promoting investment and output growth. Furthermore, expansionary fiscal policies would create pressures not only in product markets, leading to faster inflation, but also in financial markets, resulting in higher real interest rates, thereby crowding out private investment. These views are particularly widespread in financial markets, not least because holders of financial assets are most concerned about the possible impact of policies on the real value of their wealth.

The concern that faster demand expansion would only lead to faster inflation is unjustified in current economic conditions. Not only is there a considerable slack in the labour market, but also the institutional changes that have been introduced since the beginning of the past decade have made it much more difficult for a wage-price spiral to emerge. Given the reduced bargaining power of the unions and increased competition in the labour market, workers are wary of pricing themselves out of the market. There is also a greater realization that in today's environment of increased global competition, workers' jobs depend on the profitability of their companies. This has been a major factor in establishing a closer link between productivity and compensation. Indeed, as already noted (see Part Two, chapter I), one of the most significant features of the current recovery in the major industrial countries is the tendency for unit labour costs in manufacturing to fall and profit margins to rise, even in countries which have had substantial currency depreciations. Inflation rates have continued to fall in the United States and Western Europe throughout the recovery, while in Japan the price level has actually been falling. Clearly, labour markets will tighten somewhat as

the slack is reduced, but on the other hand productivity will rise as new investments come on stream.

Besides, the reduced costs of undertaking international transactions and greater and faster dissemination of information have weakened considerably the quasi-monopolistic positions enjoyed by local firms. Hence the probability that greater demand will result in higher prices and profits rather than higher output and sales is now much smaller, and firms attempting to raise prices and profits run the risk of losing business to more efficient producers. Moreover, the greater openness in trade helps to overcome problems of capacity bottlenecks that would otherwise arise in the course of expansion.

2. *Public investment and budgetary policy*

While it is true that jobs need to be created primarily through private investment, public sector investment is also indispensable. Private investment depends on the provision of certain public services; as already noted, the unsatisfactory growth and employment performance of the industrialized economies since the mid-1970s has been accompanied by slow growth or stagnation in public investment. Because of a sharp slowdown in expenditures on both maintenance and new investment, there has been considerable deterioration of public infrastructure such as transport and communications, health and education facilities and various other public services. This decline has occurred even where the provision of services has itself been subcontracted to the private sector. A return to more normal levels of provision of public infrastructure services, whether by public or private providers, is needed not only to create new job opportunities directly, but also, and more importantly, to foster an acceleration of private investment and economic activity.

According to a conservative estimate, the United States would need to spend at least an additional $45 billion a year (over 0.8 per cent of GDP) on investment in infrastructure in order to meet transportation, environmental and other needs. Other studies put this figure at much higher levels.[5] It is important to view such spending as a permanent commitment carried out on a yearly basis, because infrastructure needs to be maintained and expanded alongside increased private sector growth and employment. In Europe the need for public investment is also pressing, in some cases even more so. In the United Kingdom, for instance, public investment expenditures have declined considerably during the past two decades (even allowing for the withdrawal of the public sector from the provision of certain services as a result of privatization since the first half of the 1980s), and the eastern part of Germany is notoriously poor in infrastructure. In Japan, too, investment in public services has declined substantially, despite the fact that the quality and quantity of social and economic infrastructure lag well behind Japan's high-technology industries. As noted by OECD:

> There is a significant gap between Japan and other major economies as far as public amenities such as urban park space, sewerage services and paved roads are concerned. Despite spending more than the international average on infrastructure during the 1980s, a significant gap remains, since public investments were restrained with other government spending. The clampdown also affected industrial infrastructure, such as roads and airports, which failed to grow in line with the economy, generating substantial congestion costs.[6]

Public investment is needed not only in traditional infrastructure but also to promote technological dynamism and innovation in areas such as telecommunications, computers and information processing. These industries are currently in the process of developing benchmark technologies which will emerge as generally accepted industry standards. The standards which eventually dominate will be strongly influenced by the form and quality of infrastructure which allows the exploitation of the full potential for scale economies. Such infrastructure standards, particularly those to regulate the so-called information superhighways and switching junctions for information systems, will have to be global, rather than national or regional, in nature. Provision of such services will be necessary if the new technologies are to provide the basis for the creation of new jobs to replace those eliminated by the creative destruction associated with every technological revolution. This technological revolution cannot take place in the absence of a minimum of government involvement to ensure the necessary conditions through infrastructure investment. Just as the provision of motorways and other roads was necessary for the expansion of automobile production, and public airports were extended or built to accommodate the vast increase in air travel, so government

projects in overheads and infrastructure will be required to underpin the full development of new products surrounding the telecommunications-computer revolution.

Given the links between public and private investment discussed in the previous chapter, a large and permanent increase in both traditional and technology-related infrastructure investment by the public sector can be expected to provide a major stimulus to both the level and the quality of private investment, lifting considerably the growth rate of the capital stock and of job creation. Such expenditures create productive assets (i.e. they generate a stream of goods and services over time), and consequently they should be subject to project evaluation and planning in much the same way as for private investment. Hence the total outlay should not be assigned to the current budget; the cost of the investment should be spread over the whole period during which it contributes to the output of goods and services. By the same token, investment which is financed by borrowing should not be treated as "deficit" spending, any more than capital investment by firms normally would be treated as a current expense.

To encourage a more business-like approach, one option is to place the responsibility for making such investments in the hands of semi-autonomous public corporations or publicly-owned joint stock companies, independent of political control but subject to mandates specified in their articles of incorporation. Their net annual profit or loss would be absorbed into the government budget. A business-like accounting of government expenditures also implies that the current budget should not be allowed to run up a structural deficit. Thus, any deficits that emerge during a cyclical downturn should be offset by surpluses in a previous or subsequent upturn.

The implication of all this is that any counter-cyclical expenditure policy needed to supplement the effect of automatic stabilizers should be conducted through the capital budget. This point, it should be noted, was emphasized by Keynes, whom many view as the intellectual father of deficit spending. In his view it was necessary to preserve balance on the current account budget in order "to preserve sound accounting, to measure efficiency, to maintain economy and to keep the public properly aware of what things cost".[7]

Nevertheless, while it is legitimate to use the capital budget for counter-cyclical purposes, public investment should be self-financing over the long term; in other words, the capital budget should also be in balance over the long term. When aggregate demand flags, public capital expenditures need to be raised, creating a temporary deficit financed by borrowing; this deficit is subsequently eliminated as the capital projects pay off in terms of higher tax revenues and surpluses on current account.

In practice these principles of sound budgetary policy are rarely observed. For instance, in the United States no separation is made between current and capital budgets; moreover, the federal budget does not distinguish between current and capital spending, treating the latter as a current expense rather than as investment in productive assets. This failure to observe established accounting practices is costly:

> In the present era of inevitably large government deficits and a widespread reluctance to borrow more than necessary, the inability to distinguish between investments and expenses leads to gross distortions of national priorities. The convoluted perspective created by the federal accounting system is having a disastrous effect both on short-term fiscal management and on long-term development of the nation's public assets. Government denies the economy needed fiscal stimulus; too much of the stimulus it does provide is consumed without creating assets of lasting value; and public infrastructure and other long-term interests are neglected.[8]

By contrast, in Japan capital and current budgets are separated. The current budget (general government budget) is financed by taxes and duties and has been in surplus ever since the fiscal consolidation of the early 1980s eliminated indebtedness incurred during the oil crises. In addition, the Special Account and the Public Organizations Account join to form what is known as the "second budget", which covers the Fiscal Investment and Loan Programme (FILP). This programme provides for the financing of social infrastructure projects and industry-related investment through public corporations, local governments and other public institutions as well as for lending through government-affiliated financial institutions. The size of total investment expenditure programmes and government lending facilities of the second budget has been close to 9 per cent of GDP in recent years.[9] FILP relies for its resources on com-

pulsory social security contributions, postal savings, postal life insurance and government-guaranteed bonds. As both the investment and the lending operations are expected to yield revenues, the programmes emphasize the so-called asset-creating projects.[10]

3. The debt overhang

With the exception of Japan, fiscal policy has not generally been used in developed countries for macroeconomic management since the beginning of the last decade. Systematic resort to fiscal policy tools for counter-cyclical purposes has been eschewed in the belief that, once deregulated and freed from high taxes, the economy would not need management of this sort, since the private sector would generate the requisite level of demand. This thinking held sway, for instance, in the United States where, despite its financial orthodoxy and anti-Keynesian rhetoric, the supply-side experiment beginning in the early 1980s has left a legacy of a large public debt and large budget deficits.

In Western Europe an important component of the medium-term financial strategy in the early 1980s was convergence of fiscal and monetary policy in order to better control inflation and a reduction of government borrowing and debt to lessen the crowding-out of private investment. Cuts in public spending were seen as essential for reducing budget deficits and interest rates in order to stimulate growth through increased private investment.

These objectives were formalized in the Maastricht Treaty, which established, *inter alia*, two fiscal convergence criteria as preconditions for membership of the European Monetary Union: the ratio of the general government deficit to GDP, set at 3 per cent, and the ratio of public debt to GDP, set at 60 per cent. However, budget deficits have increased and government debt has continued to rise. At the end of 1994, Luxembourg and Germany were the only EU members to have met both of these criteria. Budget deficits as a percentage of GDP for EU countries as a whole have risen from 4.6 per cent in 1991 to 6.6 per cent in 1994.

For the G-7 countries their combined recorded government financial deficits were higher during the first half of the 1990s than in the 1980s; so were the "structural deficits", as estimated by OECD. The same period has also witnessed a rate of accumulation of government debt that is unprecedented since the second world war. As a proportion of GDP, government debt increased by some 50 per cent from 1978-1982 to 1991-1994 for the G-7 countries as a whole (see table 49).

The rapid accumulation of government debt has been due to a combination of slower growth, increased unemployment, and tight monetary policies. The slowdown in the trend growth rate has raised structural deficits net of interest payments on outstanding debt (i.e. structural primary deficits); and while cyclical downswings widened deficits considerably, upswings have generated little revenue. This asymmetric behaviour is explained by the fact that economic upturns have been quickly reined in by monetary tightening, while downturns have often been left to self-adjusting forces which have worked only slowly if at all. This cyclical behaviour of policy has thus contributed to an increase in long-term unemployment and to persistently higher budget deficits by raising expenditures on unemployment benefits and other forms of income support.

This effect has worked primarily via two channels. First, total expenditures on unemployment compensation have increased considerably in a number of countries despite the cutback in benefits. Second, pension funds have suffered losses as employment declined and claims exceeded contributions. According to a rough estimate, with the structure of revenues and expenditures prevailing in the late 1980s, a 1 per cent drop of actual output below the trend (or potential) level of output could raise public sector deficits in the major industrial countries taken together by as much as 0.5 percentage points of GDP.[11] In short, the fiscal deficits incurred in the 1980s and 1990s would have been considerably smaller had employment and growth been more buoyant.

More importantly, much of the recorded and structural deficits in recent years has been due to interest payments on outstanding government debt. In the G-7 countries taken together, such payments now account for almost the entire budget deficit, which means that the primary budget has been in balance (in respect of both the recorded and the structural budget positions). With the exception of Japan and the United Kingdom, government interest payments stand at much higher levels than in the late 1970s and early 1980s. The situation of Japan is explained by the fact, already noted, that

Table 49

GENERAL GOVERNMENT FINANCIAL BALANCES AND DEBT IN MAJOR OECD COUNTRIES, 1978-1994

(Percentage of GDP)

Country	Period	Financial balance	Gross debt	Net debt interest payments	Primary balance	Structural balance[a]	Structural primary balance[a]
United States	1978-1982	-1.0[b]	38.4	1.3	0.3[b]	-0.8	0.5
	1983-1989	-2.8[b]	49.4	2.0	-0.8[b]	-2.6	-0.7
	1990-1994	-3.1[b]	61.1	2.0	-1.0[b]	-3.2	-1.1
Japan	1978-1982	-4.4	51.7	1.0	-3.4	-4.0	-3.0
	1983-1989	-0.4	70.5	1.4	1.0	0.6	2.0
	1990-1994	1.1	72.2	0.4	1.5	0.8	1.2
Germany	1978-1982	-3.0	34.0	1.4	-1.6	-3.3	-1.9
	1983-1989	-1.6	42.7	2.3	0.7	-0.7	1.6
	1990-1994	-2.8	46.7	2.4	-0.4	-3.4	-1.0
France	1978-1982	-1.5	31.5	0.9	-0.6	-1.9	-1.0
	1983-1989	-2.3	38.9	2.0	-0.3	-1.6	0.4
	1990-1994	-3.8	47.0	2.9	-1.0	-3.0	-0.2
Italy	1978-1982	-10.4	62.1	5.1	-5.3	-10.9	-5.8
	1983-1989	-11.2	86.8	7.6	-3.6	-11.4	-3.9
	1990-1994	-10.0	111.7	10.3	0.3	-10.2	0.1
United Kingdom	1978-1982	-3.2	55.0	3.0	-0.2	-2.5	0.5
	1983-1989	-1.7	48.9	3.0	1.3	-1.9	1.0
	1990-1994	-4.9	42.0	2.3	-2.7	-3.5	-1.3
Canada	1978-1982	-3.1	46.1	2.1	-1.0	-3.0	-0.9
	1983-1989	-5.0	65.3	4.0	-1.0	-5.3	-1.3
	1990-1994	-6.2	85.6	5.1	-1.1	-4.5	0.6
Total G-7	1978-1982	-2.8	43.2	1.7	-1.2	-2.7	-1.1
	1983-1989	-2.8	55.2	2.5	-0.4	-2.5	0.0
	1990-1994	-3.1	63.9	2.6	-0.5	-3.1	-0.4

Source: *OECD Economic Outlook,* No 56, December 1994, annex tables 29-33.

Note: A minus sign (-) indicates a deficit.

a As a percentage of potential GDP. For United States, Japan and Germany 1991 figures exclude expenditure and receipts relating to military operations in the Persian Gulf.

b Excluding deposit insurance outlays.

little debt is incurred to finance current expenditures in the general budget, and that of the United Kingdom, on the other hand, by privatization, which was used to reduce debt in the second half of the 1980s. However, in the latter country, both debt and interest payments have started to rise again in the 1990s.

Monetary policy has played a major role in widening the gap between budget positions gross and net of interest payments. By pushing up the interest rate and depressing growth, tight monetary policy has raised the nominal rate of interest on government debt above the rate of growth of nominal income (i.e. the real rate of interest above the real growth rate). In such a situation, the ratio of debt to GDP will rise unless there is an offsetting primary budget surplus. This disparity between real interest rates and real growth rates first appeared in the 1980s, when monetary policy was directed single-mindedly to combating inflationary tendencies, but it now seems to have become a permanent feature of the industrial economies.

The persistence of high real interest rates has thus meant that in most major industrial countries the driving force behind government budget imbalances is the interest on government debt rather than discretionary spending and tax policies. Thus, monetary policy has resulted in a major transformation in the nature of fiscal imbalances; they are structural rather than cyclical.

The fact that increases in budget deficits are due to such a great extent to interest payments has also resulted in weakening the impact of the deficits on aggregate spending and the level of economic activity. When both the stock of government debt and the interest rate it carries are high, the ratio of interest payments to money supply will also be high. Consequently, if bondholders kept interest payments in bank deposits in order to finance their current transactions, they would add considerably to the stock of money. If the monetary growth target is set lower than the rate of interest, achieving it will require part of the interest payments to be held in government bonds - i.e. rolled over and converted into new debt. This in turn, will entail an increase in the share of government debt in portfolios, and hence require the interest rate to be higher than otherwise.

The greater the gap between the target for money supply growth and the interest rate, the higher will be the proportion of interest payments to be converted into new debt, and the smaller the impact of the government deficit on aggregate spending. Thus, the tighter is monetary policy and the higher the proportion of interest payments in the deficit, the smaller will be the expansionary effect of the increased government deficit.

The logic of this situation suggests that the only way to regain the ability to use fiscal policy for overall economic management is to reduce the outstanding stock of debt. The combination of increased public debt with reduced public investment during the past two decades suggests that this debt does not correspond to an equivalent build-up of productive capacity; it would not be possible to service it without incurring additional debt in a Ponzi-type financing process. Nor is it possible to reduce it by creating primary surpluses; this would lead to a serious deterioration of public services and introduce a self-defeating deflationary force that would dampen government revenues and raise unemployment- and poverty-related spending.

Real interest rates cannot be allowed to exceed real growth in the long run, for that would imply an accumulation of debt that cannot be fully repaid in real terms. A reduction of the real value of debt will eventually be needed. In the past this has been achieved through inflation; recent and current efforts to eliminate inflation go precisely in the opposite direction. Accordingly, as discussed in detail in *TDR 1993*,[12] a once-and-for-all capital levy designed to bring the stock of government debt down to a sustainable level represents the most sensible solution. It is also one that is much more equitable - and hence politically more feasible - than meeting the claims of bondholders year after year by increasing and inventing new kinds of taxation on incomes or transactions, and/or cutting welfare spending and thus adding to social problems that are already serious not least because of mounting unemployment and inequality in earnings.

4. Monetary policy and interest rates

While the changing composition of budget deficits has virtually paralyzed fiscal policy as an instrument to achieve objectives such as full employment and growth, monetary policy has failed to be used to that end, having been confined solely to dealing with inflation. Even if Governments were able to overcome their fiscal paralysis, little would be achieved unless the goal of monetary policy were

widened to include growth and employment objectives. In particular, it needs to be aimed at reestablishing low and stable interest rates, which, as already emphasized, would raise investment and reduce government deficits. This in turn would require a significant change in the way monetary policy is conducted, with emphasis on targeting short-term interest rates and avoiding large swings in rates over the business cycle.

The changes needed in fiscal and monetary policy are thus complementary. If fiscal policy could be and were used for counter-cyclical purposes, the burden on monetary policy would be considerably lighter, allowing it to concentrate on the task of achieving low and stable interest rates. Using fiscal rather than monetary policy to smooth business cycles would avoid the disturbances that sharp swings in interest rates inflict on the balance sheets of both banks and business corporations. Fiscal tightening rather than interest rate hikes should be used to cool an overheating economy in order not to discourage private investment, and to slow down demand without changing its composition at the expense of investment. Should the need arise, it might be desirable to allow inflation rather than interest rates to vary over the course of the business cycle, provided that such variations remain within relatively narrow limits (say 2-5 per cent) and inflation shows no tendency to accelerate.

Even if central banks were willing to use monetary policy to keep interest rates low and stable, they may not be able to do so because they can only influence short-term intervention rates directly; the expectations of investors in the bond markets may move long-term interest rates independently of policy intentions. Thus, even if there are no real grounds for believing that a monetary policy more appropriate to increasing employment would generate an acceleration of inflation, bond markets may react perversely to such a policy. If long-term interest rates rise as a result of an increased inflation premium, there would be no gain to economic activity from monetary policy. The possibility of joint action by the central bank and the treasury to influence the bond market and engineer a durable decline in long-term interest rates is limited because of the sheer size of government debt. This problem has also been aggravated by the increasingly speculative character of trading in long-term government securities.

It should be noted that this rapid growth of the bond and securities markets and the extent of their globalization is closely linked to the increased government indebtedness (see box 7). Consequently, the constraints placed on monetary policy by those markets would also be greatly reduced if monetary policy were reoriented and the stock of government debt reduced in the ways suggested above. The consequent reduction of the size of the bond market and of government deficits, together with low interest rates, would slow the rate of growth of the securities markets relative to investment, GDP and the money market. This, in turn, would widen the scope for using monetary policy to influence asset prices, interest rates and economic activity.

On a number of occasions the bond market has failed to respond to monetary relaxation, and long-term interest rates have remained high. This steepening of the yield curve is usually explained as reflecting expectations of faster inflation. However, such a reaction can also reflect an expectation that short-term interest rates will be quickly raised again as soon as the economy begins to recover. This has indeed been the case on a number of occasions since the beginning of the 1980s. For instance, in 1983 the Fed tightened monetary policy only six months after the United States economy emerged from its longest and deepest postwar recession of 1980-82; it did so again in early 1994 as soon as recovery was under way following a hesitant upturn from a recession dominated by a debt deflation process.[13] This suggests that a return to a policy of stabilizing short-term interest rates can have a strong influence on the behaviour of the bond market and long-term interest rates.

As noted above, the way that monetary policy has been conducted since the beginning of the past decade has also added considerably to the instability of interest rates and asset prices which has, in turn, led to the widening of the yield gap by raising the risk and the liquidity premium. A revision of monetary policy in favour of low and stable interest rates would reverse this process.

5. *Full employment in one country*

A single country seeking to attain full employment is apt to be constrained by its balance of payments. Indeed, this was a major concern of the architects of the Bretton Woods system, who realized that with fixed exchange rates a country which

Box 7

MONETARY POLICY, GOVERNMENT DEBT AND GLOBALIZATION OF FINANCE

The rapid growth of the bond and securities markets and the extent of their globalization has been greatly influenced by the way monetary policy has been conducted. Central banks have stopped monetizing government debt, and have also increased borrowing needs by pushing up interest rates. In their attempt to control the growth of liquid assets, they have encouraged the direct sale of government debt to households. In many countries the decision to create funded private pension systems was taken against the background of their potential role as purchasers of government debt. Governments have also sought to facilitate the sale of debt to foreign buyers, reducing or eliminating withholding taxes and denominating debt in foreign currencies. When limits were reached on the sale of bonds, they have turned to the indirect financing of deficits through the privatization of public assets and the sale of equity in government-owned public companies. Privatization funds have sometimes been used to reduce outstanding government debt, and sometimes to avoid new debt issues. As national markets were frequently too small to absorb these new equity issues, Governments often looked to investment bankers to place the securities internationally.

Thus, much of the recent expansion in the global bond and equity markets stems from the attempts to control the growth of the money supply, the increasing sale of debt to private holders, and privatization. Global diversification, privatization and the development of funded pensions have all been crucial in allowing central banks to meet their money supply targets while Governments have continued to fund increasing deficits and growing interest payments by adding to the stock of outstanding debt.

Consequently, interest incomes, which had been virtually eliminated during the Golden Age through low interest rates, have increased rapidly. A new rentier class has thus emerged, holding government debt which central banks are no longer willing to finance.

ran persistent trade surpluses might prevent other countries from pursuing a policy of full employment. Floating exchange rates tend to facilitate balance-of-payments adjustment, but at the cost of increasing the trade-off between full employment and price stability.

When domestic demand in one country grows faster than in others, demand tends to spill over abroad; output and employment grow more slowly than domestic demand, and the balance of payments deteriorates. If a potentially inflationary currency depreciation is to be avoided, it is consequently necessary for interest rates to rise sufficiently to generate the additional capital inflows required to finance the additional imports. However, a higher rate of interest may be inimical to full employment. Clearly, the weaker the influence of the exchange rate over the trade balance, the larger the devaluation needed to correct an unfavourable change in the balance of any given size. Thus, while a depreciation can help to reconcile full employment with external payments equilibrium, it can result in strong pressures on the price level by raising import costs and making it easier for domestic producers of import substitutes to raise prices.

A country that pursues expansionary macroeconomic policies on its own thus tends to export jobs, as well as create them at home, and import inflation. Attempts to check the leakage of jobs through depreciations will tend to increase the import of inflation, whereas greater emphasis on exchange rate and price stability will tend to make it more difficult to generate home employment without resorting to protectionism.

The consequence is that, unless strong inflation is feared, there will be a tendency to resort to beggar-my-neighbour devaluations. However, if many countries opted for this approach, the outcome would be competitive devaluations with con-

sequences disastrous for international trade and payments - a danger that the Bretton Woods system was designed to avert. Despite mounting unemployment and social pressures, competitive currency devaluations have so far been avoided because concerns over inflation have been stronger than those over unemployment. However, now that inflation is negligible, the risks of deflation are becoming more evident for the first time since the collapse of the Bretton Woods system. One indicator is that many central banks are finding it difficult, despite recovery, to keep money supply growth from falling below the lower limits of their target ranges. The potential for competitive devaluations thus increases as unemployment rises. Indeed, the "benign neglect" of the recent depreciation of the dollar by the United States, and the proposals made in the United States Congress that Chile should be admitted to NAFTA only on the promise that it would not devalue the peso, may simply be the first signs of potential exchange rate conflicts.

The difficulties faced by a single country in attaining full employment point to the need for international policy coordination to make it possible for all to do so. Such coordination would need to include action to secure low and stable interest rates, as well as exchange rate stability. Past issues of the *TDR* have discussed in some detail the causes and effects of exchange rate volatility and the policy actions needed to attain greater stability.[14] The main points are as follows:

- Given the size and mobility of international capital, and the tendency of currency markets to amplify the effects of policy shocks and generate disturbances on their own, exchange rate stability requires more than macroeconomic policy coordination and concerted intervention in currency markets. The experience of the European Monetary System shows that even a multilateral commitment to exchange rate stability combined with convergence of macroeconomic policies and performance is not enough to cure currency turmoil.

- Since neither fixed nor flexible exchange rates achieve the desired results, one way out is for interested countries to establish a monetary union, as is the intention in the European Community. However, the convergence process laid down in the Maastricht Treaty needs to be reconsidered so as to remove some of the restrictions on policy and deal with the overhang of excess debt through a once-and-for-all capital levy.

- Serious consideration should be given to possible ways and means of reducing the scope of currency markets for generating disruptions and instability, for instance through a tax on foreign exchange transactions. Such a tax would need to be imposed by all the major industrial countries as well as offshore financial centres, and apply not only to spot and forward transactions and foreign exchange swaps, but also to other contracts involving the obligations or right to exchange foreign currencies at a future date, such as futures and options. However, interbank foreign exchange transactions could be exempted, and banks could be required instead to make non-interest-bearing deposits corresponding to increases in open positions in foreign exchange, or be imposed capital charges in a way analogous to those already proposed as part of the current initiative of the Basle Committee concerning standards for the supervision of banks' market risks for prudential reasons.

- More direct controls may also have to be introduced, since market-based and prudential measures may still leave considerable leeway for speculation. The consequences of excessive risk taking and speculation are not confined to those engaged in such activities; they have serious repercussions on other actors and institutions over a whole range of financial markets and countries. Direct restrictions may therefore be warranted on the acquisition and issuance of financial assets and liabilities.

Notes

1 For a fuller discussion of these policies see Commission of the European Communities, *Growth, Competitiveness, Employment - The Challenges and Ways Forward into the 21st Century: White Paper* (Brussels and Luxembourg, Office for Official Publications of the European Communities, 1993); The McKinsey Global Institute, *Employment Study,* 1994; C. Freeman and L. Soete, *Work for All or Mass Unemployment? Computerized Technical Change into the Twenty-First Century* (London: Pinter, 1994).

2 For recent assessments of the design and likely effectiveness of these policies see Lars Calmfors, "Active labour market policy and unemployment - a framework for the analysis of crucial design features", *OECD Economic Studies,* No. 22, Spring 1994; J. Drèze and E. Malinvaud, "Growth and employment: the scope of a European initiative", *European Economic Review*, 38, 1994.

3 In a recent paper Blanchard has reached a similar conclusion (see O. Blanchard, "Macroeconomic implications of shifts in relative demand for skills", *Federal Reserve Bank of New York Economic Policy Review*, January 1995).

4 In the United Kingdom the National Institute of Economic and Social Research has done extensive research on differences among national training systems. See, for example, Valerie Jarvis, "Smoothing the Transition to Skilled Employment: School-based Vocational Training in Britain and Continental Europe", *National Institute Economic Review*, No. 150, November 1994; *Productivity, Education and Training: Britain and Other Countries Compared,* London, 1989.

5 See S. Jay Levy and David A. Levy, "How to Restore Long-Term Prosperity in the United States and Overcome the Contained Depression of the 1990s", The Jerome Levy Economics Institute of Baird College, Annandale-on-Hudson, New York, January 1992.

6 *OECD Economic Surveys 1992-1993: Japan* (Paris: OECD, 1993), p.84.

7 Keynes wrote that one should "aim at having a surplus on the ordinary Budget, which would be transferred to the Capital Budget, thus gradually replacing deadweight debt by productive or semi-productive debt .... I should not aim at attempting to compensate cyclical fluctuations by means of the ordinary Budget, I should leave this to the Capital Budget" (*Collected Writings of J.M. Keynes*, Vol. XXVII, London: Macmillan, for the Royal Economic Society, 1980, pp. 224-25 and 277-78). For Keynes' various pronouncements on budgetary policy see also J.A. Kregel, "Budget Deficits, Stabilization Policy and Liquidity Preference: Keynes' Post-War Policy Proposals" in Fausto Vicarelli (ed.), *Keynes's Relevance Today* (London: Macmillan, 1985).

8 Levy and Levy, *op. cit.* p.11. Recognizing the difficulties in creating a federal capital budget in the near future, the authors go on to propose an ingenious programme of public investment that is both compatible with the existing accounting practices and consistent with the principle of separating accounts for investment and current expenditures. This programme could be implemented by means of the federal government (Treasury) purchase of zero-coupon bonds issued by state and local governments and public enterprises to finance their public investment projects. The Treasury would fund these purchases by the sale of traditional government securities in the capital market. The initial capital expenditure would thus appear as a zero net capital flow in the budget. Instead, the public investments would appear as the annual interest expense on the Treasury borrowing. At maturity the zero-coupon bonds would be repaid to the Treasury which would use the funds to retire its outstanding debt, the surplus would offset the annual interest expense. Such a system would imply a rearrangement of the public expenditure and net interest expense entries on the balance sheets of the Treasury, rather than a change in the actual amount of government spending. The projects would have to be based on explicit plans for generating revenues required to repay the debt held by the Treasury. This could be in the form of user fees or tax revenues assessed by regional governments on their constituents who directly benefit from the projects. Rather than being a balance-sheet trick using "smoke and mirrors" to try to decrease the reported deficit without changing actual spending, its basic purpose is to attempt to make federal spending more accountable and business-like.

9 *TDR 1993*, box 6, and OECD, *op.cit.*, sect.IV and annex I.

10 It is notable that while this differentiation between current and capital budgets, and their financing, is

based on the recognition of the differences in their nature and effects, OECD has argued in favour of lumping them together for purposes of evaluating budget policy. As a result, it concluded that if FILP is "taken into account, the public sector is larger, the fiscal balance less favourable, and net public debt much higher than they seem" and that "although the quality of public spending may appear to be relatively satisfactory, in so far as there is an emphasis on public investment and tight control over current expenditures, government outlays are subject to pressures which threaten to increase tax and public debt in the future". *(op. cit.,* p.105). It is difficult to understand why public debt associated with the creation of productive assets should cause concern, particularly when it is also recognized that Japan needs better infrastructure, or why such investment should lead to greater future tax burdens.

11 Precise quantitative estimates of these effects are extremely difficult to make, and OECD's cyclical fiscal deficit adjustment model shows that the estimated effect of the slowdown in potential growth on budget deficits is subject to considerable margins of error and uncertainty that vary considerably across countries. See J-C. Chouraqui, R.P. Hagemann and N. Sartor, "Indicators of Fiscal Policy: A Reassessment", *OECD Department of Economics and Statistics Working Paper,* No. 78, April 1990.

12 See Part Two, chap.I.

13 See *TDR 1992*, Part Two, chap.II and *TDR 1994*, Part Two, chap.II.

14 See in particular *TDR 1990*, Part Two, chap.I; *TDR 1993*, Part Two, chap.I; *TDR 1994*, Part Two, chap.II and annex.

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Annex I to Part Three

A SIMULATION MODEL OF NORTH-SOUTH TRADE AND UNEMPLOYMENT

This annex presents a modified Heckscher-Ohlin model of international trade in order to describe the links between trade and employment and to simulate the effects of certain responses, including policy responses, to increased competition from low-wage countries on the level and distribution of income, level and structure of employment, terms of trade, and the distribution of the benefits from trade between North and South.[a]

It should be pointed out that the model, like the Heckscher-Ohlin theory underlying it, has serious limitations. Being a neoclassical general-equilibrium model that assumes constant returns to scale, it leaves no room for either dynamic economies and other non-linear effects, or for demand and expectations; it reduces all problems of employment and output to technology and labour market rigidities; and neither capital stock nor international lending plays a role. The results of the simulations are, nevertheless, interesting as they reveal that North-South trade brings considerable benefits to the North even when it gives rise to labour market problems. More important, they suggest that some policy proposals that are often advocated as a remedy for unemployment in the North (such as greater labour market flexibility in those countries or higher labour standards in the South) would at best have a limited impact, and might well leave the North worse off than before.

A. The model

In this model there are two countries, North and South. In each country there are three sectors and two kinds of labour (skilled and unskilled). Sector 1 produces "skill-intensive" manufactures using a relatively high proportion of highly educated labour. Sector 2 produces "unskilled labour-intensive" (or simply "labour-intensive") manufactures using unskilled labour, i.e. labour possessing only a basic education. Sector 3 produces non-tradeables such as public services and the construction of dwellings. Labour is the only input to production and there is no capital (except the human capital of skilled workers). In each sector there is a constant elasticity of substitution between the two kinds of labour, and output is given by CES (constant elasticity of substitution) production functions; however, it is not assumed that the same technologies are employed in the two countries. All agents in a given sector have the same constant-returns-to scale CES utility function. Under this

assumption aggregate utility provides a measure of national income independent of income distribution.

The North is well endowed with skilled labour whilst the South has a plentiful supply of unskilled labour. Workers receive their marginal product, and wages for a particular type of worker are uniform throughout the economy. The supply of each type of labour is fixed in both countries. The wages of skilled labour are set so as to achieve full employment of this type of labour in both countries. In the South, the wages of unskilled labour are set so as to clear the market.

In the absence of trade, the wages of unskilled workers in the North are set to clear the market. In the open-economy case, imports and exports are in balance: the South exports labour-intensive products from sector 2 and the North skill-intensive products from sector 1; wages of unskilled workers in the North are either flexible enough to clear the market or are set equal to the relative wage in the absence of trade; taxes are levied in the North on those in employment either to support the unemployed or to compensate the unskilled for the decline in their relative wages arising from international trade. In either case, the government budget is balanced.

Using this model, a number of simulations were run. The first point to note is that certain effects are highly sensitive to the choice of parameter values. Thus, in every simulation considered, including those not presented here, the overall gains from trade are substantial but their distribution is highly sensitive to the choice of parameter values. The gains of the North are greater, the more trade depresses the price of labour-intensive goods, i.e. when the North's price elasticity of substitution in consumption is low and the South's price elasticity of export production high. When the contrary holds, the gains are reaped predominantly by the South. Despite this qualification, certain results from the simulations are fairly robust. Trade invariably reduces the pre-tax relative wage of unskilled workers (by between 12 per cent and 30 per cent, depending on the simulation), and in most cases it also reduces their real wages in absolute terms.

B. The base run

The point of departure is a base run in which there is no trade, and wages are set so as to clear the labour market in both countries. In the South, because unskilled labour is plentiful and its relative wage is extremely low, the relative price of the labour-intensive product is also very low, being only one-fifth the level observed in the North.

What happens when the two countries begin to trade? Two cases are considered, depending on the behaviour of wages of unskilled labour in the North. In the "rigid wage" case, the wages of skilled workers in the North are set so as to clear the market for this type of labour, but for unskilled workers wages are set so as to preserve their level relative to those of skilled workers. The result is unemployment among the unskilled in the North. In the "flexible wage" case, the wages of the unskilled in the North are also set so as to clear the market, and there is no unemployment.

Table A shows some of the main results on the North for the base run. Trade leads to a massive reduction in the relative price of the labour-intensive good in the North, with the result that its production ceases altogether. What happens to the unskilled workers that are displaced depends on how their wages adjust. If their relative wage is kept at the pre-trade level, the unemployment rate for this type of worker rises by 13.6 per cent, even after taking into account some increase in employment of unskilled workers in sector 1, where output expands in response to the growth of domestic and export demand stimulated by trade. If, on the other hand, their relative wage is allowed to fall, the preservation of full employment requires a 13 per

Table A

EFFECTS OF TRADE ON LABOUR MARKETS IN THE NORTH

(Percentage change over closed economy simulations)

	National income	*Total unempl.*	*Manufacturing employment*		*Pre-tax real wage*		*Tax rate*		*Post-tax real wage*	
			Total	*Unskilled*	*Skilled*	*Unskilled*	*Skilled*	*Unskilled*	*Skilled*	*Unskilled*
Base run										
Rigid wages	5.3	13.6	-18.4	-41.4	10.2	10.2	2.3	2.3	7.7	7.7
Flexible wages	8.1	0.0	-13.0	-30.9	18.3	-12.4	8.7	-23.2	8.0	8.0
Innovation										
Rigid wages	5.3	13.6	-18.4	-41.1	10.2	10.2	2.3	2.3	7.7	7.7
Flexible wages	9.5	0.0	-13.3	-30.3	19.5	-10.5	8.7	-21.1	9.4	9.4

cent reduction in the pre-tax real wage rate. This is not sufficient to stop the labour-intensive sector from closing down, but it does encourage greater employment of unskilled labour in non-tradeables and, to a lesser extent, in skill-intensive manufacturing.

In either case there is a substantial drop in manufacturing employment. If relative wages are rigid, total employment in manufacturing falls by around 18 per cent, while in the case of complete flexibility the fall is about 13 per cent.

C. Innovation

Competition from imports from the South may stimulate firms in the labour-intensive sector in the North to undertake defensive innovation and to raise productivity in order to stay in business. Even without innovation, such competition will drive out the least efficient producers first, leaving only the most efficient in business. The labour-intensive sector in the North will therefore register an improvement in efficiency even though no individual firm becomes more efficient.

However, this sector would be dramatically reduced in size, even with a very large productivity improvement (assumed in the simulation to be as high as 250 per cent). The survival of a small number of super-efficient producers in the North would further depress world prices, shifting the terms of trade against the South. Clearly, the South would be better off if the North abandoned labour-intensive production altogether and redeployed workers to other sectors.

D. Unemployment benefits or employment subsidies?

Table A also compares the effects of unemployment benefits with those of employment subsidies in the North in offsetting some of the distributional effects of trade. With rigid wages, the unemployed in the North receive social security benefits equal to 50 per cent of the post-tax wage of unskilled workers; the tax rate applied to finance these benefits is identical for skilled and unskilled workers. On the assumption of flexible relative wages there is no unemployment but skilled workers are taxed more than the unskilled so as to restore their relative wages to the pre-trade level. This is technically equivalent to the provision of a subsidy to employers of unskilled workers under conditions of rigid relative wages in order to eliminate unemployment.

Comparing these two cases, skilled workers are better off when taxes are spent on employment subsidies rather than unemployment benefits, but only marginally so. Their tax rate is higher, but, on the other hand, their pre-tax real wages are also substantially higher. The reason is that although employment subsidies for the unskilled reduce the relative demand for skilled labour, they increase the overall demand for labour by raising national income. Since the income effect of employment subsidies is greater than the substitution effect, the demand[b] for skilled workers rises, sharply increasing their pre-tax wage - much more so than the taxes on their incomes required to pay for employment subsidies instead of unemployment benefits.

It is interesting to note that employment subsidies for unskilled workers in the North actually help the South. That is because, being general subsidies for the unskilled, they are not industry-specific (i.e. they are not designed specifically to protect labour-intensive production), but seek to encourage greater employment and production in all sectors, including those not competing with southern exports. Besides, by raising national income in the North, they increase global demand for labour-intensive goods, thus improving the terms of trade of the South and raising its national income.

In short, employment subsidies for unskilled labour benefit both North and South. This extremely important result for the North is not sensitive to the choice of parameter values: much the same result was obtained in every simulation considered, including the large number not reported here.

E. Labour standards in the South

Within the framework of the model, labour standards can be introduced only in a very crude manner, since there is no explicit provision for such items as child labour, minimum wage rates or hours of work. To explore the effect of labour standards, consider what happens if the relative wage cost of unskilled workers in the South is increased by 50 per cent. Given that wage differentials between the South and the North are still very large compared to productivity differences, this does not suffice to make northern labour-intensive industries competitive. Nevertheless, both output and employment in the South fall because the higher wage costs and export prices depress both exports of, and overall domestic demand for, labour-intensive goods.

However, if the elasticity of substitution in consumption is low, as in the base run, there is a massive improvement in the terms of trade for the South (see table B), because of the large rise in its export prices, which more than offsets the loss of output; consequently, both the purchasing power of exports and national income in the South in-

Table B

EFFECTS OF SETTING MINIMUM LABOUR STANDARDS IN THE SOUTH

(Percentage change over closed economy simulations)

	No fiscal transfer		With fiscal transfer[c]
	Low[a] elasticity of substitution	High[b] elasticity of substitution	
World income	-0.8	-1.2	0.0
North			
National income	-5 1	-0.5	0 0
Unskilled manufacturing employment	0 0	0 0	0.0
Unskilled real wage	-7.1	-0.1	0.0
South			
National income	2.9	-2.5	0.0
Terms of trade	116.8	8.7	0.0
Unskilled employment	-20.7	-18.5	0.0
Unskilled pre-tax real wage	49 9	42.6	0.0
Unskilled post-tax real wage	49 9	42 6	39 6
Skilled tax rate *(percentage)*	0.0	0.0	7.4
Unskilled subsidy rate *(percentage)*	0.0	0.0	39 6

a An elasticity of substitution in consumption in the North of 0.5.

b An elasticity of substitution in consumption in the North of 0.95.

c Assumes an amount of transfer sufficient to ensure a 50 per cent increase in the relative wages of unskilled workers

crease, despite the decline in export volume. On the other hand, there is an even larger fall in national income in the North. The net result is a decline in global income. Moreover, the real wage of unskilled workers in the North declines as a result of the price rise of labour-intensive goods.

But, if the elasticity of substitution in consumption in the North is high (as assumed in the second column of table B), the imposition of higher labour standards leads to only a very small increase in export prices, and the South experiences only a very small improvement in its terms of trade, which is far outweighed by the loss of output and employment. Global income falls even more, since there is a decline in national income in the South as well as in the North.

If, in the real world, labour standards are raised only in some developing countries, their terms of trade gains will be much less, and they will suffer large declines in output, income and employment even if the overall elasticity of demand is low.

One way of preventing declines in southern employment and output is to accompany higher labour standards with fiscal measures designed to offset the higher cost of labour. This might be done by taxing skilled workers and using the revenue to subsidize the wages of unskilled workers. The simulations reported here show what happens in the base run when there is a 50 per cent rise in the relative wages of the unskilled workers. To achieve this shift in relative income through fiscal transfers requires a 7.4 per cent tax rate on the wages of skilled workers and a 39.6 per cent subsidy to employers of unskilled workers. This is a globally efficient solution because all prices are at the perfectly competitive level (no change in the terms of trade and pre-tax relative wages) and there is full employment. In this scenario, the unskilled are not made better off at the cost of unemployment.

Notes

a This annex draws on B. Rowthorn "A Simulation Model of North-South Trade", *UNCTAD Discussion Paper*, forthcoming.

b By assumption, the number of skilled workers in employment is always equal to the fixed supply of such workers. Thus, an increase in demand for skilled workers will always be matched by a wage increase just sufficient to maintain a constant level of employment.

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Annex II to Part Three

THE DYNAMICS OF SERVICE SECTOR EMPLOYMENT

The expansion of service sector employment is often attributed to changes in the pattern of consumption in favour of services. It has been suggested that consumer preferences are shifting towards services because consumers have become satiated with durables.[a] If consumers are in fact spending more of their incomes on services, then the reasons for the large difference in the rate of job expansion in services between the United States and western European countries must lie on the supply side - i.e. in the relative flexibility of labour or service markets. Services are in general more labour-intensive than manufacturing, and presumably employment in services is more sensitive to wage costs; hence the need for greater labour market flexibility. The regulation of services in European countries is also said to stifle the expansion of service output and employment. Hence, it is argued: restrictive regulations in such areas as retail trade and the audio-visual media should be removed; social regulations such as zoning and the setting of environmental standards in the construction industries should be relaxed or eliminated; and more transparent regulations in financial services should be introduced.[b]

However, the view that in developed countries consumers in general are satiated with industrial goods is open to question, given that income growth has slowed down in those countries in the last two decades, whereas there is continuing invention and innovation in manufactured consumer goods. It is more likely that income redistribution has been a more decisive factor in changing the pattern of demand in favour of services. If higher-income households allocate a larger proportion of their expenditure to services than low-income groups, a redistribution of income in their favour will result in an increase of services in total consumer expenditure. Evidence from the United States and the United Kingdom tends to support this conclusion. According to a survey of consumer expenditure in 1993 in the United States, the share of services in total expenditure increases as one moves from the first income quintile (the poorest) to the higher-income quintiles (see table A). Since income distribution in the United States has become much more unequal in the last two decades (from 1970 to 1990 the Gini index rose by 12 per cent)[c], part of the rise in the share of services in expenditure may well be due to income redistribution.

Similar results (also shown in the table) have been found for the United Kingdom in 1985, where a survey also distinguished five income groups. Although the types of expenditure distinguished in the survey do not allow a clear separation of services (some services being included in items where functionally related goods and services are combined), expenditure on "services" as defined claimed a higher share of total consumer expenditure in the two highest income quintiles. Furthermore, simulations for the United Kingdom economy for the period 1986-2000, using a macroeconomic model (of the Cambridge Growth Project) with output disaggregated by industry, show that a more equal income distribution eventually generates a lower output for services, confirming that increasing demand for services is closely linked to income redistribution. It thus appears that while the saturation argument may be plausible, it is so only for the higher income groups.

The above evidence gives a broad picture of the relationship between income distribution and the demand for services in developed countries. However, not all services are linked to consumer demand in the same way, or have increased em-

Table A

EXPENDITURE ON SERVICES ACCORDING TO INCOME QUINTILE IN THE UNITED STATES AND THE UNITED KINGDOM

(Percentage of total consumer expenditure)

UNITED STATES

	Income quintile				
Type of expenditure	*I*	*II*	*III*	*IV*	*V*
Mortgage interest and charges	2.3	2.5	4.1	7.0	8.3
Vehicle finance charges	0.3	0.6	0.9	1.0	0.8
Vehicle insurance	1.7	2.3	2.4	2.3	2.1
Vehicle rental, leases, licences, other charges	0.8	0.7	0.9	0.9	1.3
Health insurance	3.5	4.0	3.1	2.3	1.7
Life and other personal insurance	0.9	0.8	1.1	1.1	1.6
Pensions and social security	1.4	3.6	7.0	10.1	13.2
Subtotal	10.9	14.5	19.5	24.7	29.0
Food away from home	4.7	4.8	5.5	5.9	5.7
Housing maintenance, repairs, insurance, other expenses	2.0	2.2	2.0	1.9	2.0
Telephone services	3.3	2.7	2.5	2.0	1.5
Water and other public services	1.0	0.9	0.8	0.7	0.6
Personal services	0.5	0.6	0.6	0.8	0.8
Vehicle maintenance and repairs	1.9	2.1	2.2	2.2	1.9
Public transportation	0.8	0.9	0.9	0.9	1.2
Medical services	2.0	2.1	2.0	1.9	1.5
Entertainment fees and admissions	0.8	0.9	1.0	1.3	1.7
Total	27.9	31.7	37.0	42.3	45.9

UNITED KINGDOM

	Income quintile				
	I	*II*	*III*	*IV*	*V*
Services (total)	10.5	10.6	10.5	11.0	14.4

Source: *United States:* Calculated from results of the US Consumer Expenditure Survey, provided by the Department of Labour Statistics. (Data relate to expenditure in 1993.)
United Kingdom: Vani Borooah, "Income distribution, consumption patterns and economic outcomes in the United Kingdom", *Contributions to Political Economy*, Vol. 7, March 1988. (Data relate to expenditure in 1985.)

Table B

NON-GOVERNMENT SERVICE EMPLOYMENT TRENDS IN OECD COUNTRIES, 1979-1990

(Average annual percentage change)

Country	Wholesale and retail trade	Transport and communications	Finance and business services	Community, social and personal services	Total
United States	1.9	1.2	4.3	3.1	2.7
Japan	1.2	0.9	2.9	3.6[b]	2.3
European Union	1.3	0.4	4.1	3.4	2.1
United Kingdom[a]	1.3	-0.1	5.2	5.5	2.8
Germany	0.9	0.4	1.7	3.4[c]	1.8
France	0.8	0.8	3.5	2.3	1.7

Source: *The OECD Jobs Study. Evidence and Explanations* (Paris, OECD, 1994), table 1.1.

a Including trainees on work-related government programmes.

b Including hotels and restaurants.

c Including business and real estate

ployment at the same rate. The greatest increase in employment has been in finance and business services, including insurance and real estate (see table B). The boom in these services in the 1980s is partly a statistical illusion created by their "externalization" in some cases. Many manufacturing enterprises have dismissed staff that carried out service functions such as data processing, security, and cleaning, preferring to procure such services from specialized providers. This shift is reflected in the statistics as a rise in output and employment in services and a decline in manufacturing output and employment, although in fact there has been no change in relative shares in the economy.

The increase in business and financial services is also a result of the surge in financial and real estate activity (which followed deregulation in the 1980s), in conjunction with income redistribution. The subtotals for financial services by income quintile for the United States in table A reveal that nearly all of the difference in service expenditure shares between the lowest and the highest income quintiles is due to the different share of financial services. Income redistribution and financial deregulation together bred the so-called "Yuppies" in finance, who specialized in real estate dealings, managing the portfolios of high-income groups and arranging corporate acquisitions and mergers. Their activities contributed to the asset price inflation of the 1980s. The subsequent deflation of asset prices, as well as the onset of the recession, took its toll on employment in these sectors: in the United States, France and Canada employment in financial institutions, which rose in the 1980s, started to decline around 1990. Similarly, the United Kingdom experienced a downturn in 1990 in total employment in finance, insurance, real estate and business services.

Employment in community, social and personal services has had the second highest rate of expansion among the service sector groupings in the 1980s. Increased demand for some of these services was partly due to greater female participation in the labour force, this itself being partly related to the fall in family incomes and to greater dependence on paid services for the care of children, the aged and the sick. Thus, for some of these services the increase in demand is clearly associated with the increase in social inequality and deteriorating living conditions. Some of the occupa-

tions in which the United States Department of Labour has estimated that employment will continue to expand over the next decade give an idea of the social changes behind the growing demand for services: homehealth workers, travel agents, childcare workers, guards, restaurant cooks, gardeners/groundkeepers, lawyers, janitors and cleaners.[d]

Apart from the effect of a possibly faster increase in demand for services than for manufactures (due to income redistribution, higher female participation, etc.), employment would tend to grow faster in services even if the demand for manufactured goods and for services were to increase at the same rate. The reason is that in most services the technologically determined productivity growth is inherently slower than in manufacturing, so that with an equal rate of growth of output, services would increase employment faster than manufacturing.

However, not all of the observed productivity differences between services and manufacturing are due to differences in production techniques imposed by technology. As a result of the deficiency of aggregate demand in a number of countries, workers displaced from industry have been absorbed by service sectors without there being a proportionate increase in the demand for service output. As discussed in annex III, the low levels of, and slow growth in, productivity in the service sectors are associated with disguised unemployment.■

Notes

a Eileen Appelbaum and Ronald Schettkat, "The End of Full Employment? On Economic Development in Industrialized Countries", *Intereconomics*, May/June 1994, p.125.

b For an elaboration of this argument, see *Employment Performance* (Washington D.C., McKinsey Global Institute, November 1994).

c Wallace C. Peterson, *Silent Depression : The Fate of the American Dream* (New York: Norton and Company, 1994), p.78.

d *The Economist* (London), 11 February 1995, p.22.

Annex III to Part Three

DISGUISED UNEMPLOYMENT IN THE NORTH[a]

The concept of disguised unemployment was first developed by Joan Robinson in the 1930s to describe a situation of expanding employment in low-productivity, low-wage occupations caused by deficient aggregate demand for the goods of sectors with normal productivity and wage levels. She wrote:

> In a society in which there is no regular system of unemployment benefit, and in which poor relief is either non-existent or "less eligible" than almost any alternative short of suicide, a man who is thrown out of work must scratch up a living somehow or other by means of his own efforts. And under any system in which complete idleness is not a statutory condition for drawing the dole, a man who cannot find a regular job will naturally employ his time as usefully as he may. Thus, except under peculiar conditions, a decline in effective demand which reduces the amount of employment offered in the general run of industries will not lead to "unemployment" in the sense of complete idleness, but will rather drive workers into a number of occupations - selling matches in the Strand, cutting brushwood in the jungles, digging potatoes on allotments - which are still open to them. A decline in one sort of employment leads to an increase in another sort, and at first sight it may appear that, in such a case, a decline in effective demand does not cause unemployment at all. But the matter must be more closely examined. In all those occupations which the dismissed workers take up, their productivity is less than in the occupations that they have left. For if it were not so they would have engaged in them already. The wage received by a man who remains in employment in a particular industry measures the marginal physical productivity of a similar man who has been dismissed from it, and if the latter could find an occupation yielding him a better return, he would not have waited for dismissal to take it up. Thus a decline in demand for the product of the general run of industries leads to a diversion of labour from occupations in which productivity is higher to others where it is lower. The cause of this diversion, a decline in effective demand, is exactly the same as the cause of unemployment in the ordinary sense, and it is natural to describe the adoption of inferior occupations by dismissed workers as *disguised unemployment*.[b]

Robinson's analysis implies a dual economy where the two sectors are driven by different economic forces. In the high-productivity, high-wage sector (A) the level of employment is determined by aggregate demand. In the low-productivity, low-wage sector (B) employment is determined by the supply of labour to that sector. Sector B may comprise formal or informal activities, and possibly self-employment. If aggregate demand declines and some workers in sector A are laid off, and if there are no unemployment benefits or the benefits are very low, these workers are forced to take up jobs in sector B.[c] The crowding of workers into sector B jobs diminishes labour productivity there and pulls down wages. If the increased competition in sector B markets causes a decline in prices in those markets, this adds to the fall in measured productivity.

Given the way labour productivity is measured, it can differ across sectors for a variety of reasons without implying disguised unemployment. The skills of the labour employed, the production techniques used, and competitive conditions in input and output markets that determine pricing behaviour all have some influence on value-added per

worker. The physical productivity of a worker is closely linked to the capital equipment used: changing the equipment can change productivity. Productivity is also influenced by prices: an increase in the price of the good or service produced relative to prices of the intermediate goods or the raw materials used increases measured productivity. Thus, contrary to what is often implicitly assumed, the skills of a worker are only one of the many determinants of his productivity, and hence productivity differences do not directly reflect skill differences.

Although labour productivity differs among sectors owing to differences in production processes, it does not follow that wage rates for identical labour must also differ. On the contrary, competition would be expected to equalize wage rates, as well as profit rates, among sectors. If one sector has lower labour productivity than another, it can still pay the same wage and earn the same rate of profit, as long as lower productivity is matched by lower capital per worker. However, if excessive labour is drawn into a sector, average product per worker decreases; consequently, in order for that sector to earn the same profits, it has to lower wages. This is why disguised unemployed typically earn low wages.

To the extent that unemployment benefits influence the reservation wages of workers who become unemployed in sector A (the wages they aspire to when assessing job offers), reducing or abolishing these benefits may increase the supply of labour to sector B. The expansion of disguised unemployment can also be promoted by removing regulations on wage setting (e.g. minimum wage laws) or by deregulating economic activities (e.g. permitting more taxis to circulate, allowing shops to remain open longer hours, reducing zoning regulations for construction, removing regulations on broadcasting and television). These measures reduce measured unemployment. If sector B acts as a perfect sponge for dismissed workers, then measured employment will become independent of aggregate demand. This is the "full employment" that will be attained with a highly flexible labour market.

There can be several approaches to quantifying disguised unemployment. One is to identify the normal level of labour productivity for each sector. This can be done by taking as the norm the sectoral productivities in countries where the sectors are known to be "efficient"; but such an approach can be misleading because the same sector in different countries can be at different levels of development; furthermore, a different composition of output within the sector in different countries can influence average productivity figures when these are calculated from aggregate sectoral employment and output statistics. Another method is to determine a year in which a sector in a country had no disguised unemployment, and then to estimate the increase in disguised unemployment there by comparing its productivity growth rate with the "normal" rate for that sector. But again, determining the norm is problematical: the highest sectoral productivity growth rates are often observed in countries where the relevant sector is underdeveloped.

With full recognition of these difficulties, an estimation of disguised unemployment in the five major industrialized countries is attempted in this annex. The focus is on services as a possible sector for absorbing labour laid off in manufacturing, and on agriculture as a sector that may be retaining excess labour, in spite of large productivity differences with manufacturing, because of the slow output expansion of the latter.[d] Table A shows the ratios of labour productivity (i.e. productivity of all persons engaged) in agriculture and in services to labour productivity in manufacturing in the five major industrialized countries in 1979 and 1987 (the "productivity ratios").

In order to allow for the particular circumstances of each country that may influence these ratios, the average for the five countries of the productivity ratios in a sector is taken as the benchmark for that sector. Thus if a sector's productivity ratio in a country is lower than the average for the five countries, the difference is attributed to disguised unemployment in that sector. The proportion of disguised unemployment in sectoral employment is thus equal to the difference between the sector's productivity ratio and the benchmark ratio. The absolute figures of disguised unemployment in table A are estimated on this basis. The sectors for which the estimates have been made are by no means exhaustive, and the methodology used errs on the side of caution, so that the extent of disguised unemployment is probably understated.[e]

If the estimated disguised unemployment is added to open unemployment, "true" unemployment turns out to be markedly higher than measured unemployment for the United States and Ja-

Table A

PRODUCTIVITY DIFFERENTIALS AND DISGUISED UNEMPLOYMENT IN AGRICULTURE AND SERVICES IN SELECTED OECD COUNTRIES, 1979 AND 1987

		Productivity in relation to manufacturing[a]		*Disguised unemployment (Thousands)*[b]	
Country	*Sector*	*1979*	*1987*	*1979*	*1987*
United States	Agriculture	77.2	76.2	-	-
	Services[c]	77.4	61.0	2048	6305
Japan	Agriculture	25.9	23.9	2201	3224
	Services[c]	74.3	63.3	1951	3117
Germany	Agriculture	32.0	42.6	303	185
	Services[c]	88.2	94.3	-	-
France	Agriculture	49.4	64.0	79	-
	Services[c]	90.2	89.2	-	-
United Kingdom	Agriculture	83.1	88.1	-	-
	Services[c]	84.0	66.4	-	736

Source: UNCTAD secretariat calculations based on OECD, *National Accounts, 1979-1991,* Vol. II - *Detailed Tables* (Paris: OECD, 1992); *Annual Abstract of Statistics 1988* (London: HMSO, 1988) and *ibid.* 1995 (London: HMSO, 1995).

a Expressed as a percentage of labour productivity in manufacturing. Sectoral productivities are calculated from GDP figures at constant prices (1980 for the United States and France, 1985 for Japan and Germany, and 1979 for the United Kingdom, derived for the last country from index numbers of output at constant factor cost).

b A dash signifies that the sector's productivity ratio is above average; hence the sector has no disguised unemployment.

c Excluding financial, real estate, insurance and business services.

pan in 1979 (see table B). In the following eight years measured unemployment showed little increase, but disguised unemployment rose substantially in services in the United States, and in agriculture and services in Japan (see table A). In Germany and France measured unemployment rose markedly, while agricultural disguised unemployment declined in both countries. Indeed, there was no longer any disguised unemployment in French agriculture in 1987 because productivity growth in the sector was much higher than in manufacturing compared to the four other countries; moreover, labour productivity in agriculture grew faster than in the other countries (by 51 per cent over the period, compared to 40 per cent in Germany and 29 per cent in Japan). In the United Kingdom, where labour market deregulation began early in the 1980s and has gone further than in the other countries, both measured and disguised unemployment increased substantially. Not only have service sector productivity growth rates in the United States and the United Kingdom been slower than in manufacturing compared to the other countries, but also their productivity growth within the sector has been much lower (5 per cent and 8 per cent, respectively, compared to 18 per cent in Japan, 13 per cent in Germany and 15 per cent in France).

The "true" unemployment rates vary less among the five countries than the measured rates, and even show a tendency to converge.[f] Thus, much of the variation among them in measured unemployment rates can be ascribed to variations in disguised unemployment, and the low measured un-

Table B

MEASURED AND "TRUE" UNEMPLOYMENT RATES IN SELECTED OECD COUNTRIES, IN 1979 AND 1987

Country	1979		1987	
	Measured rate[a]	*"True" rate*[b]	*Measured rate*[a]	*"True" rate*[b]
United States	5.8	7.8	6.2	11.5
Japan	2.1	9.5	2.8	13.3
Germany	3.2	4.4	7.7	8.4
France	6.0	6.4	10.7	10.7
United Kingdom	4.7	4.7	10.5	13.2

Source: As for table A, and OECD, *Labour Force Statistics 1972-1992* (Paris: OECD, 1994).

a Percentage of unemployed in the civilian labour force (in the total labour force for Japan).

b Percentage of measured plus disguised unemployed in the civilian labour force (in the total labour force for Japan).

employment rates in the United States and Japan can be attributed to high levels of disguised unemployment.

However, where income or price support is provided in sectors harbouring disguised unemployment the relationship between disguised unemployment and aggregate demand is not the same as when wage incomes in the sector are allowed to fall. For example in Japan farmers, whose productivity relative to manufacturing is very low, receive substantial subsidies and are protected from agricultural imports.[g] This not only boosts farm incomes, but also makes employment in agriculture less dependent on fluctuations in aggregate demand. In the United States, by contrast, the disguised unemployed make do with low wages; their occupations and income levels are determined by macroeconomic policy and the state of aggregate demand. It follows from the above that in Japan an increase in aggregate demand and a rise in job offers in urban sectors would not induce labour to move from agriculture in the same way as an increase in aggregate demand would induce United States workers to quit low-paying service sector jobs to move into industry. Nevertheless, in one sense disguised employment in Japanese agriculture is also linked to the level of aggregate demand, because in the absence of subsidies and protection the sector would have released much more labour than has actually been the case, and increased employment in the urban sectors would have required a greater growth of aggregate demand. At the actual pace of aggregate demand expansion there would have been a higher rate of (open) unemployment.■

Notes

a This annex draws on ideas developed in a forthcoming UNCTAD *Discussion Paper* by John Eatwell, entitled "Disguised Unemployment: The G-7 Experience". The methodology employed in this annex, however, differs from that used by the author.

b Joan Robinson, *Essays in the Theory of Unemployment* (London: Macmillan, 1937), pp.83-84.

c An alternative course of action for such workers is to drop out of the labour force altogether and earn their living by criminal activities, which seems to be a course increasingly adopted in the United States. (See Richard Freeman, "The Limits of Wage Flexibility to Curing Unemployment", *Oxford Review of Economic Policy,* Vol. 11, No.1, 1995).

d Agriculture includes hunting, forestry and fishing. Services comprise wholesale and retail trade; hotels and resturants; transport, storage and communication; and personal, social and community services. Finance, insurance, real estate and business services are excluded from services in order to avoid the distorting effects that the surge in financial and real estate speculation in the latter 1980s might have had on the productivity figures for these activities.

e One important sector not included is construction. In the United States, for example, employment in that sector rose by 20 per cent from 1979 to 1987, while labour productivity declined by 15 per cent.

f While the coefficient of variation of measured unemployment rates of the five countries rose from 0.35 in 1979 to 0.39 in 1987, the same coefficient for the "true" unemployment rates fell from 0.29 to 0.16.

g The UNCTAD secretariat has estimated that the producer subsidy equivalent for rice in Japan averaged over 90 per cent of the value of the crop in 1987-1993.

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